

Understanding Co-operative and Non-Profit Law

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The following is a commissioned work by Saskatchewan Co-operative Association and Le Conseil de la coopération de la Saskatchewan to clarify the relationship between co-operative law and non-profit and charitable status in Saskatchewan in order to assist professionals and co-op developers.

Co-operative law in Saskatchewan is unique. Whether one is forming a traditional for-surplus or “for profit” co-operative where dividends flow to members or a non-profit co-operative, or even a co-operative that fulfills charitable purposes, a co-operative must be incorporated under the *Saskatchewan Co-operatives Act*.ⁱ The purpose of this article is not to give legal advice, but rather explain what is possible with the co-operative model. Co-operatives can become non-profits and they can become charities. Non-co-operative organizations incorporate either under the *Non-Profit Corporations Act*ⁱⁱ or, if it is a share company for profit, the *Business Corporations Act*.ⁱⁱⁱ Because the *Act* catches all co-operatives, potential co-operators must know all options available under the *Act*, as one of the most important decisions new co-operatives make is the choice of organizational form.

The benefit of incorporation of any co-op is limited liability. The co-op becomes a separate individual under the law. But the status of co-ops and their ability to operate on a non-profit or charitable basis needs to be understood. Given that co-operatives operate, by definition, “for the benefit of their members,” it is not clear from the *Co-operatives Act* alone they can be non-profits. In part this is from a lack of co-operative law resources. A consultation with a lawyer or other professional advisor may lead to individuals to a nonprofit corporation, as lawyers tend toward precedents they know and many have little experience with co-operatives. But a non-profit co-operative is always an option.

There are also practical considerations a beginning co-operative must consider. The advantages and disadvantages must be weighed of being for-profit, non-profit, or a charitable co-operative when it concerns decisions about capitalization, usually the most difficult struggle in getting a co-operative started.

For “Profit” Co-operatives

As co-operators will often say, co-ops do not make profit, they make surplus. Surplus is treated differently under the *Income Tax Act*.^{iv} While all of the nuanced differences are too complex to go into here, in essence, dividends paid to co-op members are exempt from taxation by the co-operative. Instead they are taxed in the hands of the members, unlike a corporation, where all profits of a corporation are taxed (including dividends), and corporate shareholders receive a “gross-up” on dividends (a set rate that is multiplied to compensate for tax already paid by the corporation) to avoid double taxation (the tax paid by the corporation and income tax paid by shareholders). The intended policy effect is that corporations with shareholders and co-operatives with members will pay roughly equal tax in aggregate (dividends paid by a co-operative are not multiplied by the “gross up” rate since the co-op is exempt from tax on allocated dividends). The

unallocated portion of surplus not distributed as dividends to members that is retained by the co-op is treated the same way as profit is in a business corporation (it is taxed as business income). So we can talk about “for-profit co-operatives” as those co-operatives in the business of making surplus for the benefit of members. It should be noted that corporations that pay dividends according to patronage receive the same tax treatment as co-operatives.

Advantages

In terms of capitalization, this type of form has great flexibility. These co-operatives can use member loans as a form of capitalization. They can issue equity shares, or make use of the increasingly available option of selling preferred (or special and usually non-voting) shares to non-members who want to invest in the co-operative for a return on investment. The preferred share option is used to attract investors looking for a return on investment, rather than who would use the services of the co-op, and so they are non-voting shares in most circumstances to keep the co-op controlled by its member-users.

Disadvantages

Incorporation as a for-profit co-op carries higher costs. For smaller co-ops, that may not have a large profit margin, the issuance of shares carries 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. Each time a share or number of shares is offered a cost is involved in issuing them in terms of lawyer’s fees and administration. As well, for offerings outside of specific exceptions in securities legislation, a prospectus may need to be prepared under securities legislation, that incurs a cost. This means small issuances of a few hundred dollars each to many shareholders may not be practical given the transaction costs of each issuance. The costs of incorporation and share issuances should be made apparent at the outset through a consultation with a lawyer.

Non-Profit Co-operatives

Non-profit does not mean at cost. Non-profit co-operatives can make surpluses like every other co-operative enterprise. It just means the purposes of the organization are not organized for the reasons of profit. That means there are broader goals to the organization that are characterized as not being commercial in nature.

Advantages

The major advantage of a non-profit business is an exemption from paying income tax under section 149(1) of the *Income Tax Act* so long as they pursue non-profit objectives. Non-profit co-operatives *can* generally engage in commercial-like activities, so long as the non-commercial purposes of the co-operative are not tied to its commercial success. For example, a retail co-operative that donated its profit to organizations for people with disabilities, would not qualify, because its purpose is contingent on the co-op being commercially successful and making a profit. A retail co-operative that trained people with disabilities as part of its mandate would count, because its non-commercial purpose, to provide training for people with disabilities, is not

contingent on its commercial success (i.e. making a surplus or profit). The tax exempt status, without the narrow purpose and reporting criteria attached to charitable status, is the key advantage to non-profit status. Non-profits are also often able to qualify for many government programs and funding.

Disadvantages

Canada Revenue Agency (CRA) has maintained consistently it is not the form of the organization, but rather the purposes that determine whether it is a non-profit. The Courts have ruled in cases where even a business corporation, under the right circumstances, with the right restrictions in place, qualified as a non-profit.^v Generally what is required is a provision in the articles of incorporation and bylaws that the co-operative is carrying on business without the purpose of gain for its members and any profit or gain will be used for promoting its objectives. This invariably means an explicit provision that dividends and interest will not be paid out to members on share equity. In fact, in the Saskatchewan legislation, only community services co-operatives have this prohibition spelled out explicitly under the *Act*,^{vi} leading to some to believe only community service co-ops can be non-profits or achieve charitable status. This prohibition on paying dividends or interest on shares hinders capitalization efforts, as well as attracting members, as this is the financial incentive for investing in or joining co-operatives. However, member loans and debt financing is still a possibility, and participation in a non-profit co-operative is usually for some social good. Saskatchewan legislation allows the possibility of forming a co-operative without share capital. Generally, this is seen as how to form a non-profit co-operative. But this is actually not the case in law. CRA only looks toward the purposes of the co-operative, and whether or not any individual will profit from the co-operative. A sufficient prohibition in the articles and bylaws on shares is the test. All charitable organizations are non-profits, but not all non-profits are charities. Those that are not charities will not be able to issue tax receipts on donations, even if they are not taxed on income.

Charitable Status Co-operative

A co-operative 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 or the founding documents accordingly. A final requirement for charitable status is that assets of the co-op must be transferred to another charity in event of the co-operative's dissolution.^{vii}

Advantages

The major advantage for a co-operative being a charity is being able to issue tax-deductible receipts for donations and to be a qualified donee, as only they can receive funds from other charities and specifically, charitable foundations, which are often pools of capital. Charitable status also confers a degree of legitimacy on an organization owing to the much more rigorous accounting and reporting procedures required by CRA. As capitalization is historically a major weakness of co-operatives compared to corporations that can issue shares, and non-profit co-ops

can not issue shares that pay dividends or interest on share capital to attract shareholders, the capacity to issue tax deductible receipts for donations and tap into pools of capital from charitable foundations allows for capitalization from donations.

Disadvantages

The rigorous accounting and reporting criteria demanded by CRA is one of the major disadvantages of charitable status. It adds accounting and administrative costs. CRA does not have a preferred corporate form for charities, but rather a registry of charitable organizations. A co-op can be a charity just like any other business form.

To become a registered charity, and reap the benefits of being able to fundraise, issue tax deductible receipts, and receive moneys from charitable foundations as a means of capitalization, a co-operative must fit within much narrower grounds of having a “charitable purpose,” and are then restricted to these purposes. These include advancement of education, advancement of religion, the relief of poverty, or “any other purpose beneficial to the community.” The latter category is the subject of much of the case law and ambiguity with CRA. The purposes of the co-operative are much more limited as opposed to a non-profit. For instance, a charitable organization is severely limited in terms of lobbying, advocacy, or political activities. A charitable co-op may also be curtailed in its ability to issue debt, own shares, or run related businesses, a key decision in capitalization or business planning. Close consultation with a lawyer should be undertaken to ensure the activities of the co-operative fits under the charitable criteria.

Co-operative Innovation

One option rarely considered by non-profits is the issuance of shares at zero rate of interest and no dividend rate. With a prohibition on the paying of dividends and interest sufficient in the articles of incorporation and bylaws to ensure no members profit or gain from membership, non-profit co-operatives could issue preferred (or special) non-voting shares at par (or face) value. These shares would pay no interest or dividends, but would still enable the capitalization of a co-operative from benevolent co-operators or investors not interested in a return on investment but in community development. This means non-profit co-ops could get capital investment from those interested in the non-profit purpose and are willing to forego any return on investment, but still want security on the principal investment. With such a capital investment, for instance in real estate, buildings, or equipment, the co-op would be in a better operating position to leverage for more debt.

Canadian legislation is not as progressive as countries like the U.K. and the U.S. that have found new hybrid economic structures that blend the social purposes of non-profits with the capacity for capitalization and 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.”^{viii}

Canadian co-operators must be aware of the full capacities of existing legislation, and should be exploring ways in which the legislation and can be used to achieve the same policy ends in promoting social enterprise and co-operative development. A start is knowing all of the options under the *Co-operatives Act* including the possibility of incorporating a non-profit and the option of achieving charitable status co-operatives, and more importantly, the advantages and disadvantages of each model. By understanding this fully, new co-operatives can make the important and key decision on organizational form at the outset.

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

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

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

^{iv} *Income Tax Act*. R.S.C. 1985, c. 1

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

^{vi} Saskatchewan Co-operatives Act, R.S.S. 1996. c. C-37-3, section 246.

^{vii} See Bridge, R. (2003) *Co-operatives and Charity Law*. Canadian Co-operative Association, BC Region

^{viii} 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.