

## **EFFECTIVE ASSET PROTECTION THROUGH MULTIPLE CORPORATE STRUCTURES**

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### **A. INTRODUCTION**

- The topics to be addressed in this presentation include:
  - Purpose of multiple charitable corporations;
  - Different types of multiple charitable corporations;
  - Indirect control of multiple charitable corporations;
  - Avoiding cross over liability; and
  - Canada Revenue Agency (CRA) draft policy on umbrella organizations.
- However, this presentation does not address the numerous income tax issues that may arise in utilizing multiple charitable corporations.
- For more information on this topic, please see the following publications available at [www.charitylaw.ca](http://www.charitylaw.ca):
  - “Pro-Active Protection of Charitable Assets” – A Selective Discussion of Liability Risks and Pro-Active Responses, November 20, 2001;
  - “National and International Charitable Structures: Achieving Protection and Control”, November 26, 1998;
  - “Cross-over Liability: Principles from the Residential Schools Cases (*Charity Law Bulletin* #19 - January 31, 2003);
  - Update on Christian Brothers (*Charity Law Bulletin* #24 – September 30, 2003); and
  - New CRA Policy on Umbrella Organizations (*Charity Law Bulletin* #78, October 12, 2005).

## B. PURPOSE OF MULTIPLE CHARITABLE CORPORATIONS

- Multiple corporations have been utilized in the business sector for years to contain liabilities and to protect assets. While similar use of multiple corporations by charities has been slow to develop, the advantages of multiple corporations are just as significant for charities as they are for the business sector.
- The use of multiple charitable corporations will protect charitable assets, as well as assist in reducing the potential personal liability exposure of directors. This is because they will either be managing fewer assets, will have less potential liability exposure, or both.

## C. DIFFERENT TYPES OF MULTIPLE CHARITABLE CORPORATIONS

### 1. Overview

- While there are many different types of multiple charitable corporations, the three main types are parallel operating charities, parallel foundations and umbrella associations.

### 2. Parallel Operating Charities

- A parallel operating charity can be used when an incorporated charity has a number of operating divisions, some of which involve a greater degree of liability exposure than others. For example, if a church corporation operates a school or a children's camp, as well as operating a traditional church facility, then the risks associated with those operating divisions might severely prejudice the future viability of the church and the assets that it owns, including land and buildings.
- A parallel operating charity, such as a summer camp or a school, could be established to take over these various high risk operations and to operate them through one or more separate corporations for purposes of containing the liability associated with their operations and protecting the assets of the main operating charity.

### 3. Parallel Foundations

- A parallel foundation can be utilized for a broad range of reasons including:
  - the establishment and management of endowment funds;
  - the protection of surplus funds from governments;
  - the separation of capital fundraising campaigns from operating fundraising campaigns;
  - the encouragement of *inter vivos* and testamentary gifts; and
  - the encouragement of planned giving programs.
- Given the *Christian Brothers* case, however, the utilization of parallel foundations has now become very important for purposes of protecting future donor restricted gifts, as well as endowment funds, where the capital is to be held in perpetuity and is not to be subject to any operating liabilities of the charity.

- A parallel foundation can also be used as a form of holding corporation for the assets of a charity, such as holding land and buildings and/or holding existing endowment funds.
- However, the option of utilizing a parallel foundation as a holding corporation for existing assets is dependent upon the charity complying with creditor protection legislation. As a result, the option of transferring existing assets to a parallel foundation is normally limited to protecting only those existing assets that are not subject to claims either past or present.
- Where a parallel foundation is established for the purpose of holding land and buildings for a church, consideration should be given to the *Assessment Act* (Ontario). This is to ensure that the church parallel foundation would meet the definition of a “religious organization” in order to maintain the municipal tax exemption of the church property.
- As well, it may also be necessary to develop a license or lease agreement between the church parallel foundation and the church, as well as possibly the seeking of a pre-ruling from the Municipal Property Assessment Corporation (“MPAC”) on the ability to maintain the tax exemption on the church property.

#### 4. Umbrella Associations

- The utilization of an umbrella association involves structuring a national or provincial charity that consists of member organizations into multiple legal entities instead of operating under the auspices of a single corporation.
- This involves having a separately incorporated governing body, normally established as a federal corporation, to act as the governing body. Each member organization, eg. local churches and/or separate ministries, would then be separately incorporated under the auspices of the national organization.
- The alternative way of structuring a national and/or provincial charity is by operating it through a single corporation that includes all of the various divisions and chapters as part of the single legal entity.
- While a single legal entity provides simplicity in administration and operations, its disadvantage is that all the assets of a charity are left in one single legal entity. This may result in the loss of all of the assets of the national or provincial charity in the event of a claim being made against any one of the divisions or chapters of the charity.
- The advantages of utilizing an umbrella association are as follows:
  - Reduced overall liability exposure in operating a national or provincial charity by containing the liability associated with a member organization within a separate corporate entity.
  - Where one member organization owns real estate that is subject to toxic contamination, the costs associated with the clean up of the contamination will generally be limited to only the assets of the incorporated member organization.
  - If a member organization was to lose its charitable status with Canada Revenue Agency (“CRA”), only the charitable status of that member organization would be at risk.

- For national charities which carry on operations in Ontario, the creation of a separate charitable corporation in Ontario to oversee Ontario activities would mean that the jurisdiction of the Public Guardian and Trustee in Ontario ("PGT") would generally be limited to only the assets of the Ontario charity.
  - Similarly, the operations of the umbrella association that are carried on outside the province of Ontario through separate corporations in other provinces would not be subject to the provisions of the *Charities Accounting Act* (Ontario).
- Some issues to consider in utilizing an umbrella association include the following:
    - The governing body could lose control of its separately incorporated member organizations if appropriate steps are not implemented to ensure that the member organizations are subject to necessary contractual and/or licensing control mechanisms.
    - Generally a member organization will need to utilize the name and/or trade-marks of the umbrella association, which trade-mark rights are usually owned by its governing body. This requires proper protection of the name and/or trade-marks of the national or provincial charity and the proper documentation through appropriate trade-mark license agreements.
    - With member organizations that have names that are similar to that of the umbrella associations, confusion can occur with gifts given to the wrong charity which could result in the estate having to apply for a *cy-près* court application to determine which charitable organization is legally entitled to the testamentary gift.
    - Effective utilization of an umbrella association requires the creation of multiple charitable corporations, as well as the implementation of appropriate indirect control provisions.

## D. INDIRECT CONTROL OF MULTIPLE CHARITABLE CORPORATIONS

### 1. The Need for Indirect Control

- When businesses utilize multiple corporations, the parent corporation can maintain control over subsidiary corporations through the ownership of the majority of the voting shares of a subsidiary corporation. Charities, however, are non-share corporations that do not afford themselves control through the ownership of shares.
- When dealing with the relationship between a governing body and a member organization, the separate nature and autonomy of each charity must be recognized and respected. Accordingly, it is extremely important that the relationship between a governing body and a member organization be addressed early in the structuring process and that it be carefully considered, as it is very difficult for the governing charity to "rewrite the rules" later and regain control.
- There are two different types of indirect control models that can be put in place to establish different degrees of indirectly controlled relationships between a governing body and a member organization:
  - Ex officio control model; and/or

- Franchise control model.

## 2. Ex Officio Control Model

- The most common method of indirectly controlling member organizations by a governing body is the Ex Officio Control Model. This model requires that the by-laws of the member organization provide for ex officio directors who are either directors of the governing body or alternatively hold officer positions in the national organization.
- This is for the specific purpose of allowing those individuals to become qualified to sit as national representatives on the board of the member organization. Both the *Canada Corporations Act* and the *Corporations Act* (Ontario) permit the establishment of ex officio directors in the form of corporate by-laws that are permitted.
- However, this model should not be relied upon to any great extent, i.e. there should be no more than one ex-officio member on the board because of concerns about cross-over liability. In addition, it does not fully reflect the expectations between a governing body and its member organizations or related intellectual property licensing considerations.

## 3. Franchise Control Model

- A practical parallel can be drawn between the relationship of a franchisor and its franchisees and the relationship between multiple charitable corporations.
- By way of example, in applying the Franchise Control Model to an umbrella association, the governing body of an umbrella association, as the franchisor, must establish an alternative means of control over its member organizations, as the franchisees. This is done through the contractual relationship of a franchise agreement, which can be adapted to establish an effective control mechanism between a governing body and its member organization in a charitable context.
- By utilizing the Franchise Control Model, a governing body can establish an effective contractual relationship with its member organizations involving key factors, such as the requirements for membership in the umbrella association and the consequences of losing that membership.
- The Franchise Control Model can also be used to authorize the licensing of trade-marks and copyrights owned by the governing body.

## 4. Basic Features of the Franchise Control Model

### a) Overview

The Franchise Control Model works well with all types of multiple charitable corporations. One example of this is with an umbrella association, such as a religious denomination or other type of national charity, since the model provides an effective tool to ensure compliance by member churches with denominational standards and expectations.

The basic components of the Franchise Control Model involve developing an association agreement, including appropriate control provisions within the incorporating documents of member organizations, and implementing a licensing arrangement to protect the applicable intellectual property.

b) Association Agreement

The association agreement sets out the contractual relationship between the governing body and its member organizations.

Some of the more important considerations that should be included in an association agreement are as follows:

- The preamble should state that the governing body and the member organizations have similar charitable purposes, that they are recognized at law as being separate and distinct corporate entities with separate boards of directors, and that they are to remain independently responsible for their own management and governance.
- The term of the agreement should be indicated. It is suggested that a period of five years is appropriate with an automatic renewal thereafter for an additional five year term, unless written notice is given by one party to the other.
- The basic requirements of the association relationship should be clearly articulated. These could include, but are not limited to, the following considerations:
  - a requirement that the contents of the letters patent of the member organization include the specific wording of, or at least the general parameters, for the charitable purposes of the member organization, a requirement that the member organization include a denominational statement of faith, the wording for the dissolution clause, etc;
  - a requirement that the governing body be able to review and approve the general operating by-law for the member organization, as well as the right to approve other fundamental changes; and
  - an explanation of the parameters under which the name and trade-marks of the governing body can be utilized by the member organization, with particulars to be set out in a separate trade-mark licence agreement.
- The association agreement should also set out the rights that flow from the association relationship, should clearly state what actions by the member organization would terminate the association relationship and then delineate the consequences that flow from the termination of the association agreement.

c) Incorporating Documentation for Member Organizations

- The incorporating documents for a member organization should be drafted or amended in accordance with the requirements set out in the association agreement.
- The governing body should be given an opportunity to review the final form of the application for letters patent and general operating by-law for the member organization before it is filed for incorporation.

d) Trade-mark Considerations

- The most important asset of a charity is the goodwill associated with its name as a trade-mark. In the context of a governing body, its name as a trade-mark and associated logo constitute the basis by which the public will identify the organization and the activities that it carries on.
- The trade-marks of the governing body can include its corporate name and various operating names and logos. All of these should be protected by applying for trade-mark registration.
- The registered trade-marks should be owned by the governing body and then licensed to each member organization pursuant to a separate trade-mark license agreement.
- A trade-mark license agreement should include, among other things, the following:
  - recognition of the ownership of the trade-marks by the governing body;
  - an explanation of how the trade-marks can be used by a member organization and sufficient means by which the governing body can exercise control over the use of the trade-marks;
  - how the trade-marks are to be protected and enforced; and
  - a description of what constitutes default under the trade-mark licence agreement and what are the consequences resulting from the termination of the trade-mark licence.

e) Copyright Considerations

- Copyright issues can also be an important part of establishing control by an umbrella association. Once the issue of ownership of the copyrighted materials has been established, it may be prudent to register the copyright, particularly if the materials are going to appear in a public source, such as on an internet web page.
- Examples of copyright materials belonging to the governing body that are used by member organizations include, but are not limited to, resource materials, audiotapes, videotapes, training manuals, checklists, brochures, fundraising documentation, etc.

- It is important that the governing body set out in a copyright licence agreement an acknowledgment of its ownership rights in the copyrighted materials, the parameters under which the member organization can use those copyrighted material, the basis by which the copyright licence will be terminated and the consequences of such a termination.

## 5. Avoiding Cross-over Liability

- A fundamental aspect of utilizing multiple charitable corporations is the need to maintain the integrity of the limited liability protection of the various incorporated entities.
- While the concept of limited liability protection is still the general rule for corporate entities, there are instances where the governing body or an operating charity might be found to be liable for the actions of a member organization or affiliated corporation as a result of the equitable doctrine known as "piercing the corporate veil".
- Instances where courts in the U.S. have been prepared to "pierce the corporate veil" have occurred where a subsidiary corporation has been found to be a mere instrument or alter-ego of the parent corporation and where there have been significant elements of common identity established between the parent and the subsidiary corporation resulting in the courts.
- In Canada, recent case law involving residential schools has suggested that a multiple corporate structure could still leave affiliated corporate entities exposed to liability where a member or employee of either an affiliated member entity or a governing entity is found liable for damages in a lawsuit. As well, the *Christian Brothers* decision was also a landmark case on the application of cross-over liability to charitable organizations and not-for-profit organizations.
- Based on a review of recent residential school caselaw, it appears that there may be cross-over liability for an umbrella organization which has a significant degree of control over the actions of the members or employees of associated incorporated entities.
- In the case of a single national legal entity, such as the national religious denomination, liability arising in any part of the entity will affect the assets of all of the other parts of the national entity.
- The following are practical steps that can be taken to reduce a finding of cross-over liability between multiple charitable corporations:
  - ensure separate incorporation of each entity;
  - expressly define the limits of power and authority of the entities so that each separate entity is clearly self-contained in its operations; and
  - have each incorporated entity keep up-to-date records of activities in its own corporate minute book, to show its independence from other affiliated entities.
- Some of the factors suggesting "central control" that should be avoided, where possible, are outlined below as follows:



- having the governing body involved in the licensing, hiring, disciplining, payment or general day-to-day direction and supervision of employees of the member organization;
- having common bank accounts or investments shared between the governing body and a member organization;
- making explicit or implicit representation that the governing body is responsible for the operations of the member organization;
- having both organizations occupy the same location for either operational or administrative activities;
- using the same officers or employees unless there is documentary evidence establishing that one organization is invoicing the other organization for the services provided by the employees of the other organization;
- having either the governing body or a member organization use the land, buildings or property of the other organization without an arms length lease agreement;
- having the same individuals serve on the board of directors or key committees of both the governing body and member organization, such as where there is a significant overlap in the membership of the finance committees of the two organizations;
- directly or indirectly indicating on letterhead, signs, brochures, or other documentation that the member organization is an operating division of the governing body; and
- having the governing body and a member organization use the same lawyers or accountants on a regular basis.

## E. CRA DRAFT POLICY ON UMBRELLA ORGANIZATIONS

### 1. Overview

- CRA released a new draft policy on umbrella organizations in July 2005, entitled Guidelines for the Registration of Umbrella Organizations, which is available at its website, [www.cra-arc.gc.ca](http://www.cra-arc.gc.ca).
- The Guidelines define a charitable umbrella organization as one that “works to achieve a charitable goal by supporting, improving, and enhancing the work of groups involved in the delivery of charitable programs.”
- The Guidelines make it clear that an umbrella organization can qualify for registration, since it is the position of CRA that “umbrella organizations that, through their activities, improve and enhance the charitable activities of other, generally community minded organizations, are also advancing a charitable purpose.”

## 2. Types of Umbrella Organizations

### a) Charities Established to Assist Other Registered Charities

- These are organizations that support the charitable sector by promoting the efficiency and effectiveness of registered charities.
- The beneficiaries of the services of an umbrella organization must be predominantly other registered charities, although some incidental support of organizations that are not registered charities is permitted, i.e. must not exceed ten percent (10%) numerically and in terms of devoted resources.
- The objects of these charities must clearly reflect that the purpose of the organization is to improve the efficiency and effectiveness of other registered charities. As well, the activities must be logical means of accomplishing its charitable purposes and reasonably result in the improvement of the efficiency and/or effectiveness of the other registered charities.

### b) Umbrella Organizations Advancing a Recognized Charitable Purpose

- These are organizations which are established to further a particular charitable purpose, i.e. other than assisting charities, which may convey benefits on constituent groups as ancillary to the achievement of that purpose.
- Where these types of umbrella organizations are specifically designed to increase, enhance or improve services to charitable beneficiaries, then it is also acceptable for such umbrella organizations to increase the capacity and ability of member organizations as a secondary result of their work.
- The purposes of this type of umbrella organization must always be stated in relation to the charitable category that the organization is established to advance. As well, acceptable activities include those that achieve or advance a charitable purpose.

### c) Charities Established to Hold Title to Property

- The recognition by CRA that organizations established to hold title can be charitable organizations, as opposed to charitable foundations, is an important development. Now, it is possible for charities, as charitable organizations, to incur debts in taking title to property, thereby increasing the availability of asset protection arrangements.
- The beneficiaries of this third type of umbrella organization must only be registered charities. Its formal purpose must be to provide a charitable service of benefit to the tenant charity and not merely to hold title to property, as this alone is not charitable at law.

- The activities of these title holding organizations can vary from merely title-holding entities to ones that provide a more comprehensive range of services eg. property management services.
- Further, the land holding charity must show that it provides some benefit to the tenant charity, although it is not clear why since the provision of land, typically with a building on it, should be recognized as an inherent benefit to the tenant charity.
- The Guidelines then address the requirements of these title holding entities with regard to reporting expenses. CRA takes the position that a mere permission to occupy the premises does not constitute an expenditure, nor does it constitute a gift to the tenant charity.
- However, if the provision of services to other charities is considered to be charitable for the first type of umbrella organization, i.e. charities established to assist other registered charities, there is no reason why the fair market value of the provision of the premises to the tenant charity should not also constitute a charitable expenditure for a title-holding charity.



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