# The Legal Context of Nonprofit Management

Chapter 5

# Defining Charitable and Nonprofit Organizations

- Both charitable and nonprofit organizations operate on a nonprofit basis in that both must devote all of their resources to their activities and neither may distribute any of their income to their members, officers, directors or trustees.

- Charitable organizations are somewhat limited in their activities but has an advantage of being able to issue charitable tax receipts.

# Defining Charitable and Nonprofit Organizations

- Charitable organizations specific purposes are limited to:
  - Relief of poverty;
  - Advancement of education;
  - Advancement of religion; and
  - Other purposes beneficial to the community not falling under any of the preceding heads.

- A registered charity may take one of three forms and is relational to its source of funds: charitable organization, public foundation or private foundation.

# Defining Charitable and Nonprofit Organizations

- A nonprofit organization is defined as a "club, society or association that…was not a charity.. An that was organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose, except profit, no part of income of which was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder."

# Defining Charitable and Nonprofit Organizations

- A nonprofit organization has the same tax-exempt status and does not pay tax on income or capital gains, the non profit organization is unable to issue charitable tax receipts and is not required to disburse a specified percentage of its earnings as a charity is required to do in accordance with its disbursement quota.

# Legal Environment

- There is a plethora of both Federal and Provincial legislation which dictate the legal environment of nonprofits and charitable organizations. Often, even the most well intentioned board members are not prepared for the potential legal, financial and practical consequences of their involvement.

# Legal Environment

- Applicable Federal and Provincial Legislation:
  - **Income Tax Act** – in addition to determining whether an organization is nonprofit or charitable, it places certain obligations upon directors of organizations, some which continues for a period after the individual ceases to be a director
  - **Canada Corporations Act** – is the statute under which all federal non-share capital corporations are incorporated.

# Legal Environment

- Competition Act – is a federal statute, the purpose of which is to encourage competition and to prohibit unfair business practices.  Provides rules to regulate fundraising activities

- Federal Lobbying Act – Lobbyist registration legislation governs the conduct of lobbyists by requiring them to register and file reports to a lobbyist to a lobbyist registration.

- Provincial Legislation – Manitoba regulates fundraising activities through the Charities Endorsement Act requiring ministerial authorization to solicit funds.

# Legal Structures for Nonprofit Organizations

- Just like a for-profit business, a nonprofit organization must determine the appropriate legal structure to meet its needs.

- When starting a nonprofit organization, the organizers must consider the following factors:

  - The objectives of the proposed organization;
  - Whether the objectives will be of short or long duration;
  - The proposed size of membership;
  - Whether the organization will be of national or local concern;
  - Whether the organization will be called upon to enter into contracts or hold real properties;
  - Whether it will incur debts or liabilities for which the contracting members or directors may be personally liable;
  - The tax treatment of the organization; and
  - Whether registration as a charity is desired because of ability to issue receipts or because funders require it.

# Legal Structures for Nonprofit Organizations

- Canadian law provides four different legal structures for nonprofit organizations;
  - A trust;
  - An unincorporated association;
  - A corporation without share capital; or a
  - Co-operative without share capital.

# Legal Structures for Nonprofit Organizations

- **Trusts** – are an attractive form of legal vehicle for charitable organizations made up of a few people, however as identified in the Income Tax Act are not available to nonprofit organizations.

- In situations where there will be a limited number of individuals wishing to aid in the administration of a nonprofit or charitable Endeavour, a trust is a useful vehicle, as involvement in the trust is limited to the trustees.

- It is generally regarded as the relationship between the settlor (the donor) and the trustee, where the trustee holds the trust property for the benefit of the of some persons or for some objectives in such a way that the real benefit of the property accrues to the beneficiaries of the trust rather than the trustee.

# Legal Structures for Nonprofit Organizations

- **Unincorporated Associations** – defined as a group of two or more persons united together by mutual consent in order to determine, deliberate and act jointly for a common purpose.

- An unincorporated association is governed by a contractual arrangement, which is commonly referred to as a "Memorandum of Association" or Constitution.

- Although the unincorporated association must included a clause stipulating similar nonprofit legal limitations, it does not have the legal capacity to sue or be sued.

# Legal Structures for Nonprofit Organizations

- Corporation without Share Capital – similar it akin to the traditional corporate structure, except that the members (similar to shareholders) do not benefit financially from the organization.

- A corporation without share capital can be incorporated federally or provincially and should be noted that incorporation is a privilege not a right and requires letters patent – as such the government exerts more control over a corporation without share capital.

- In order to become a corporations without share capital multiple persons must make an application for letters patent to the appropriate authority (varies jurisdictionally).

- Provides a greater protection from liability.

# Legal Structures for Nonprofit Organizations

- Co-operative without share capital – is intended to be operated as nearly as possible at cost. A co-operative without share capital cannot distribute any surplus or dividends to its members, unlike a co-operative with share capital.

- Must be operated and administered in accordance to basic principles set out in legislation: each member only has one vote, no proxy voting, and restrictions on conversion or dissolution of co-operative (assets can only be distributed to similar organizations).

# Legal Structures for Nonprofit Organizations

- Advantages & Disadvantages of different legal structures:
  - Nonprofit and charitable organizations are exempt from income tax;
  - Set up costs – the more complex the legal structure the more expensive;
  - Legal capacity – refers to the organization's ability to be recognized at law, whether I is a separate legal entity with the capacity to commence or defend a lawsuit, enter into contracts, or own land in its own name;
  - Liability – is dependent on the legal structure and can come in the form of failure to follow statutory rules, breach of contract, negligence, or intentional harm; and
  - Perpetual existence – all legal structures with the exception of an unincorporated association – have the ability to exist and endure with changes in membership.

# Legal Structures for Nonprofit Organizations

- National Nonprofit Corporate Structures

  - Nonprofit organizations have been slow to establish multiple nonprofit corporations – mostly focused on obtaining limited liability protection for its members – and little thought given to the benefits associated with carrying on operations within separate corporation in order to contain liabilities and protect charitable assets.

  - There are two models:
    - The national association model; or
    - The centralized chapter model.

# Legal Structures for Nonprofit Organizations

- The national association model involves multiple legal entities that are organized at various levels, such as incorporated provincial associations or incorporated local organizations.

- The national association model will have a governing body, normally established at a federal level to act as an umbrella body over its member organizations (corporations or incorporated associations)

# Legal Structures for Nonprofit Organizations

- Centralized Chapter Model involves one legal entity acting as a single nonprofit organization across Canada, normally involving multiple divisions at either the provincial, regional or local level.

- Associated agreements are referred to as a "chapter agreement", an "affiliation agreement" or "membership agreement". The agreement sets out the contractual relationship between the governing association and its member organizations.

# Registered Charities Under the Income Tax Act

- Types of Registered Charities:

- A charitable organization on which devotes all of its resources to charitable activities carried on by the organization itself.

- A Charitable foundation is an entity which is created and operated exclusively for charitable purposes, which they be either  a public foundation or private foundation.  They may carry on a limited number of charitable activities – they generally provide funds to other charitable organizations so as those organizations may carry out their charitable activities.

# Registered Charities Under the Income Tax Act

- Specific rules affecting registered charities:

- **Relationships between Directors/Trustees and Control**
  - More than 50% of the directors/trustees of charitable organizations and public foundations must deal with each other and with each of the other directors/trustees at arms length.
  - Not more that 50% of the capital contributed or otherwise paid to a charitable organization or public foundation be contributed by one person or member of a group of such persons who do not deal with each other at arms length, save and except some organizations(governments) .
  - This is the control test.

# Registered Charities Under the Income Tax Act

- Specific rules affecting registered charities:

- **Disbursement Quota Rules**
  - All registered charities are required to annually expend a portion of their assets in accordance with a disbursement quota, which is a prescribed amount that registered charities must disburse each year in order to maintain their charitable registration.

  - The purpose is to ensure that most of a charity's funds are used to further its charitable purposes and activities; to discourage charities from accumulating excessive funds; and to keep other expenses at a reasonable level.

  - Registered charities must disburse 80% of funds which is aimed at limiting administration expenses and 3.5% asset disbursement aimed at prevention accumulation of funds.

# Registered Charities Under the Income Tax Act

- Specific rules affecting registered charities:

- **Related Business**
  - Charitable organization and public foundations can carry on related businesses – however if they carry on unrelated business can have their charitable status revoked.

- **Charitable Activities**
  - Charitable organizations are to primarily carry  on their own charitable activities and my give funds to other qualified donees but must not disburse more than 50% of their income annually

  - Whereas public foundation must disburse over 50% of their income annually.

  - The ITA is ambiguous on the disbursement  quota of over 50% for private foundations.

# Registered Charities Under the Income Tax Act

- Specific rules affecting registered charities:

- **Borrowing**
  - Public and private foundations are prohibited from incurring debts other than debts for current operating expenses, the purchase and sales of investments or the administration of the charitable activities – these do not apply to charitable organizations.

- **Control of Other Corporations**
  - Public and private foundations cannot acquire control of any corporation, generally control occurs when the foundation owns 50% or more of a corporation's issued share capital, having full voting rights under all circumstances. (exception where a foundation has not bought more than 5% of these shares and is given a bloc of shares that brings up its total holder to more than 50%.

  - Charitable organizations have no restrictions.

# Registered Charities Under the Income Tax Act

- New Regulatory Regime:

- Interim Sanctions
  - Revocations occurred sometimes inadvertently as a result of a failure by the charity to file and information return or because the charity was being discontinued and in some cases there were serious infractions.

  - To provide an alternative to the revocations of charitable status for minor or unintended infractions, the ITA now provides for intermediate sanctions

# Registered Charities Under the Income Tax Act

- New Regulatory Regime:

- Appeals Process
  - The appeals regime is intended to make the appeal process more accessible for registered charities and unsuccessful applicants for charitable status by extending existing internal objection review process to notices of decisions by CRA, revocations or annulment, the denial of applications, suspensions, or the imposition of monetary penalties through the filing of a notice of objection to commence an appeal process.

# Registered Charities Under the Income Tax Act

- New Regulatory Regime:

- Fundraising Policy
  - The CRA fundraising policy explains how to distinguish between fundraising and charitable activities and provides guidance concerning the amount of expenses that may be expended on fundraising activities compared to resulting revenue from such fundraising endeavors.

# Risk Management and Liability

- The exposure of charities and non profits to liability goes further than the loss of assets and/or the insolvency or winding up of a charity or non profit.

- Directors may also personally face legal actions against themselves by donors, embers, third parties and governmental authorities for breach of their fiduciary duties or even breach of trust in failing to adequately protect or apply the assets of a charity or nonprofit.

# Risk Management and Liability

- Risk is defined as the change of injury, damage or loss
- Risk management is defined as the procedures or systems used to minimize accidental losses.
- Although risk cannot be completely eliminated, but can be managed through conscientious and careful planning and organization.

# Risk Management and Liability

- Considerations for risk management include:
  - **Choice of nonprofit or charitable structure** – depending on the choice of legal structure, risk and liability will rest with different parties (as discussed earlier in legal structure for nonprofit organizations).
  - **Standard of care** – is a legal concept referring to the degree of care expected on an individual in relation to a duty to other individuals.

# Risk Management and Liability

- Considerations for risk management include:
  - **Vicarious Liability**– imposes liability upon and employer or principal for the conduct of an employee or agent, on the grounds that the employer or principal should be held accountable for losses o third parties that arise from the actions of the employee or agent.
  - **Anti-terrorism Legislation Compliance** – identified as a critical week point in money laundering and terrorist financing initiatives in the international community, increasing scrutiny by government on nonprofit organizations that engage in raising or disbursing funds for charitable, religious, cultural, educational, social or fraternal purposes may be misused or exploited by the financiers of terrorism with or without the knowledge of the donor or directors of the organization.

# Risk Management and Liability

- Considerations for risk management include:
  - **Role and Duties of Directors and Officers**– although the roles and duties of Directors and Officers form the basis for the nonprofit organization's by-laws, Directors and Officers must demonstrate they manage the affairs of the organization in accordance with the governing legislation and ensure they manage the fiduciary duties including:
    - a duty to act honestly;
    - a duty of loyalty;
    - a duty of diligence or to act in good faith;
    - a duty to exercise power;
    - a duty of obedience;
    - a duty to avoid conflict of interest;
    - a duty of prudence; and
    - a duty to continue.

# Risk Management and Liability

- Considerations for risk management include:
  - **Liability of Directors and Officers**– Manitoba has codified an objective standard of care which has set the standard of care as “conduct that may reasonably be expected from a person of such knowledge and experience as the identified director”
  - Good governance is the responsibility of directors and includes such principles as participation in decision making; accountability and transparency; responsive, effective, efficient performance; and sound rule of law.

# Risk Management and Liability

- Considerations for risk management include:
  - **Rights and Powers**– Directors have the right to unimpaired access to all resources of the corporation in order to effectively perform their duties and the power to manage the affairs of the corporations.
  - **Statutory Protection** – the only two forms of statutory protection for Directors are in respect to:
    - Contacts with third parties – Directors will not be liable to those parties so long as they are acting within the scope of their authority as agents to the corporation; and
    - Conflict of interest – the liability is managed as long as the Director does not benefit or participate in discussions or decisions to benefit from the activities of the organization.

# Risk Management and Liability

- Other Means of Reducing Risks:

- **Indemnifications, Insurance and Risk Transfer:**
  - Indemnifications is the process by which the corporation agrees to cover the cost of , or compensate the director for, any loss or damage sustained as a result of the acts or omissions of the director in their capacity as a director of the organization.

  - Insurance is a safety net and should include general liability insurance, directors and officers liability insurance providing protection in relation to acts or omissions and any activities conducted under the auspices of the Board of Directors.

  - Risk Transfer is the development and administration of effective liability shields in the form of informed consents, disclaimers, releases, waivers and indemnities for program participants as necessary.

# Risk Management and Liability

- Other Means of Reducing Risks:

- **Due Diligence in Operations** – Directors must exercise due diligence to protect themselves and the organization. Due Diligence includes utilizing the rights and powers of the director and seeking professional advice when necessary.

- **Legal Risk Management Committees** – reducing risk is through establishing legal risk management committees to conduct the reviews of the organization's policies, activities and associations and identify risk areas.

- **Crisis Management Committees** – focus their work on events and circumstances that have the potential to completely disrupt and organization operations. They assess risk, develop a crisis management and business continuity procedures and plan.

# Risk Management and Liability

- Other Means of Reducing Risks:
- **Independent Legal Advice**– Directors should obtain independent legal advice in situations where they may be facing a high degree of exposure to personal liability
- **Size of the Board** – Careful consideration should be given to the appropriate number of directors required to effectively operate the nonprofit corporation.
- **Transfer of Assets**– In circumstances where the organization participates in high risk activities, it may be advisable for the director to transfer his or her personal assets to his or her spouse <u>in advance</u> of jointing the Board in order to aid in shielding the assets in the event of a finding of liability.
- **Checklists** – use of a checklist in order to ensure the nonprofit corporation has complied with all legal requirements is an effective tool in any organizations risk management strategy. (a sample legal risk management checklist for charities is available at http://www.charitylaw.ca)