

Co-ops, the Law, and the Pursuit of (Non)Profit in Saskatchewan

Saskatchewan Co-operative Association

and

Le Conseil de la Coopération de la Saskatchewan

Robert Dobrohoczki

Table of Contents

Abstract:.....	2
Executive Summary	4
Co-ops, the Law, and the Pursuit of (Non)Profit in Saskatchewan	7
1. Introduction.....	7
2. The Co-operative Advantage	13
3. For Profit Versus Non-Profit Versus Charitable Status.....	15
3.1 “For Profit” Co-ops.....	15
3.2 Non-Profit Co-operatives and the Law	18
3.3 Charitable Status Co-operatives.....	34
4. Policy Considerations: Non-profit Capitalization in Community Economic Development	38
5. Conclusion	41
Appendix A: Securities Exemptions.....	42
References.....	44

Abstract:

Often one of the most important decisions a beginning co-operative will need to make is the choice of organizational form. A consultation with a lawyer or other professional advisor may lead to individuals choosing between the options of an investor owned firm, a co-operative, or a non-profit corporation. For community organizations, the choice is often between a co-operative and a non-profit corporation. Yet there is a great deal of confusion about the status of co-operatives and their ability to operate on a non-profit basis or their capacity to apply for charitable status given that co-operatives operate for the benefit of their members. This paper examines co-operative law in Saskatchewan to articulate exactly the relationship and capacity of co-operatives to operate on a non-profit and/or a charitable basis in Canada in an attempt to clarify the law in Canada for legal professionals and co-operators alike.

This paper also examines the choice of organization form in the context of practical considerations a beginning co-operative must make concerning decisions of capitalization. Co-operatives can either use member loans as the traditional form of capitalization, make use of the increasingly available option of selling preferred shares with the transaction costs and restrictions under securities regulations, or have the capacity to fundraise and issue charitable tax receipts through charitable status if a non-profit and/or charitable option of co-operative is chosen. The cost and benefit of each of these options must be made clear to the founders of the co-operative at the outset at the time of incorporation to ultimately meet the needs of the membership.

Souvent un des décisions les plus importantes qu'une coopérative de commencement devra faire est le choix de la forme d'organisation. Une consultation avec un avocat ou tout autre conseiller professionnel peut mener aux individus choisissant entre les options d'une société appartenant aux investisseurs, une coopérative, ou une société sans but lucratif. Pour des organismes de la communauté, le choix est souvent entre une coopérative et une société sans but lucratif. Pourtant il y a beaucoup de confusion au sujet du statut de coopératives et leur capacité d'opérer une base sans but lucratif ou de leur capacité de s'appliquer pour le statut charitable étant donné que les coopératives fonctionnent au profit de leurs membres. Ce document examine la loi coopérative au Saskatchewan pour articuler exactement le rapport et la capacité de coopératives d'opérer une base sans but lucratif et/ou charitable au Canada afin d'essayer de clarifier la loi au Canada pour les professionnels juridiques et les coopérateurs de même.

Le papier examine également le choix de la forme d'organisation dans le cadre des considérations pratiques qu'une coopérative de commencement doit faire au sujet des décisions de la capitalisation. Les coopératives peuvent employer des prêts de membre comme forme traditionnelle de capitalisation, se servir de l'option de plus en plus disponible de vendre les actions privilégiées avec les coûts et les restrictions

de transaction aux termes des règlements de valeurs, ou avoir la capacité de collecter des fonds et de sortir les recettes fiscales charitables par le statut charitable si une option sans but lucratif et/ou charitable de coopérative est choisie. Le coût et l'avantage de chacune de ces options doivent être faits clairement aux fondateurs de la coopérative au départ à l'heure de l'incorporation pour répondre finalement aux besoins de l'adhésion.

Executive Summary

1. Introduction

This paper was prepared for the Saskatchewan Co-operative Association and Le Conseil de la coopération de la Saskatchewan for a number of reasons. First, to clarify the relationship between co-operative law and non-profit and charitable status in Saskatchewan; second, to build on what few publications exist in the literature in this area; third to assist professionals and co-op developers alike in choosing organizational form when establishing new co-operative ventures.

2. The Co-operative Advantage

Co-operatives hold a number of advantages compared to investor owned firms. Co-operators need to clearly distinguish the reasons why a co-operative wants to incorporate as a co-operative rather than an investor owned firm or other business form. Co-ops are primarily not motivated by profit, but by member need. Once the co-operative is chosen as an organizational form, co-operators must then choose whether to incorporate as a for-profit, non-profit, or charitable status co-operative. Knowing the advantages and disadvantages of each at the outset is key for co-operators in getting the co-op started.

3. For Profit vs Non-profit vs Charitable Status Co-ops

Each organizational form has its advantages and disadvantages:

For Profit Co-ops - the traditional co-op structure provides the greatest flexibility in capitalization. The co-op can borrow money in terms of debt, issue debentures, can borrow money from members through member loans, can capitalize by the issuance of equity shares to members with a limited return on investment, and can issue preferred shares to non-members. Members have a financial incentive to join the co-op from the payment of interest and dividends. However, the co-op will need to pay income tax on unallocated surplus, and as a “for profit” entity not qualify for many government programs and grants that would be available to a non-profit. The co-op will not be able to fundraise and issue tax-deductible receipts, or solicit donations from foundations, as it would be ineligible for charitable status. The co-op will need to pay close attention to securities regulations, and weigh the administrative, legal, and accounting costs in its share structure to raise capital.

Non-Profit Co-ops – The main benefit of non-profit co-ops is that they are exempt from paying income tax. The co-op can engage in a wide range of activities including commercial-like activities but only so long it is pursuing a non-commercial purpose and any surplus goes toward that purpose. There is no special legal structure or legislation, the co-op still incorporates under the *Co-operatives Act*. They do not fall under the *Non-Profit Corporations Act*, which is usually how non-profits associations incorporate, as co-operatives must incorporate under the *Co-operatives Act*. However, the co-op will have to indicate in its articles of incorporation that the co-op is carrying on business without the

purpose of gain for its members, and that any profit or surplus that the co-op earns will be used for the purposes of promoting its stated object. The co-op will also need to state it cannot issue shares that will pay dividends or interest on share capital. This may make it difficult to attract members, and to raise capital. While a non-profit can solicit for donations, it cannot issue tax-deductible receipts and a non-profit co-op can also not receive charitable funds unless itself is a qualified donee (a registered charity). A non-profit co-op can, however, still issue shares if they pay no dividends or no interest on share capital, a formula that may assist in capitalization for community minded projects with socially minded investors interested in protecting their principal investment but foregoing any return on investment.

Charitable Status Co-ops – The major advantage of a charitable entity is its tax status. As well as not paying income tax like a non-profit, a co-op with charitable status has the ability to issue tax-deductible receipts to fundraise and solicit for charitable donations as a means of capitalization. The Co-op has the ability to leverage the credibility charitable status has for support in the community. Legally, it would need to have in its articles provisions similar to section 246 of the *Saskatchewan Co-operatives Act* that deal with Community Services Co-ops to satisfy Canada Revenue Agency: A co-operative charity is generally prohibited from issuing shares given the prohibition on the paying out of dividends and interest on share capital and that all assets must be given to other charities on dissolution. The key disadvantage of charitable status is that the co-op is severely restricted in any commercial activities; a related business must be subordinate to the charitable purpose and a necessary offshoot to the core programs. The co-op must also go through much more rigorous scrutiny with CRA and the scope of activities is limited to four narrow charitable criteria (relief of poverty, education, religion, and other purposes “beneficial to the community.”) and the co-op is restricted in its political/lobbying activities.

4. Policy Considerations: Non-profit capitalization for Community Economic Development

Co-operators need to realize the full potential of the non-profit and charitable co-op model as a democratic and community controlled alternative for organization. The non-profit model can be utilized for capitalization as the issuance of shares is not technically prohibited, merely the member benefit. From a policy perspective, Canadian legislation has not evolved new hybrid economic structures that blend the social purposes of non-profits and the tax advantages they have with the capacity for capitalization and social investment. In the UK, a new legislative framework exists to enable the creation of a company for social enterprise known as the “Community Interest Company” or CIC. In the United States in a number of states legislation exists for a new type of enterprise called the “Low-Profit Limited Liability Company.” These forms combine the advantages of capitalization with the advantages of tax rate policies aimed toward social investment that go with non-profits.

6. Conclusion

The advantages and disadvantages of each of “for-profit,” “non-profit,” and charitable status co-operatives need to be weighed by legal professionals, co-operators, and co-op developers alike when forming a co-operative, often for reasons pertaining to capitalization. Canadian co-operators must be aware of the full capacities of existing legislation, and should be exploring ways in which the legislation can be used to promote social enterprise and co-operative development.

Co-ops, the Law, and the Pursuit of (Non)Profit in Saskatchewan¹

1. Introduction

This paper will examine co-operative law in Saskatchewan to describe the capacities of co-ops to operate on a non-profit and/or a charitable basis in Canada in an attempt to clarify the law in Saskatchewan for legal professionals and co-operators alike, and to build on what few publications do exist on co-ops and charity law. Based on this discussion I shall offer some policy suggestions in terms of key issues lawyers need to watch out for in assisting clients, and for policy makers in considering how to assist co-operative ventures.

Often one of the most important decisions a beginning co-op will need to make is the choice of organizational form. A consultation with a lawyer or other professional advisor inevitably leads to individuals seeking to form an enterprise in choosing amongst the options of an investor owned firm, a co-op, or a non-profit corporation. For community organizations, the choice is often between a co-operative and a non-profit corporation. Knowing the advantages and disadvantages of each in advance can assist an organization in making important decisions in getting the co-operative off the ground, especially around decisions concerning the advantages and disadvantages of capitalization of different co-operative structures.

There is a great deal of confusion among co-operators about the relationship of co-op legislation with non-profit and charity law. A belief among some is that co-ops cannot achieve charitable

¹ The author would like to acknowledge funding and assistance for this project from the *Saskatchewan Co-operative Association* and *Le Conseil de la Coopération de la Saskatchewan*

status or be non-profits because co-ops are by definition “for the benefit of their members”. They confer a benefit to their members and therefore do not qualify as non-profit entities. Non-profits must, by definition, not be for the benefit of individual members. Another mistaken belief is that only certain types of co-ops can qualify. For instance, in Saskatchewan, there are explicit legislative provisions around “community service” co-operatives. These provisions, for those who only look to legislation, appear to indicate that only those co-ops qualify for charitable or non-profit status. In reality, of course, none of the above is entirely true. The problem is that very little accurate information exists to assist non-lawyers in clarifying the relationship of co-op and non-profit law.

What is the source of this confusion? The first and most important factor is the nature of co-operative legislation itself. All provinces have separate pieces of legislation for business corporations and non-profit corporations. There are two separate legislative and regulatory regimes for each, so choosing to incorporate means choosing to incorporate under one piece of legislation or the other. Saskatchewan is no exception, “for-profit” companies are registered under *The Business Corporations Act, 1978*² and non-profits under the *Non-Profit Corporations Act, 1995*.³ The two different legislative regimes make it easy for lawyers and non-lawyers alike to discern the difference between for profit and non-profit *corporations*. But there is only one piece of co-operative legislation in Saskatchewan and it is the *Co-operatives Act, 1996*⁴. What is

² R.S.S. 1978. c. B.-10.

³ R.S.S. 1995. c. N-4.2.

⁴ R.S.S. 1996. c. C-37-3

needed is the ability to distinguish the legal nuances between “non-profit” and “for profit” co-ops (or rather “for-surplus”).

This confusion is not aided by the fact that there is very little published information on the explicit relationship between charity law, non-profit law, and co-operative law. The last Canadian co-op law textbook was published in 1981 and is hardly on the shelf of most lawyers,⁵ especially in an era of increasingly electronic legal research. Richard Bridge has an excellent publication out of British Columbia on co-operatives and charity law⁶ that draws extensively on the work of Kate Blomfield in a publication from the B.C. Institute for Co-operative Studies⁷ and the Ontario Co-operative Association has some fact sheets aimed at less technical readers.⁸ Most organizations seeking to form a non-profit co-operative option would not have much money to spend on a lawyer to do an extensive examination into new areas of law, which means the lawyer will either recommend what he likely knows best (either a corporate structure or non-profit corporation law) or the traditional co-operative structure, without finessing any new structures in which they may have little training or background. Law is a conservative profession by nature, and it makes use of precedent both in theory (judicial decisions) and in practice (how law operates), as using precedent files allows lawyers to keep their costs down, having learned from past cases. The more lawyers familiar with co-operatives, the more co-operatives will likely be considered as an optimal organizational form.

⁵ Ish, Daniel, *The Law of Canadian Co-operatives* (Carswell; Toronto, 1981).

⁶ Bridge, R. (2003) *Co-operatives and Charity Law*. Canadian Co-operative Association, BC Region,

⁷ Blomfield, K. (2002). *Co-operative Associations in British Columbia and Registered Charitable Status*. Victoria: British Columbia Institute for Co-operative Studies.

⁸ Ontario Co-operative Association (2010). OnCoop Educational Resources: Co-op Development ToolKit. Available at: <http://www.ontario.coop/toolkit/>

Co-operators will often say, co-ops do not make profit, they make surplus. Surplus is treated differently under the *Income Tax Act*.⁹ There are numerous distinctions in the *Income Tax Act* but in essence, dividends paid out to members in a co-op are exempt from taxation, and are instead taxed in the hands of the co-op member. This is unlike a corporation, where all profits are taxed, and corporate shareholders receive a “gross-up” on the dividends (they are multiplied by 1.25 or 1.45 over a certain amount for certain larger or public corporations that pay significantly higher tax rates). This “gross-up” amount compensates shareholders of corporations for the fact the corporation has already paid tax (avoiding double taxation), so the higher multiplier compensates for the higher tax rate the larger corporation paid. However, in co-operatives, the unallocated portion of surplus not distributed as dividends to members that is retained by the co-op is treated in essence the same way as profit is in a business corporation. So we can talk about “for-profit co-ops” as those co-ops engaged in a commercial enterprise for their members that pay out dividends or interest on shares to members. Because the co-operative does not pay tax on these dividends, there is no complex formulae of “gross-ups” or multipliers of the dividends in adjusting the tax on income, and the taxpayer treats it as just as straight income.¹⁰ Co-operatives

⁹ *Income Tax Act*. R.S.C. 1985, c. 1

¹⁰ In fact, Canada Revenue Agency *does not discriminate on corporate form* but on how the allocation is paid out. See section 135 of the *Income Tax Act*, *Supra* Note 8. A corporation that paid out dividends, or a portion of its dividends, *according to patronage* is taxed exactly the same as a co-operative on those dividends (the corporation would be exempt from paying tax on those dividends allocated according to patronage). Of course it is *usually* co-operatives that pay dividends according to patronage given the co-operative structure. The *Income Tax Act* aims to, in essence, treat co-operators operating through a co-operative and shareholders operating through a corporation roughly the same way, paying roughly the same tax, with minor differences between provinces (as the “gross-up” or multiplier of corporate dividends in the hands of the taxpayer is aimed to compensate for the fact corporate dividends were already taxed at the corporate level, and as it is set by the federal government to compensate for federal *and* provincial tax levels combined, it is only an estimate, and so differs by a percentage point or two depending on the provincial rates).

and corporations pay about the same tax regardless of organizational form. It is just the case that corporations pay tax on all of the profits, and dividends paid to shareholders are grossed up to compensate for this (to avoid the double taxation), whereas a co-operative is viewed as a flow through entity for the dividends paid to members (on the logic that the co-op is merely returning the surplus earned on patronage to the member). The member's dividend is taxed as income without a gross up, but the co-op is only taxed on the unallocated portion. For our purposes, we shall refer to a "for-profit" co-op as one that is able to pay dividends on surplus.

Some co-operative legislation across the country simplifies the issue of non-profit and for profit status by allowing for incorporation with share capital or without share capital (or rather co-operatives where there is just one class of member shares and other classes of equity or preferred shares). The Ontario¹¹ and Canada Co-operatives Act¹² for instance, allow this distinction, as does the Saskatchewan legislation under section 7(2)(c).¹³

This innovation was, in part, to allow the distinction between non-profit and for-profit co-operatives, or as it was conceived, those that would normally pay out interest and dividends on share equity and those that would not see a need to do so being member rather than economically driven. However, sometimes innovation muddies the waters. While often true, the distinction

11 *Co-operative Corporations Act*, R.S.O. 1990, c-35. See section 5.1

12 *Canada Co-operatives Act*, S.C. 1998, c-1. See section 9 that reads "A cooperative may be incorporated with or without membership shares and with or without the power to issue investment shares." Of note also is section 20(3): "If the business of a cooperative is restricted by its articles or by a resolution of its members to a specific business purpose, the cooperative must have as part of its name one or more words that suggest the nature of the restriction."

¹³ *Supra* Note 4.

between share capital and non-share capital co-operatives is technically not the difference in law between profit and non-profit co-operatives, and given that lawyers are often dealing with complicated cases, it is disingenuous for legal texts and articles to suggest otherwise. Being incorporated as a co-operative without share capital is not sufficient to be a non-profit (there is a non-commercial purpose test for instance), nor is being a co-operative with a share capital prohibitive (co-operatives or even corporations with share capital can become non-profits with the right restrictions on the shares). Similarly, one can still form a non-profit or charitable status co-operative in British Columbia, which makes no distinction between share capital and non-share capital co-operatives in its legislation. Likewise, past legal cases indicate that having share equity is not the prohibition for either non-profit or charitable purpose; rather it is shareholder *benefit* that is the prohibition.

Ultimately however, one should keep in mind that non-profit and charitable status is determined not by any provincial registrar of co-operatives, but by Canada Revenue Agency (CRA) and ultimately, the Courts. Another source of confusion is that non-lawyers searching for information may seek guidance from Canada Revenue Agency interpretation bulletins or memorandums available through the CRA website. Reliance in the sector on information bulletins by CRA may be problematic as they are often technical in nature and misleading to non-lawyers. They are also only an *opinion* as to the state of the law (CRA's interpretation). They may not be representative of the actual state of the most up to date law, as CRA currently would currently enforce it (so one should watch for updates) or as the courts would interpret it. Policies change, as do interpretations. Ultimately CRA may provide a more conservative interpretation than a knowledgeable lawyer with the luxury of knowing recent court decisions, and in some cases, the

willingness to take a much more aggressive position weighing the risks of a CRA challenge and communicating the risks and rewards with his or her client.

2. The Co-operative Advantage

Co-operatives have a number of advantages over the conventional corporate structure. The co-operative movement has long held that the commitment to the principles and values of co-operation is a significant advantage in focusing the co-operative on member need rather than profit. Because Co-ops are driven by member needs, they have a higher accountability to their members than corporations do to their shareholders who only focus on profit margins. In addition, co-ops are more stable as community-based organizations. Earnings generated by co-ops flow to the local communities in which members are situated unlike corporations where they may flow to wherever the shareholders may live, often far away. Co-ops provide a means of local economic development, and local economic sustainability, as a member based organizations is less likely to be taken over by non-local or foreign ownership.

Co-ops, being member rather than shareholder driven, also have the advantage of being less likely to be effected by fluctuations in capital and equity markets. Co-ops are not the subject of speculative investment and the focus even in a for-profit co-op is on the long-term health and sustainability of the co-op in delivering member services.

The greatest disadvantage of the co-operative business structure is the difficulty co-ops have in raising capital. For capital-intensive businesses, the corporate structure which allows for the buying and selling of shares on the open market and an unlimited return on investment and speculative purchase makes it easier to attract investors. Co-ops traditionally rely on their

members for capital injection, although modern co-op legislation allows for investment shares, and legislation across the country has increasingly brought in preferred share possibilities for outside investors, raising capital from outside investors through non-voting preferred shares remains generally more difficult for co-ops than corporations.

The first question any lawyer, co-op developer, or professional should ask potential co-operators is “why a co-op?” Sometimes the model fits; but sometimes the investor owned model is the better choice if the motive is a return on investment. Each model has its advantages. Co-operative ventures are inherently grassroots organizations organized primarily not for profit but for the needs of members located in communities. This is after all, why co-operators would choose the co-operative form in the first place rather than a corporate form, to meet the needs of members. For this reason, co-operatives inevitably are one form of organization looked at by community groups and organizations that may be interested in some form of enterprise. Even a “for profit” co-operative, which actually aims at generating surplus, as an enterprise motivated toward the economic benefit of its members, shares a concern for community, albeit an economic one in the needs of its members. This is because, unlike a shareholder company, its members are not necessarily motivated by profit but member need. Often this means they are located in a community in where the users are situated. Sometimes the community is defined by the users such as the need for basic mountain equipment apparel and clothing (Mountain Equipment Co-op)¹⁴, and its members are motivated by member need, even if consumer or economic need.

¹⁴ See *Mountain Equipment Co-op*, (2010) located at <http://www.mec.ca/Main/home.jsp>

Once the co-operative model is chosen, the kind of co-operative form must be decided. Co-operative organizations that have a concern for community are often in a choice between what form of organization they must choose, a for profit, non-profit, or charitable organization. Often this is driven by purpose. If the need were primarily economic, to make surplus through marketing, retail, or providing employment through a worker co-operative, then clearly a “for profit” model would fit. But if the purpose is more community orientated, the choice becomes more difficult. There are criteria that must be met for non-profit and charitable status. Ultimately the choice may revolve around the major impediment for most co-operatives, capitalization. Knowing the costs, advantages, and disadvantages associated with each model may help facilitate that decision.

3. For Profit Versus Non-Profit Versus Charitable Status

3.1 “For Profit” Co-ops

Co-ops that generate surplus for their members benefit, or what we can call “for profit” co-ops (in that the surplus is treated and taxed like profit under the *Income Tax Act*), are often the default kinds of co-ops under the Co-operatives Act. In terms of capitalization, this type of co-op has greater flexibility than other types. The patronage dividend structure returns surplus to the owners according to usage, member economic need, and the need for capitalization, are likely the key drivers in opting for a “for-profit” co-operative over a business corporation or a non-profit organization. When starting a new co-op, capitalization is usually one of the major obstacles faced. The question of which corporate form that will best enable to get the co-op off the ground is often the most difficult decision. This question often revolves around capital.

Depending on the type of co-operative, there may be very high start-up costs and high entry costs into the market. Whether it is commercial or non-profit enterprise, both need a solid financial footing in order to succeed. Generally co-ops can capitalize by debt, member loans, and issuing equity or even preferred shares.

For-profit Co-operatives: Advantages and Disadvantages

For-Profit co-ops provide the greatest flexibility in capitalization. The co-op can borrow money, issue debentures (debt), or borrow money from members in terms of member loans. They can capitalize by the issuance of equity shares to members with a limited return on investment, and issue preferred shares to non-members. Capital can be attracted by the promise of a limited rate of return on shares, and of a patronage dividend. Important to note is that securities provisions bind co-operative organizations unless the issuance of said securities are exempted. If not exempted, in order to issue a security, or shares or debt instruments to the wider public, a prospectus may need to be prepared by a lawyer and one may need to sell shares through a securities dealer, all of which have significant transaction costs. In Saskatchewan, these exemption provisions are found in the *Co-operatives Act*. A number of exemptions are found in section 221 of the Act and in section 14 of the regulations (see appendix A) that should be explored with due diligence. Furthermore, under section 47 of the *Co-operatives Act*,¹⁵ co-ops may waive in their bylaws a requirement on the issuance of share certificates for common shares in certain circumstances:

¹⁵ *Saskatchewan Co-operatives Act*, Supra Note 4

47 (7) The bylaws may provide that a co-operative is not required to issue share certificates with respect to common shares, and, in that case:

(a) the register of members and shareholders kept by the co-operative pursuant to subsection 27(1) is evidence of the number of shares held by each member; and

(b) where requested in writing by a member, the co-operative shall provide a statement to the member showing the interest of the member in the co-operative.

This is in large part an acknowledgement of the costs associated with share issuances in large consumer co-operatives, which is one disadvantage of a for-profit co-operative. Each securities issuance of a share, equity, debt, or investment instrument will have an associated cost with it, a cost of administration and legal and accounting fees often not considered by smaller co-operatives just starting.

Share offerings may need to be in blocks of thousands of dollars or so for any significant cost efficiency that may effect a co-operative's decision on whether to fundraise for donations or member loans as a non-profit or issue shares as a for-profit co-op. Much is dependent on the target market for raising capital funds, is it member-owners? Preferred shareholders? A large benevolent shareholder? Foundations? Corporate investors? And all of this rests on what the purpose of the co-op is to be—is it to generate a surplus for its members or some community good? These decisions affect a new co-operatives capitalization decisions. A co-op developer, advisor, or lawyer may need to direct the organization toward the right choice of business model. Of importance is the need to weigh capitalization decisions with the need to keep the co-operative member owned, controlled, and operated to meet member need. But of paramount importance is to know the full range flexibility of the co-op legal structure under the current *Act* to achieve ends that meet the co-ops objectives.

One of the main disadvantages of a for-profit co-operative is that, like a corporation, the “for-profit” co-operative has to pay income tax on its unallocated surplus because surplus is treated as profit. For smaller co-ops that may be community minded and considering the non-profit option, the issuance of shares carries with it transaction costs and restrictions under securities regulations (depending on the size, nature, and to whom the share issuance is being made) that may not be readily transparent to a layperson. The costs of incorporation and share and securities issuances should be made apparent at the outset through consultation with a lawyer. Every security instrument issued can have a cost associated with it in terms of lawyer’s fees and processing costs. These co-ops will not have the capacity to fund-raise or qualify for many government or granting agencies that are limited to supporting non-profit organizations. These co-ops will also not be able to issue charitable tax receipts or receive monies through charities, as would a co-op that would qualify as a registered charity.

3.2 Non-Profit Co-operatives and the Law

While by default co-ops are for-profit co-ops, special provisions are needed for co-ops to qualify for non-profit or charitable status. Charitable co-ops are simply non-profit co-ops that are registered as charities, and are by definition non-profit. Most of the confusion rests on the capacity of co-operatives to achieve non-profit and charitable status, which this section will address.

Non-profit co-operatives are not co-operatives that are run “at cost.” Indeed non-profit co-operatives are run like any other business organization, and aim for surpluses. But it does mean the purposes of the co-operative are primarily not commercial in nature and the members do not seek “individual” benefit. The specific approved purposes of a non-profit organization are those

that are for “social welfare, civic improvement, pleasure or recreation, or any other purpose except for profit.” Most commentators maintain that any other purpose other than profit will qualify, making all but the last criteria superfluous.¹⁶ In a non-profit organization, regardless of its corporate structure (co-operative or non-profit corporation) there are broader goals. The organization can produce revenue through its activities and can generate a surplus, but the surplus must be used for its stated goals. The major advantage of a non-profit business is an exemption from paying income tax under section 149(1) of the *Income Tax Act*.¹⁷

Canada Revenue Agency has maintained consistently it is not the form of the organization, but rather the purposes that determine whether it is non-profit. They have gone so far as to say a share company could, under the right circumstances, with the right restrictions in place, qualify. It is possible for co-operatives with shares to be non-profits, under very specific circumstances. It is even possible for corporations with shares to be non-profits. One of the key cases in non-profit corporation law involved a Supreme Court of Canada decision that maintained that the corporate form in determining non-profit status is less important than the restrictions in its constating

¹⁶ See Drache, A.B.C., R. Hayhoe, and D.P. Stevens (2007). *Charities Taxation, Policy and Practice*. Toronto: Carswell. p. 16-10.

¹⁷ There is a criteria in common law that a non-profit also “not be a charity.” This is rather technical distinction still held but rather moot in that the major advantage of being a charity only comes under the *Income Tax Act* with achieving charitable status; that is, registering with Canada Revenue Agency. The practical effect of this distinction is that Canada Revenue Agency expects organizations doing charitable work to register as charities, after which they are treated differently by Canada Revenue Agency, and if they do not, they are just treated as non-profits. But in theory an organization can be a charity at common law (fulfilling a charitable purpose) and not have charitable status (be a registered charity). An “unregistered charity” would essentially, for all intents and purposes, have the same tax advantages and disadvantages as a non-profit, and we would ordinarily call them such.

documents. In *M.N.R. v. St. Catherines Flying Training School*¹⁸ the court determined whether profits of a company incorporated *with* share capital under the *Companies Act*,¹⁹ or the predecessor of the *Canada Business Corporations Act*, were exempt from taxation on the ground that *a corporation with share capital* was being operated on a non-profit basis with non-profit purposes for the period in question.

The distinction between a share capital co-operative and a co-operative without share capital is not in and of itself determinative of non-profit status. It is the restrictions on shares and the purpose of the organization that is determinative of the status. There is a tendency by some leading non-profit textbooks to accept the distinction without a real explanation on the nuanced distinction. For the most part this suffices, but in cases of conversion for instance, from a non-profit to a for-profit co-op, or vice-versa, should be treated carefully. There is also a tendency for some leading legal textbooks to focus on Ontario legislation explicitly, as indicative of legislation throughout the country, again simplifying the law.²⁰ British Columbia for instance does not distinguish between share and non-share capital co-operatives. Saskatchewan does have the possibility of incorporating without share capital under section 7(2)(c) by treating the interest of each member the same where there is no share capital:

¹⁸ [1955] S.C.R. 738

¹⁹ 1934 (Can.) c.-33.

²⁰ See Bourgeois, D. (2002). *The Law of Charitable and Not-for-Profit Organizations*, (3rd ed.) Toronto: Butterworths. The text for the most part looks at the Ontario and Canada legislation, which more explicitly differentiates co-ops with share capital and co-ops without share capital (unlike B.C. legislation which makes no distinction) and tends to be more restrictive in that co-ops must do a certain percentage of business with members. With all due respect to the author of this text, the characterization of non-profit status is oversimplified.

7(2) The incorporators shall set out in the articles of incorporation of a proposed co-operative the following information:

(a) the name of the co-operative;

(b) where there is to be share capital:

(i) the par value of the shares;

(ii) whether the number of shares to be issued is unlimited or, where limited, the maximum number of shares that may be issued; and

(iii) where there are two or more classes of shares, the designation of each class, the par value of the shares of each class and the special preferences, rights, conditions, restrictions, limitations and prohibitions attaching to each class;

(c) where there is no share capital, a statement that the interest of each member is the same as that of every other member;

However, even a co-operative without share capital must satisfy Canada Revenue Agency that it is a non-profit organization in order to gain exemption status. Non-profit organizations must meet the test of what is a non-profit, that is, not pursuing profit or commercial gain.

Incorporating a non-profit, whether a co-operative or a non-profit business corporation *without* any share capital ensures dividends and interest on share capital cannot be paid out on share capital. But the lack of share capital in and of itself is not a test of non-profit status; rather it is whether members gain. There are a number of criteria that a co-operative must satisfy under paragraph 149(1)(l) of the *Income Tax Act* for exemption status. Section 149(1)(1) states that:

149(1) No tax is payable under this Part on the taxable income of a person for a period when that person was:

(l) “non-profit organizations – a club, society or association that, in the opinion of the Minister, was not a charity within the meaning assigned by subsection 149.1(1) and that was organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit, no part of the income of which was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder thereof unless the proprietor, member or shareholder thereof was a club, society or association the primary purpose and function of which was the promotion of amateur athletics in Canada.”

Therefore, the real test is whether a member of the co-op will gain from membership. In practical terms, gaining from membership in a co-op comes from either a) dividends or interest on share capital or b) patronage dividends to its members. A prohibition on both of these qualifies the co-operative for non-profit status. In Saskatchewan, only community service co-ops have this latter prohibition against personal benefit *in statute*:

No interest on share capital or patronage dividends

246(1) No community service co-operative shall pay any dividends or interest on share capital to its members or patronage dividends to its members or patrons.

(2) No part of a community service co-operative's surplus is to inure to any member or patron.

(3) Any surplus of a community service co-operative shall:

(a) be set aside as a reserve fund for unforeseen losses or other contingencies, or for the maintenance or further development of the services provided by the co-operative; or

(b) where the members authorize at an annual meeting as provided in the bylaws, be donated by the directors to one or more:

(i) organizations, associations or groups with objectives of a benevolent or charitable nature; or

(ii) cultural, recreational, educational, social or other community-based organizations of a non-profit nature.

This has led some laypersons to believe *only* community service co-operatives can be non-profit or charitable co-ops. It is a misconception held because only community service co-operatives have a legislative prohibition in the *Co-operatives Act* on the paying out of dividends or interest on member shares when one looks only at the legislation. Other co-operatives can simply accommodate this through structuring their articles of incorporation and bylaws.²¹ In fact,

²¹ This mirrors an earlier formulation of a precedent bylaw found in Francis, W.B. (1959) *Canadian Co-operative Law*, pp. 208-209. It was approved by the Department of National Revenue of the time, which allowed co-operatives of the non-profit or charitable type to obtain exempt status under the Act; the bylaw stated: "The net income of the association shall be retained as a reserve and used only for

Richard Bridge, in one of the few publications on the relationship of co-ops and charity law, cites a 1988 internal memorandum to Revenue Canada Charities Division staff from the Director of the Division addressing the *Saskatchewan Co-operatives Act* to demonstrate how co-ops are viewed by Canada Revenue Agency.²² It states, in essence, that if a co-op is established for charitable purposes and devotes its resources to charitable activities, it can become a registered charity if it “is prohibited from paying any dividends or interest on share capital to its members or patronage dividends to its members or patrons.”²³ In the *St. Catherine’s Flying School* case involving a corporation mentioned earlier, it was exactly the structure and limitations on the paying out of shares or interest on shares, to wit, the ability of shareholders to benefit as individuals, that was the determining factor in the decision.

Some have suggested co-ops “without share capital” are the only ones that can be non-profits - most legislation across Canada allows co-ops with or without share capital. Canada Revenue Agency has allowed various organizational structures, corporations, partnerships, or trusts, to receive non-profit status for periods of time with the right restrictions. Most co-op legislation distinguishes between co-operatives *with* share capital and co-operatives *without* share capital.

educational or charitable purposes and no part of the income or reserve shall be payable to or otherwise available for the personal benefit of any member. The association shall not declare any dividend or distribute any of its property among its members during the existence of the association or upon its winding up or dissolution. On the winding up of the association the surplus, if any, shall be used for charitable or educational purposes as the members may determine by resolution and not for the personal benefit of any member.”

²² Canada Revenue Agency (CRA) in the past was called Revenue Canada (RC) and Canada Customs and Revenue Agency (CCRA)

²³ Bridge, R. (2003) *Co-operatives and Charity Law*. Canadian Co-operative Association, BC Region, p.14. The internal memorandum is reproduced in Appendix A of Bridge’s publication.

Many in the sector believe that this is the distinction between non-profit and for-profit co-operatives and this is specifically important for reasons of capitalization and conversion. A co-operative with share capital could convert to a non-profit co-operative with simple changes in its articles and bylaws: it does not need to divest its entire share equity structure, but merely limit the paying out of dividends and interest on such shares. Similarly, such a co-operative could, in theory, issue shares that pay no dividends or interest on equity, although this would attract close scrutiny from securities regulators and CRA. A benevolent investor or government development agency could also see the purchase of such shares as a way of capitalizing a non-profit co-operative, facilitating a non-profit co-ops ability to leverage debt by increasing its assets and strengthening its balance sheet.

The criteria a co-operative must meet to be a non-profit are explained in an Interpretation Bulletin IT-469R²⁴ published by CRA, which states in paragraph one that:

1. In general terms, paragraph 149(1)(l) provides that the taxable income of an association is exempt from tax under Part I of the Act for a period throughout which the association complies with all of the following conditions:

(a) it is not a charity (see paragraph 4);

(b) it is organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit (see paragraphs 5 to 10);

(c) it is in fact operated exclusively for the same purpose for which it was organized or for any of the other purposes mentioned in (b); and

(d) it does not distribute or otherwise make available for the personal benefit of a member any of its income unless the member is an association which has as its primary purpose and function the promotion

²⁴ Interpretation Bulletin IT-496R, dated August 2, 2001, Canada Revenue Agency.

of amateur athletics in Canada

Whether a co-operative meets all of these criteria is “a question of fact that can only be determined after” reviewing the “purposes and activities of the association.”²⁵

Should a co-operative lose its non-profit status, then at the time of the contravention it becomes a taxable entity under Part I of the Income Tax Act, and will be deemed to have a taxation year ending at the time it loses its exempt status and a new taxation year beginning at the same. It will also be deemed to have disposed of all its property at fair market value at the time immediately before the exempt status is lost, but then to have subsequently re-acquired all the property at fair market value at that time as well.

The *Income Tax Act* does not define the terms, “social welfare”, “civic improvement”, and “pleasure or recreation” but CRA does so in Interpretation Bulletin IT-496R:

In general terms, social welfare means that which provides assistance for disadvantaged groups or for the common good and general welfare of the people of the community. Civic improvement includes the enhancement in value or quality of community or civic life. An example would be an association that works for the advancement of a community by encouraging the establishment of new industries, parks, museums, etc. Under the categories of social welfare and civic improvement, care must be taken to ensure that the purposes of the association are not those of a charity. Pleasure or recreation means that which

²⁵ The prohibition on not being a charity is something of a technical one. There is a technical loophole in the *Income Tax Act* that an unregistered charity in common law may actually be a taxable entity, although likely not enforced or potentially not enforceable as a taxable income source (see *Schwartz v. R.* [1996] 1 S.C.R. 254.) If the Minister (of Canada Revenue Agency empowered under the *Income Tax Act*) should find an organization is a charity, then it would be considered not a non-profit but a charitable organization and be encouraged to register.

provides a state of gratification or a means of refreshment or diversion. Examples include social clubs, golf clubs, curling clubs, badminton clubs and so on that are organized and operated to provide recreational facilities for the enjoyment of members and their families. The phrase any other purpose except profit is interpreted as a catch-all for other associations that are organized and operated for other than commercial or financial reasons.

The co-op's constituting or founding documents are to be reviewed when determining whether the organization in question is established for non-profit purposes and it does not require an express statement the organization is non-profit. Paragraph 5 of CRA's Interpretation Bulletin IT-496R states:

(5) When determining the purposes for which an association was organized, the instruments creating the association will normally be reviewed. These instruments may include letters patent, articles of incorporation, memoranda of agreement, bylaws, and so on. . . .

The *Income Tax Act* requires that not only that a non-profit co-operative be "organized exclusively" for a purpose except profit. It must also be "operated exclusively" for the purpose the non-profit is organized. In *L.I.U.N.A. Local 527 Members Training Trust Fund v. Her Majesty the Queen [L.I.U.N.A.]*²⁶ Justice Bowman in weighing whether an organization was operated exclusively for its purpose, stated both the original purpose and the actual manner it is operated should be considered for each year the organization seeks the non-profit exemption under paragraph 149(1)(l) and determination must be based on the facts of each case.

Commercial Purpose Test

In order to be a non-profit the Canada Revenue Agency criteria states that an organization is not

²⁶ *L.I.U.N.A. Local 527 Members Training Trust Fund v. Her Majesty the Queen [L.I.U.N.A.]* 92 D.T.C. 2365.

carrying on a trade or business. CRA mandates a non-profit be operated exclusively for non-profit purposes. Paragraph 7 of Interpretation Bulletin IT-496R states:

It will be a question of fact to be determined with regard to the particular circumstances as to whether an association is carrying on a trade or business and if so, whether it will result in finding that an association is not operated exclusively for non-profit purposes. Some characteristics that might indicate that an activity is a trade or business are as follows:

- (a) it is a trade or business in the ordinary meaning, that is, it is operated in a normal commercial manner;
- (b) its goods or services are not restricted to members and their guests;
- (c) it is operated on a profit basis rather than a cost recovery basis; or
- (d) it is operated in competition with taxable entities carrying on the same trade or business.

Generally, the carrying on a trade or business directly attributable to, or connected with, pursuing the non-profit goals and activities of an association will not cause it to be considered to be operated for profit purposes.

Income generating activity cannot be the principal activity of the organization and any income must be used in carrying out its exempt objectives. The court in *Gull Bay Development Corporation v. Her Majesty the Queen*²⁷ held that although the corporation in question was incorporated to promote the economic and social welfare of persons of native origin, it was permissible for that corporation to engage in a logging operation on an Indian reserve and use the profits from the logging operations in social welfare activities carried on by the corporation. In *Gull Bay*, a commercial operation was clearly in operation and the proceeds were going to the Band. However, the case in part stood for the notion that a commercial activity that was contingent on their being an actual profit would be insufficient to meet the non-profit purposes test. A co-op can be engaged in a commercial or business-like activity so long as it is organized for a non-profit or charitable purpose, and it must state this purpose in its Articles of incorporation. The purpose cannot be contingent on the co-op making a surplus however. For

²⁷ 84 D.T.C. 6040 (F.C.T.D.).

instance, a retail co-op that says it will donate all of its profits to disability organizations will not qualify, but a retail co-op that trains employees with disabilities will. If the co-op is not dependent on profits from the commercial enterprise to fulfill its purpose, it will qualify. A retail co-op that uses its *profits* for job training people with disabilities, for instance, would not qualify, as it is contingent on there being profits (commercial success). A co-op that engages in the same retail activity that provides on the job training for people with disabilities will qualify (because it is engaged in that non-commercial activity regardless of how commercially successful it is—whether the co-op turns a profit or a loss the non-commercial activity of job training will still be engaged in). But if these employees become permanent in nature, the equation may change (in that workers would be gaining an advantage from the co-op in employment, and job training implies a turnover).

Three key cases, *Woodward's Pension Society*,²⁸ *Otineka*,²⁹ and *Tourbec*³⁰ indicate that a non-profit cannot qualify for the paragraph 149(1)(l) tax exemption if it is unable to accomplish the objectives for which it was established unless it realizes profits that make it commercially successful. *Woodward's Pension Society*, involved a situation where the Society could not help fund pension benefits unless it made a profit on its trading in securities. In *Tourbec*, a travel agency set up for student discount travel could not provide travel for students at less than cost unless it made a profit on its sales to others. In *Otineka*, a business established on reserve could

²⁸ *Woodward's Pension Society v. M.N.R.*, 62 D.T.C. 1002

²⁹ *Otineka Development Corporation Limited v. H.M.Q.*, 94 D.T.C. 1234 (T.C.C.)

³⁰ *Tourbec (1979) Inc. v. M.N.R.*, 88 D.T.C. 1439 (T.C.C.)

not fund other native organizations unless it made profits on its real estate development activities. Interestingly the *Otineka* case stood for another precedent, as the court weighed whether the corporation operated by the band council was equivalent of the holding of a municipal corporation and therefore exempt in the same way as municipal governments, a logic ultimately upheld.

It is important to note that a non-profit does not need to have a social or public purpose to pass the test. It can be strictly commercial in nature, so long as the non-profit enterprise is structured as a non-profit and as an organization does not have a commercial purpose it can serve the commercial interests of its members. What it cannot do is be structured in such a way that its non-profit purpose is contingent on turning a profit.

In two cases, recently upheld, one involving a mutual company and another a co-operative; economic interests were paramount. In *Canadian Bar Insurance Association*³¹ (CBIA) the organization was engaged in selling various insurance products to lawyers, such as life and disability insurance, including coverage for business expenses during disability in a sector populated with commercial insurance companies and with little doubt that CBIA was engaged in a high level of commercial activity. Morgan, J. held "that high level of commercial activity, by itself, does not prove that the Appellant operated for profit." CBIA's attempt to provide insurance products "at cost" to the legal community was held as not just an attempt to avoid the paying of tax on a commercial enterprise, with weight being on the real purpose of the CBIA as established in its founding documents. This has direct analogies for co-operatives that operate on surplus

³¹ *Canadian Bar Insurance Association v. H.M.Q.*, 99 D.T.C. 653

rather than profit basis. In *Gulf Log Salvage Co-operative*³², a co-op was established in an attempt to deter private profiteers from salvaging logs that had gone astray from log booms owned by mill companies and sell them for their own profit at the expense of the owners. In both cases the organizations are engaged in commercial or business activity for their members. These decisions were recently approved in the recent case of *BBM Canada v. Canada*.³³

Income must also be more than passively earned for it to be disqualifying income, in *L.I.U.N.A.*,³⁴ the court held as follows:

For an organization to be operated for the purpose of earning a profit so as to disqualify it for the exemption under paragraph 149(1)(1), it would be necessary that it do more than merely earn passive investment income. The earning of such income would need to be both an operating motivation of the fund and a focus of its activity.³⁵

In that case, the court held that the “earning of interest income was not the purpose – primary or secondary - for which the fund was operated.” The court continued to hold that “[t]he earning of interest was simply an incident of the only purpose for which the fund was operated, the training of the members of the union; it was a means to an end and not an end in itself.”³⁶

Another criteria suggested by CRA’s Interpretation Bulletin IT-496R when determining if an association is operated exclusively for non-profit purposes is whether the association has

³² *Gulf Log Salvage Co-operative Association v. M.N.R.*, 60 D.T.C. 239

³³ *BBM Canada v. Canada* (Minister of National Revenue – MNR) [2008] T.C.J. No. 254

³⁴ *Supra* Note 14.

³⁵ *Ibid.*

³⁶ *Ibid.*

accumulated excess funds each year that is beyond the association's reasonable needs to carry on its non-profit activities. In this regard, paragraphs 8 and 9 of Interpretation Bulletin IT-496R provides as follows:

An association may earn income in excess of its expenditures provided the requirements of the Act are met. The excess may result from the activity for which it was organized or from some other activity. However, if a material part of the excess is accumulated each year and the balance of accumulated excess at any time is greater than the association's reasonable needs to carry on its non-profit activities, profit will be considered to be one of the purposes for which the association was operated. This will be particularly so where assets representing the accumulated excess are used for purposes unrelated to its objects, such as the following:

(a) long-term investments to produce property income;

(b) enlarging or expanding facilities used for normal commercial operations, or

(c) loans to members, shareholders or non-exempt persons. The amount of accumulated excess income considered reasonable in relation to the needs of an association to carry on its non-profit activities and goals is a question of fact to be determined with regard to the associations' particular circumstances . . . Where the present balance of accumulated excess is considered excessive or an annual excess is regularly accumulated that is greater than an association's needs to carry on its non-profit activities, it may indicate that the association's aims are two-fold: to earn profits and to carry out its non-profit purposes. In such a case, the operated exclusively requirement in paragraph 149(1)(l) would not be met.

Earning of investment income does not, in and by itself, deny an organization non-profit status as long as all funds including any investment income earned are used in achieving the non-profit objective. However income accumulated in a surplus fund far beyond that needed to carry on non-profit activities is seen as evidence of a profit purpose.

Summary: Disadvantages of Non-Profit Co-ops

The key disadvantages of non-profit co-ops is an inability to issue shares that pay dividends or offer a rate of interest. This is problematic for capitalization, as without the patronage dividend

incentive, investors may be difficult to find and the co-op may have difficulty attracting members. However, shares may still be able to be issued if the co-op is structured in such a way that there is merely a prohibition on paying dividends and any interest on shares in the Articles and bylaws. This might be an important option for capitalization in limited circumstances. The key advantage is the co-op will not have to pay tax on earnings if it has a non-commercial purpose, and the tax process is simplified. Similarly non-profits can qualify for many government grants. However the disadvantage is that the commercial purpose test means the objects of the co-op are more limited, but not as limited as many may think. Non-profit co-ops have a wide range of commercial activities they may engage in, so long as the purposes for which they engage in these activities are not linked to a profit, as the case law has indicated. There need not be a charitable or community good behind a non-profit, it can have a much more narrow focus toward its members, so long as its members do not benefit individually and this is structured in the constituting documents. However, unlike a co-op with registered charitable status, a non-profit cannot issue tax-deductible receipts for donations or receive donations from charitable foundations or other charities that can only give to qualified donees, and so may have capitalization problems.

Summary: Advantages of Non-Profit Co-ops

The key advantage of the non-profit co-op model is that non-profit status exempts it from paying tax, but so long it is pursuing non-commercial goals it can engage in commercial-like activities and it has a much broader capacity and scope of activities. Non-profits often qualify for government grants and funding agencies because individual members do not benefit, and so by practice they tend to be altruistic or community minded: because non-profit co-ops cannot issue

shares that will pay dividends or interest on share capital, this makes it difficult to attract members to the co-op if they are only interested in member dividends. But while a non-profit can solicit for donations, it cannot issue tax-deductible receipts unless it is a charity and a non-profit co-op can also not receive charitable funds unless itself is a qualified donee (another charity). A co-op can convert from a for-profit to non-profit co-op with relative ease under the *Act*; it merely takes sufficient organizational direction and mandate from the membership, purpose, and specifically, prohibitions in articles and bylaws on member benefits. Likewise, a co-op can convert from share capital to non-share capital co-op under the *Act*:

144(1) Subject to section 147 and to the approval of the registrar, the members may, by special resolution, amend the articles to:

- (a) change the name of the co-operative;
- (b) add, change or remove any restriction on the business or businesses that the co-operative may carry on;
- (c) create new classes of shares;
- (d) change the designation of all or any of its shares and add, change or remove any rights, privileges, restrictions and conditions, including rights to accrued dividends, with respect to all or any of its shares, whether issued or unissued;
- (e) authorize the directors to change the rights, privileges, restrictions and conditions attached to unissued shares of any series;
- (f) revoke, diminish or enlarge any authority conferred pursuant to clause (e);
- (g) add, change or remove restrictions on the transfer of shares;
- (h) subject to sections 7 and 82, increase or decrease the number of directors;
- (i) add, change or remove any other provision that is permitted in this Act to be set out in the articles;
- (j) subject to the regulations, convert the co-operative:
 - (i) from a co-operative with share capital into a co-operative without share capital; or
 - (ii) from a co-operative without share capital into a co-operative with share capital.

3.3 Charitable Status Co-operatives

Much like non-profits, Canada Revenue Agency does not have a preferred corporate form for charities; a co-op can be a charity just like any other business form. In fact, in a search conducted in November 2002 there were around 375 co-operatives that were registered charities in Canada, with almost a quarter (92) located in Saskatchewan.³⁷ A co-op can be eligible for charitable status if it is established for charitable purposes and devotes substantially all of its resources for such purposes and it is prohibited from paying any dividends or interest on share capital to its members or patronage dividends to its members or patrons. These can be achieved, as we have discussed, by restructuring the articles of incorporation and bylaws accordingly. A final key requirement for the charitable status is that assets of the co-op must be transferred to another charity in event of the co-op winding up.

Charities are legally structured much the same way as non-profits, but they must have more narrow goals to become registered charities by CRA. To be a charity, CRA states that the co-op must be engaged in a narrower range of activities. There is no legal definition of “charity” in Canada per se. Unlike non-profits, there is no federal or provincial “Charity Act” or regulation that spells out the meaning of the concept or lists examples of charity. Co-ops that are charities are essentially a small subset of co-operatives that are non-profit organizations. Charities fit into a much narrower subset of organizations that are organized along charitable purposes. The categories of charitable purposes have evolved through decisions of the courts of England and

³⁷ Bridge, R. (2003) *Co-operatives and Charity Law*. Canadian Co-operative Association, BC Region, p.13.

Canada for literally hundreds of years and it is this distinction that Canada Revenue Agency follows closely. The common law guidance, a categorization formally adopted by the English Courts in *Pemsel's Case*, an 1891 decision of the House of Lords, provides that charitable purposes are: relief of poverty, advancement of education, advancement of religion, or any purpose beneficial to the community “not falling under the other three purposes.” The origins of the fourfold categorization date back to the Statute of Uses of 1601.³⁸ It is the fourth category in the definition of charity that is often the subject of debate and ambiguity, as the courts have mandated a “public benefits test;” that the purpose provides a benefit to the community for public, not private benefit.³⁹ Primarily CRA administers a registration system along these four criteria that includes three types of charities: charitable organizations, public foundations, and private foundations. The latter two differ in their organizational structure only. Charitable organizations carry out “charitable activities” directly, while foundations primarily provide a way of pooling capital and funding for these activities. Public and private foundations are able to build pools of capital, the earnings from which must be used for charitable activities, whereas charitable organizations must disperse rather than accumulate funds they receive.

Advantages and Disadvantages of Charitable Status Co-ops

³⁸ Bourgeois, D.J. (2002). *The Law of Charitable and Non-profit Organizations* (3rd ed.). Toronto: Butterworths, p. 18.

³⁹ The boundaries of what is a charitable purpose are not always clear and always tested. In recent years, CRA has allowed community economic development (CED) as a mode of charitable purpose for the benefit of the community, which has a host of issues too complex to go into depth in this paper revolving around the how closely the charity can be involved in associated businesses and the degree to which charities can become involved in economic, even for-profit, activities.

Richard Bridge identifies three key advantages and two disadvantages to charitable status for co-operatives.⁴⁰ First, charities have the key advantage that they are able to issue tax receipts to donors. These receipts enable donors to take advantage of the incentives in place in Canada's income tax system that encourage donations to charities. A tax credit system has been established for donations by individuals, while charitable donations by corporations are tax deductible. In either case, Canada's tax treatment of charitable donations is a significant attraction for charitable status and donations to a charity, allowing the charity to fundraise for capital contributions.

Second, for many charitable organizations, funding from charitable foundations, which act as significant pools of capital, are often more important than donations from the public. Public and private charitable foundations provide enormous capital pools of financial support for a wide range of charitable activities, and can facilitate capitalization of a co-op. But charitable foundations are *only* able to donate funds to other registered charities, *not* to non-charities, so a co-op interested in this pool of capital funds must also be a charity. However, foundations may contract for services from a non-charity, which is often a way around such a prohibition, in which case care and control of the service delivery must be with the charity or charitable foundation, but they are precluded not to make gifts or grants to such organizations themselves. A co-op that is not also a registered charity could only perform services for a charity under the terms of an agency contract, but it could not receive grants from a charity or a charitable foundation.

⁴⁰ Bridge, R. (2003). *Co-ops and Charity Law*, pp. 10-12

Third, being a registered charity confers public legitimacy. Public confidence and trust in many public institutions and the private sector is always problematic. However, altruism continues to rank high, and registration as a charity is an important recognition that a co-operative is legitimate in its charitable goals of advancing public and community welfare. It demonstrates to the public a test has been met and a certain oversight will be applied.

There are two main disadvantages of charitable status: a higher regulatory burden than for other organizations with CRA. Legislative and administrative requirements often discourage non-profits from seeking charitable status, including the annual filing with CRA of a report that details charitable activities, compliance with a disbursement quotas on the expenditure of funds, detailed and complex records and books and often the added accounting and administrative costs that go into each of these.

The second disadvantage is that charities are limited in terms of the scope of their activities. Co-ops that are charities must devote “substantially all” of their resources to charitable activities.

The law is often not clear in this area for those engaged in charitable activities, and the dividing line between acceptable and unacceptable activity is not clear. Charities for instance are not allowed to dedicate more than 10% of their activities to political advocacy, and this 10% administrative policy rule is ill defined, creates confusion, and often leads to an advocacy chill. Charities find they are limited as to what they say, how much they say, and how they say it.

There are also restrictions on the ability of charities to carry out “related business activities.”

Most co-ops cannot meet the public benefit test, for they are commercial enterprises. Producer, consumer, and worker co-ops are usually created to pursue business opportunities on behalf of their members, and to distribute surpluses in the form of dividend or interest payments on shares

owned by members. This is a critical issue for co-ops seeking charitable status. If a co-op permits members to receive benefits of these kinds, it cannot be a charity even though its purposes and activities are charitable. It is possible for co-ops to overcome this problem by expressly stating in their constitutional documents that no such payments can be made. A charity is quite restricted in its capacity to engage in commercial activities: a related business must be subordinate to the dominant charitable purpose and must be an offshoot to the core programs. It should also be noted that charities cannot pay directors, who must serve in a volunteer capacity, which may also be considered a disadvantage in board recruitment.

4. Policy Considerations: Non-profit Capitalization in Community Economic Development (CED)

Like Ontario legislation, Saskatchewan legislation allows the possibility of forming a co-operative with no share capital. Generally, this is seen as how to form a non-profit co-operative. What is still required, however, is a provision right in the articles of incorporation that the co-op is carrying on business without the purpose of gain for its members and that any profit or gain will be used for promoting the objectives of the co-op. Clearly this hinders capitalization efforts in precluding dividends and interest. Raising member loans and debt financing is a possibility, but with a prohibition on the paying of dividends sufficient to ensure no members profit or gain from membership, there remains the intriguing possibility of issuing preferred non-voting shares with no rate of return and no-interest, generally a possibility not considered in the literature but one not precluded by law. It would enable capitalization from a benevolent shareholder not

interested in return willing to risk its capital and help the balance sheet of a non-profit that could buy back the shares over time. Such an option would be preferable to debt that may carry financing charges. It would offer some level of asset security for the investor over its principal, and on its balance sheet would remain as an asset rather than a write down. The co-op could then repurchase the shares back over time as it succeeds and builds up a surplus (as we have established, even non-profit co-ops are allowed to do). Provisions allowing the repurchase of shares could be worked into the prospectus in the securities issuance of the preferred shares, which would be recommended in any event for a below market rate issue to third parties. Share purchase provisions are in most co-op legislation. In Saskatchewan it is in section 41:

Purchase of shares

41(1) A co-operative may purchase or otherwise acquire any of its shares that are available for compulsory purchase pursuant to section 119 or that are offered for sale.

(2) Subject to subsection (4), a co-operative shall pay in cash, within one year after the day of purchase, for any shares purchased pursuant to subsection (1).

(3) Subject to subsection (4), a co-operative shall pay a purchase price for a share purchased pursuant to this section equal to the par value of the share together with any dividends accrued but unpaid with respect to the share.

(4) Subject to the regulations, the bylaws of a co-operative may authorize the co-operative to purchase or otherwise acquire its own shares on terms and at prices other than those set out in subsections (2) and (3).

(5) Subject to subsection (6), where a co-operative purchases or otherwise acquires shares issued by it, those shares are deemed to be cancelled.

(6) Where the bylaws of a co-operative limit the number of authorized shares, any shares of the co-operative purchased or otherwise acquired by the co-operative may be returned to the status of authorized but unissued shares.

In terms of encouraging private sector participation in the social economy, co-op development should be encouraged. Such encouragement, however, first needs to establish clarity of understanding in the sector over the relationship between co-operative and non-profit law.

Nationally, Share Capital Social Clubs in Ontario, which could be formed up until 1971, and many of which still exist today, used to be an example of share issuing social organizations. Internationally, Canada is falling behind a number of countries in positing hybrid organizations aimed at community economic development (CED) with the capitalization advantages of corporate structures and the social enterprise functions of social economy organizations like non-profits and charities.⁴¹ In the UK, a new legislative framework to enable the creation of a new type of company for social enterprise known as the “Community Interest Company” or “CIC.”⁴² In the United States first in the State of Vermont, now in six States (including New York), and proposed in half a dozen more and interest in other States, legislation is positing a new type of enterprise called the “Low-Profit Limited Liability Company” or “L3C.”⁴³ The Canadian co-operative sector should be exploring ways in which existing legislation and law can be used, or amended, to achieve the same policy ends in promoting social enterprise and co-operative development. The notion of non-profit co-operatives issuing shares as a means of capitalization is not widely discussed in the literature and the option not apparent from discussions in non-

⁴¹ Carter, T. and T.L.M. Man (2009). *Business Activities and Social Enterprise: Towards a New Paradigm*. The Canadian Bar Association 2009 National Law Symposium. Carters Professional Corporation.

⁴² See *Community Interest Companies: Information Pack* (2010). Issued by the Regulator of Community Interest Companies. Cardiff, UK: Department for Business Innovation and Skills. March, 2010. Available at <http://www.cicregulator.gov.uk/> for an information package on CIC companies download: <http://www.cicregulator.gov.uk/CICleaflets/CIC%20INFORMATION%20PACK%20V00.04%20Final.pdf>

⁴³ See State of Michigan, Department of Labour and Economic Growth. (2008). *Analysis of Enrolled Senate Bills 1445-6: Low Profit Limited Liability Companies*. Senate Commerce and Tourism Committee. http://www.michigan.gov/documents/dleg/Analysis_of_Enrolled_L3C_Bills_261198_7.pdf

profit texts on non-share capital co-operatives as being equated with non-profit co-operatives. More policy research needs to be done in this area on policy alternatives to bring co-operative legislation to the forefront and in line with innovative legislation in other jurisdictions.

5. Conclusion

To summarize the lengthy and technical discussion previous: co-operative legislation in Saskatchewan allows for the possibility of “non-profit,” and charitable status co-operatives as well as the traditional “for-profit” or surplus model co-operative that pays dividends and interest on shares to members. Each organizational form however needs to be weighed by legal professionals, co-operators, and co-op developers alike when forming a co-operative, often for reasons pertaining to capitalization.

While the traditional for-profit co-op has the greatest flexibility of options for capitalization, it may simply not be the best alternative for an organization for which concern for community is paramount. There are costs and disadvantages associated with each organizational form. While the charitable status co-operative has the capacity to fundraise and issue tax deductible receipts and tap into charitable foundation capital, it is also very limited in terms of purpose. Non-profits should not be discounted, as the capacity to issue shares exists and is not limited by law. What is limited is merely the prohibition on member benefits for the period for which the co-operative has non-profit status. Co-operators and co-op developers must be aware of the full capacities of existing legislation, and should be creative in their capacity and willingness to discuss ways of using the legislation with knowledgeable lawyers in the field, and exploring ways in which the legislation and can be used to promote social enterprise and co-operative development.

Appendix A: Securities Exemptions

From the *Saskatchewan Co-operatives Act*:⁴⁴

221(1) Notwithstanding any other provision of this Part, a co-operative is not required to have the board review or approve securities that are:

- (a) bonds, debentures or other evidences of indebtedness of, or guarantees by, a trust corporation or a loan corporation licensed pursuant to The Trust and Loan Corporations Act, 1997 or an insurance company licensed pursuant to *The Saskatchewan Insurance Act*;
- (b) certificates or receipts of a trust corporation or a loan corporation licensed pursuant to The Trust and Loan Corporations Act, 1997;
- (c) bonds, debentures or other evidences of indebtedness guaranteed by the government of Canada or of any province or territory of Canada; or
- (d) securities exempted in the regulations.

(2) Where the board is satisfied that it is not prejudicial to the public interest, it may exempt a sale of securities from this Part and impose any conditions it considers appropriate on that exemption.

From the Regulations:⁴⁵

Exempt securities

14 For the purpose of subsection 221(1) of the Act, a co-operative is not required to have the Co-operatives Securities Board review or approve:

- (a) any securities of the co-operative where the purchase of the security is a requirement of membership in the co-operative as set out in the bylaws and the total value of those securities purchased by the member does not exceed \$1,000;
- (b) securities to be sold only to:
 - (i) a trust corporation licensed pursuant to *The Trust and Loan Corporations Act*;
 - (ii) a loan corporation licensed pursuant to *The Trust and Loan Corporations Act*;
 - (iii) an insurance company licensed pursuant to *The Saskatchewan Insurance Act*;

⁴⁴ Supra Note 4.

⁴⁵ *Co-operative Regulations*, R.S.S. 1998. c. C-37-3

- (iv) a credit union incorporated, continued or registered pursuant to *The Credit Union Act, 1985*; or
- (v) a bank to which the *Bank Act* (Canada) applies;
- (c) prepaid accounts where the member pays for goods and services in advance of delivery;
- (d) any shares issued in payment of:
 - (i) a dividend or interest payment on shares; or
 - (ii) a patronage dividend;
- (e) any securities of the co-operative sold only to members of the co-operative where all the members are also directors of that co-operative;
- (f) any securities of the co-operative sold only to members of the co-operative where:
 - (i) the proceeds of the securities sold are used to purchase assets that are used solely by or for members; and
 - (ii) the total amount raised by a co-operative pursuant to this exemption does not exceed \$100,000; or
- (g) any securities of the co-operative sold only to members of the co-operative where:
 - (i) the proceeds of the securities sold are used to pay any of the following costs:
 - (A) costs related to the preparation of feasibility studies, business plans and other similar documents;
 - (B) costs related to the preparation of any materials used or costs incurred in relation to an offering of securities by the co-operative; and
 - (ii) the total amount raised by a co-operative pursuant to this exemption does not exceed \$100,000.

References

Legislation

Saskatchewan Business Corporations Act, R.S.S. 1978. c. B.-10.

Canada Co-operatives Act, S.C. 1998, c-1

Companies Act. 1934 (Can.) c.-33.

Ontario Co-operative Corporations Act, R.S.O. 1990, c-35.

Saskatchewan Co-operatives Act, R.S.S. 1996. c. C-37-3

Saskatchewan Co-operatives Regulations, R.S.S. 1998. c. C. 1998. C-37-3

Income Tax Act. R.S.C. 1985, c. 1

Saskatchewan Non-Profit Corporations Act, R.S.S. 1995. c. N-4.2.

Caselaw

BBM Canada v. Canada (Minister of National Revenue – MNR) [2008] T.C.J. No. 254

Canadian Bar Insurance Association v. H.M.Q., 99 D.T.C. 653

Gulf Log Salvage Co-operative Association v. M.N.R., 60 D.T.C. 239

Gull Bay Development Corporation v. H.M.Q. 84 DTC 6040 (F.C.T.D.).

L.I.U.N.A. Local 527 Members Training Trust Fund v. Her Majesty the Queen [L.I.U.N.A.] 92 D.T.C. 2365.

M.N.R. v. St. Catherines Flying Training School [1955] S.C.R. 738

Otineka Development Corporation Limited v. H.M.Q., 94 D.T.C. 1234 (T.C.C.)

Schwartz v. R. [1996] 1 S.C.R. 254

Tourbec (1979) Inc. v. M.N.R., 88 D.T.C. 1439 (T.C.C.)

Woodward's Pension Society v. M.N.R., 62 D.T.C. 1002

Secondary Sources

Blomfield, K. (2002). *Co-operative Associations in British Columbia and Registered Charitable Status*. Victoria: British Columbia Institute for Co-operative Studies.

Bourgeois, D. (2002). *The Law of Charitable and Not-for-Profit Organizations*, (3rd ed.) Toronto: Butterworths.

Bridge, R. (2003) *Co-operatives and Charity Law*. Canadian Co-operative Association, BC Region

Canada Revenue Agency (2001). Interpretation Bulletin IT-496R, dated August 2, 2001, Canada Revenue Agency.

Carter, T. and T.L.M. Man (2009). Business Activities and Social Enterprise: Towards a New Paradigm. The Canadian Bar Association 2009 National Law Symposium. Carters Professional Corporation.

Community Interest Companies: Information Pack (2010). Issued by the Regulator of Community Interest Companies. Cardiff, UK: Department for Business Innovation and Skills. March, 2010. Available at <http://www.cicregulator.gov.uk/CICleaflets/CIC%20INFORMATION%20PACK%20V00.04%20Final.pdf>

Drache, A.B.C., R. Hayhoe, and D.P. Stevens (2007). *Charities Taxation, Policy and Practice*. Toronto: Carswell. p. 16-10.

Francis, W.B. (1959) *Canadian Co-operative Law*. Toronto; Carswell.

Ish, Daniel, (1981). *The Law of Canadian Co-operatives*. Toronto; Carswell.

Ontario Co-operative Association (2010). OnCoop Educational Resources: Co-op Development ToolKit. Available at: <http://www.ontario.coop/toolkit/>

Mountain Equipment Co-op, (2010) located at <http://www.mec.ca/Main/home.jsp>

State of Michigan, Department of Labour and Economic Growth (2008). Analysis of Enrolled

Senate Bills 1445-6: Low Profit Limited Liability Companies. Senate Commerce and Tourism Committee. Available at:

http://www.michigan.gov/documents/dleg/Analysis_of_Enrolled_L3C_Bills_261198_7.pdf