



WHICH LEGAL STRUCTURE IS RIGHT FOR MY SOCIAL ENTERPRISE?

A GUIDE TO ESTABLISHING A SOCIAL ENTERPRISE IN ENGLAND AND WALES

APRIL 2012

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MORRISON FOERSTER

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LEGAL DISCLAIMER

The contents of this Guide are for information purposes and to provide an overview only. This Guide does not provide legal information on all corporate forms available and is current as at 30 April 2012 only. Although we hope and believe the handbook will be helpful as background material, we cannot warrant that it is accurate or complete, particularly **as circumstances change after publication**. Moreover, the Guide is general in nature and may not apply to particular factual or legal circumstances. This Guide is intended to convey only general information, therefore it may not be applicable in all situations and should not be relied or acted upon as legal advice. This Guide does not constitute legal advice and should not be relied on as such. Readers seeking to act upon any of the information contained in this Guide are urged to seek individual advice from legal counsel in relation to their specific circumstances.

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FOREWORD

The Thomson Reuters Foundation launched TrustLaw in July 2010. Our goal: to spread the practice of pro bono worldwide and empower people with trusted information. At the centre of TrustLaw is TrustLaw Connect, a global marketplace connecting NGOs and social enterprises with lawyers willing to work at no cost.

It was a priority for us from day one to support all sorts of organisations, including the very innovative ones trying new recipes to address key social and environmental challenges. Social enterprises are increasingly tackling the social issues which, until recently, have almost exclusively been under the remit of government and traditional charities. As the lines between ‘doing good’ and running a commercial business continue to blur, new and innovative ways of structuring social enterprises are appearing.

How an organisation is legally structured can greatly influence the types of capital available to it and how the organisation can operate and grow in the coming years. Whether you are just beginning to formulate your idea of how to change the world or are already working in an established social enterprise, this Guide will give you a good overview of the various legal structures available to you and includes a decision tree to help guide your way.

Renowned for their innovative and business-minded approach, we could not think of a better law firm to produce this Guide than Morrison & Foerster (UK) LLP. For those who discover that registering as a charity is the way forward, we refer you to the **‘I want to run a charity, where do I start?: A guide to establishing a charity in England and Wales’**, which was also produced by Morrison & Foerster (UK) LLP, to complement this Guide.

Although this research is comprehensive, you may still need a lawyer to complete the actual registering, structuring or restructuring of your organisation, but we hope this Guide will help you navigate the myriad structures available to social enterprises in England and Wales.

A handwritten signature in dark ink, reading "M. Villa". The signature is fluid and cursive, with a horizontal line underneath the name.

— **MONIQUE VILLA**, CEO, Thomson Reuters Foundation

INTRODUCTION

This Guide is intended to help social entrepreneurs navigate through the vast array of legal structures that are available for them in England and Wales.

The burgeoning field of social enterprise and the rise of impact investing have moved well beyond the dichotomy of for-profit and not-for-profit legal structures.

Generating revenue (and sometimes profit) from their enterprises is, for many entrepreneurs, a key driver, ensuring financial sustainability and avoiding the need to rely on charitable donations or grants. Others, however, may choose to pursue donations and grants as their primary funding source. The legal structure the social enterprises assume will have a significant impact on the sources of funding available to them.

Many social enterprises would not have access to the capital they need if they had to rely solely on donations. Financing options available to traditional charities or NGOs from foundations, individual donors or government agencies can be too small, risk-averse or inflexible to meet the needs of many social-purpose organisations. For those social enterprises whose strategy for social change requires a large upfront investment, for example to fund research and development or to manufacture and distribute a product or service, often the best way to access that capital is through a loan (debt) or equity investment.

The flexibility to obtain debt or equity investment may benefit a wide range of businesses, from a small social enterprise seeking “seed” capital to start up its business to a larger, growing organisation seeking to arrange debt funding for an infrastructure project. This sort of investment may not be open to all legal structures.

The ability to access larger or different sources of capital is likely to have a knock-on effect on the ability of social enterprises to scale up their operations.

As enterprises innovate and develop new hybrid corporate forms to meet their varied strategic needs, the marketplace becomes open to new legal structures and the choices for new social entrepreneurs becomes increasingly complicated and difficult to understand, particularly for the non-lawyers among us.

There are other considerations which will determine the right legal structure for a social enterprise as well, including set up costs, the size of the social enterprise and whether it trades or employs people. This Guide is designed to clarify the existing options for setting up a social enterprise in England and Wales and the important strategic considerations for enterprises to achieve near and long term sustainability and impact.

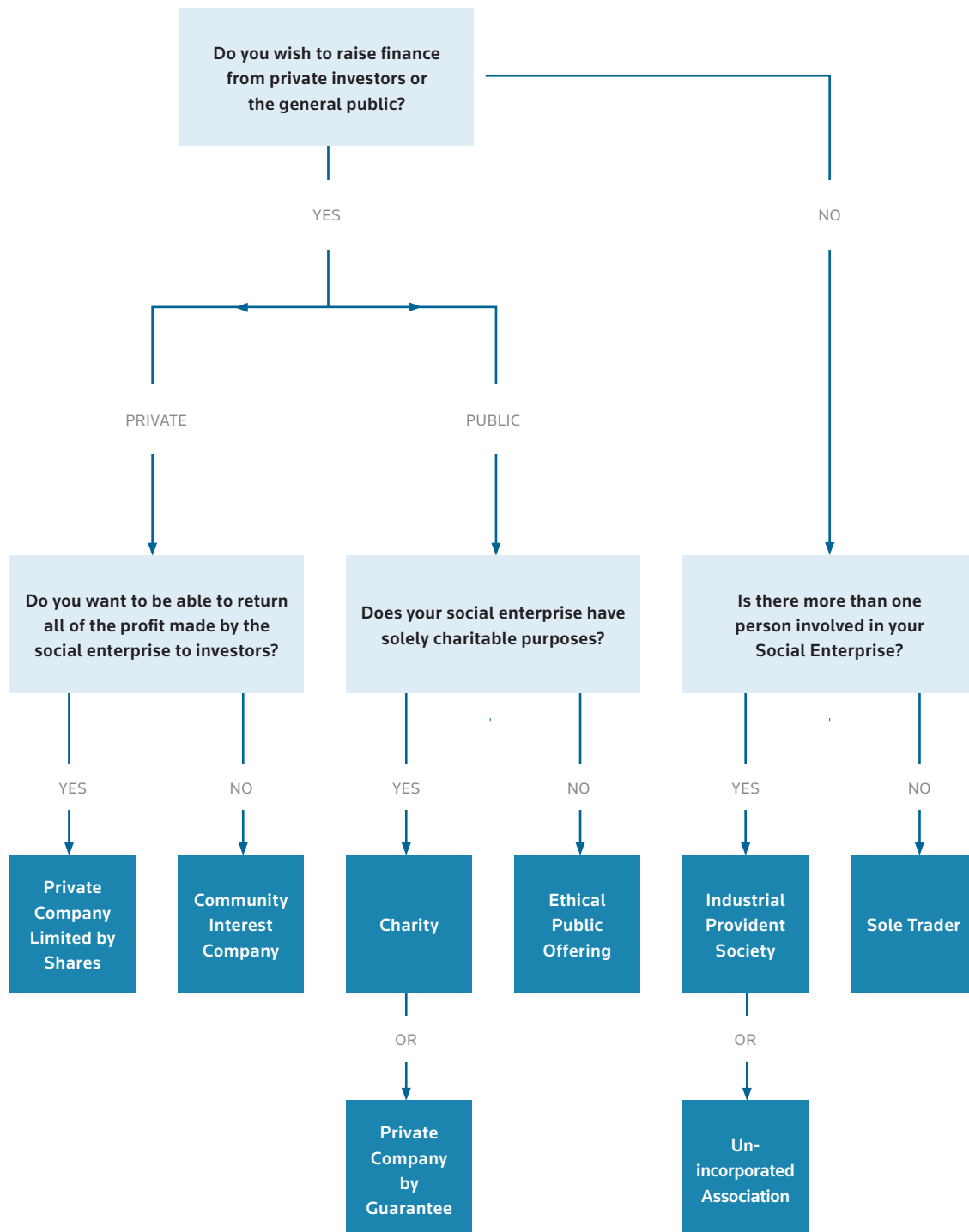
The Guide

At the beginning of this Guide, we have included a helpful decision tree and overview of the various structures which should assist in choosing the most appropriate structures for the social enterprise. We suggest that social enterprises

considering which structure or structures might be most suitable for them, begin with this decision tree and then turn to the full description of each of the corporate forms contained in **Parts 2 to 4** of the Guide. We have arranged the structures in order of complexity, from the simplest type of structure through to the more complex structures, including those that have been designed specifically for social enterprises. Each description contains a list of the main advantages and disadvantages, together with relevant case studies and details about liabilities, tax treatment, ongoing regulatory obligations and possible implications for finances and fundraising.

Please note that charities are not covered in this Guide but are covered in the separate Guide entitled **‘I want to run a charity, where do I start?: A guide to establishing a charity in England and Wales’** also drafted by Morrison & Foerster (UK) LLP. Charities are a legal structure often used by social enterprises due to their tax benefits. They are, however, subject to extensive regulation as they are governed not only by the Companies Act 2006 (the ‘Companies Act’), but also the Charities Act 2006 and the Finance Act 2010 and are regulated by the Charities Commission. In determining which type of legal structure is right for a social enterprise, we suggest that both guides are read in conjunction to get a full understanding of the structures available and which is likely to be best suited in the circumstances.

1 WHICH TYPE OF SOCIAL ENTERPRISE IS RIGHT FOR ME?



2 LEGAL STRUCTURES AVAILABLE TO ALL ENTERPRISES, INCLUDING FOR-PROFIT ENTERPRISES

2.1 SOLE TRADER

Key advantages / disadvantages

ADVANTAGES

- Easy to start up: low or no start-up costs and no registration required
- No reporting requirements: information is not made publicly available
- No reporting requirements for accounts

DISADVANTAGES

- No limited liability for the individual, therefore they are responsible for the debts and obligations of their business
- Risk of losing 'goodwill' in business name as the business name is not registered at Companies House
- Difficulty/expense of raising finance

Case study

GIVEMETAP ('GMT')

GiveMeTap aims to make clean water easily accessible to every human in the world. Its founder, Edwin Broni-Mensah, came up with an idea whereby, for the price of one of GMT's specially branded reusable aluminium drink bottles, people could access a network of cafes, restaurants and shops in various cities around the world who have agreed to provide tap water, free of charge ('taps'). This has a two-fold impact: firstly a reduction in the number of plastic bottles that are used, and secondly 70% of profits from the sale of the bottles is used to help

others in need by funding various water projects in Africa, such as the All4One Namibia Water Project.

GMT was set up by Edwin whilst he was at university, and as the sole person working full time on the project, the business was initially set up as a sole trader. However, due to GMT's phenomenal success – there are currently more than 100 'taps' in the network, in both the UK and the Netherlands, with plans to expand into other countries, an iPhone app that helps you locate your nearest 'tap', and a string of awards for both Edwin and GMT, the business is now in a position where incorporation is the next step. This will enable GMT to enter into contracts, employ staff and raise finance more easily.

For more information, visit <http://www.givemetap.co.uk>.

(a) Overview

As the name suggests, the common characteristic of a sole trader is one person carrying on a business on their own, with complete control over its operations. This means that generally sole trader businesses are very small in scale, with low turnovers, and few (if any) employees.

Being a sole trader is one of the simplest ways to run a business. It does not involve paying any registration fees, there are no reporting requirements for accounts so the sole trader can decide how sophisticated these will be (subject to HMRC's requirement that proper records are maintained and kept for a certain period) and all profits generated by the business are retained by the sole trader.

Most businesses start life as a sole trader and many remain that way. According to the Department of Business Innovation & Skills (**BIS**), there were an estimated 4.5 million private sector businesses operating in 2011, and almost two thirds of these were sole traders.¹ However, where a business evolves and expands to the point where operating as a sole trader is no longer feasible or practical, the sole trader will need to consider one of the other corporate forms available for business ownership. If choosing at the outset between forming a company and running your business as a sole trader, you will need to carefully weigh (i) the cost of establishing and administering a company and (ii) the benefits inherent in company structures, such as limited liability, which are discussed in section **Liabilities** in the section relating to private companies

¹ BIS Business Population Estimates for the UK and Regions 2001, Statistical Release dated 12 October 2011.

limited by guarantee and section **Liabilities** in the section relating to private companies limited by shares.

(b) Establishment costs and documentation

Unlike companies, sole traders are not required to register their business with Companies House and there are no establishment costs. Sole traders can simply start trading or carrying out their business activities immediately.

However, a disadvantage to non-registration is that sole traders are not able to register their business name with Companies House. Therefore they run the risk that their business name may be registered by another entity and any goodwill built up in that name would be lost. Further, it is not possible to 'reserve' names at Companies House, therefore, there is no easy way to protect the name of a sole trader.

It should be noted that in the absence of protection by way of a company name registered at Companies House, a sole trader may wish to consider trade marking or protecting the copyright of any names/logos used in the business. This can, however, be expensive and in these circumstances the sole trader should obtain specific legal advice.

(c) Liabilities

Sole traders do not have limited liability, therefore they are personally liable for all of the debts and obligations of their business. This means that a sole trader's house and other personal assets can be seized to satisfy business debts. This is one of the biggest disadvantages of operating as a sole trader in comparison to corporate forms which offer limited liability, such as a private limited company. Please see section **Liabilities** in the section relating to private companies limited by guarantee and section **Liabilities** in the section relating to private companies limited by shares for more information on limited liability.

(d) Tax treatment

Sole traders must register as self-employed with HMRC within three months of starting operations or face a penalty (currently £100). The three months' time limit begins from the last day of the first month of trading. As sole traders are self-employed, profits are taxed as personal income and should be included in the sole trader's personal self-assessment tax return each year.

Sole traders are also subject to VAT. If taxable supplies made in the previous 12 calendar months exceed the threshold for registration (currently £77,000), then the sole trader must register for VAT. If the sole trader's taxable supplies are below the threshold, they may nevertheless voluntarily register for VAT.

Sole traders can also take on employees and therefore be responsible for deducting income tax from salaries paid to employees and accounting to HMRC for both employer's and employee's national insurance contributions. However, if you are considering doing either of these, then you should also consider whether converting to a limited company at that time would be more appropriate for your business. A limited company is more suited to dealing with more complex tax arrangements, as well as giving the entrepreneur the benefit of limited liability. This means that the entrepreneur's liability for the debts of the limited company will be limited to their investment in the company, that is, the amount paid for any shares/guarantee.

For further information on the taxation of sole traders, please visit:

<http://www.hmrc.gov.uk/selfemployed/register-selfemp.htm>

Individuals who sell qualifying assets may be eligible to claim entrepreneurs' relief on the disposal proceeds, which has the effect of applying a reduced rate of capital gains tax (currently 10%) to the qualifying gains.² Where a sole trader disposes of the whole or part of his or her business 'as a going concern', that is, all of the business assets are acquired by a third party who intends to use those assets in the continuation of that business, the sole trader may qualify for the relief on the capital gains made.³ You should seek further tax advice if you believe you might qualify for the relief.

(e) Ongoing governance and regulatory obligations

One of the main advantages of being a sole trader is that the administrative requirements are less burdensome than other structures, such as a private limited company for example. In particular, the business of the sole trader is not required to file an annual return, annual accounts or a self-assessment corporation tax return. However, this does not mean that the sole trader does not have to keep any records; it is still responsible for reporting profits to HMRC and therefore must ensure that complete and proper records are kept.

² Currently applies to a lifetime limit of £10m of qualifying capital gains. Please see Chapter 3 of Part 5 of the Taxation of Chargeable Gains Act 1992.

³ The sole trader must own the business for the period of one year ending with the date of disposal.

(f) Corporate structure

Unlike limited companies, sole traders are not treated as separate legal entities and therefore the business does not have a separate legal personality from the sole trader. In other words, the sole trader is the business. This means that because it is not a separate legal entity, the sole trader is liable for the liabilities of the business. Consequently, entry into contracts and applications for debt must be made in the name of the sole trader rather than a corporate entity.

(g) Finance and fundraising

Financing opportunities for sole traders are limited. Generally, sole traders raise money for the business out of their own assets and/or through loans from banks or other lenders (often using their personal assets as security or giving personal guarantees). Sole traders may also seek funding from friends and family, normally through small informal loans.

Consequently, it is generally more difficult and/or more expensive for sole traders to borrow money and to obtain investment in their business. Particularly in relation to investments, sole traders do not have shares which can be issued to investors, and investors will generally be wary about parting with cash in favour of an individual rather than some other type of legal structure.

(h) Resources

For more information, visit:

<http://www.bis.gov.uk/>

<http://www.companieshouse.gov.uk/>

<http://www.hmrc.gov.uk/>

2.2 UNINCORPORATED ASSOCIATION

Key advantages / disadvantages

ADVANTAGES

- Easy to set up and low establishment costs
- Relatively straightforward to run, administrative requirements are low
- Can have more than one person involved in the day-to-day running of the business

DISADVANTAGES

- No separate legal identity from the individual, so no limited liability for entrepreneur
- Not suitable for raising significant amounts of external finance
- Generally not appropriate for organisations who intend to trade or earn significant revenue from their activities

Case study

A PRO BONO LEGAL AID SOCIETY (FICTIONAL CASE STUDY)

Unincorporated associations are rarely used for pure social business purposes and are more suited to sports clubs and literary associations. We have provided the illustration below to show how an unincorporated association might be used by a social entrepreneur if they decided that this was the most appropriate structure for them.

A group of university law students decided that they would like to provide legal services pro bono to the local community, particularly for those people from low income families. The students approached their university for some initial funding, and agreed to each contribute a nominal amount for 'membership' into the pro bono society.

The students decided that the society should be independent of the university, and that it should be run for the benefit of its members. Any member of the current law undergraduate and post graduate class would be eligible to become a member, provided that they paid the

membership fee and were subject to the rules.

A president, vice president, treasury and secretary would be appointed by the members for each year. As the society would be run by the students, administrative duties and costs needed to be kept to a minimum.

On this basis, the most appropriate structure for the society is an unincorporated association. Not only is this a simple structure for a group of students to operate, because the society would not be entering into contracts or employing people, there would be little point in using an incorporated entity.

(a) Overview

Unincorporated associations are one of the most commonly used vehicles in the voluntary sector. It is essentially one or more persons ('members') who have a common purpose, and who have agreed to regulate that relationship by contract.

The unincorporated association form is generally chosen where, for various reasons, the members do not wish to create a separate legal vehicle to carry out activities to further that common purpose.

Being 'unincorporated' simply means that the founding members have not formed the group as a company under the relevant legislation.⁴ Common examples of such associations include local sports clubs, investment clubs, residents' associations and voluntary organisations.

Unincorporated associations may have trading or business objectives, carry on commercial activities or have a charitable purpose. If an unincorporated association's purpose is exclusively charitable and for the public benefit, and it has the minimum amount of funding required pursuant to the Charity Commission's rules (currently £5,000)⁵, then it may wish to consider applying to the Charity Commission to be registered as a charity. Please see the **Charities Guide** for further information.

⁴ The Companies Act applies to all entities incorporated as companies.

⁵ The Charities Commission will require evidence of a minimum funding of £5,000 to register a charity. Please see http://www.charitycommission.gov.uk/Start_up_a_charity/Set_up/Things_to_think_about.aspx and the Charities Guide for further information.

Unincorporated associations with charitable purposes can also be friendly societies.⁶ The governing rules for friendly societies are prescribed by statute⁷, and allow friendly societies to do things such as borrow and loan money, make investments, bring legal proceedings in their own name and hold property (via the trustees) that ordinary unincorporated associations cannot do. A friendly society aims to assist its members, usually via financial assistance or the provision of insurance⁸, during times of sickness, unemployment or at retirement. All friendly societies must be registered with the FSA⁹, which keeps records of filings, memorandums and rules for each of the friendly societies.

The registration forms are available at:

http://www.fsa.gov.uk/smallfirms/your_firm_type/friendly/registration.shtml

Unincorporated associations which have literary or scientific interests and wish to change the objectives set out in its constitution may require the consent of the Department of Trade and Industry.¹⁰

(b) Establishment costs

Like sole traders, unincorporated associations are relatively straightforward to run, and cost nothing to set up. The members enter into a contract with each other (known as its 'constitution' or 'rules') setting out how the unincorporated association will be run. The rules can be adapted to cover a wide range of issues that the unincorporated association may wish to make provision for, and can elect a management committee to run the organisation on behalf of its members.

(c) Liabilities

Like sole traders, unincorporated associations are not treated as separate legal entities, therefore its members will be personally liable for the debts of the association. When dealing with third parties, membership of the unincorporated associations will afford no protection to the member. For this reason, much in

6 Unincorporated associations must now register as a friendly society under the Industrial and Provident Societies Act 1965 (as amended), although unincorporated associations registered before 1992 may still be regulated by the Friendly Societies Act 1992. Incorporated entities can also be friendly societies.

7 The Friendly Societies Act 1992 or the Industrial and Provident Societies Act 1965 (as amended).

8 Often the friendly society will provide life insurance, that is, insurance of a long-term nature but can also provide general insurance as long as it is in relation to accidents, sickness or miscellaneous financial loss. Insurance will be provided to the members of the friendly society or to persons connected with their members. Friendly societies providing insurance products also require FSA authorisation under the Financial Services and Markets Act 2000 (as amended).

9 Under the Financial Services and Markets Act 2000 (as amended).

10 Under the Literary and Scientific Institutions Act 1854.

the same way as sole traders, unincorporated associations are less desirable than a corporate form which has a separate legal identity. Therefore, if you intend to employ staff, raise finance through issuing shares or enter into substantial contracts/acquire property, and require protection from liability, an incorporated vehicle is likely to be more suitable for your business.

Unincorporated associations that do decide to hold property for the benefit of its members, such as the pro bono society in our case study, can do so in one of four ways. Property is either held by:

- (i) all the members;
- (ii) some of the members on trust for the benefit of all of the members;
- (iii) some of the members as trustees for the purpose of the association; or
- (iv) all of the members, subject to the rules as set out in the association's constitution (articles of association).

(d) Tax treatment

Generally, only companies are liable to corporation tax on their taxable profits. However, some members' clubs, associations, societies, Community Amateur Sports Clubs (**CASCs**) and other unincorporated organisations may also be liable for corporation tax. If the association is also a charity, it will not be liable to corporation tax. Please see the **Charities Guide** for further information.

Where subject to corporation tax, members' clubs, associations, societies and other unincorporated associations are generally subject to the same corporation tax deadlines and requirements as other corporate entities. HMRC may, however, treat some of these organisations with very small tax liabilities as dormant for corporation tax purposes. To qualify, the organisation's annual corporation tax liability must not be expected to exceed £100, and the organisation must be run exclusively for the benefit of its members. Note, however, that some types of unincorporated organisations will not be covered by this exemption and you should seek specialist tax advice on this issue.

CASCs are sports clubs that need to be registered with HMRC. CASCs are liable for corporation tax on their profits but may qualify for tax relief. Additionally, some CASC activities are exempt from corporation tax, provided that the income and/or gains generated by the CASC are used only for a 'qualifying purpose'. Generally a qualifying purpose is providing facilities for eligible sports and encouraging people to take part in them. If a CASC is liable for corporation tax then it is normally subject to corporation tax deadlines and requirements.

All unincorporated associations making taxable supplies to its members will also be subject to VAT in the same way as sole traders. Please see section **Tax treatment** in the section relating to sole traders for further information. It is important to note that any subscription fees payable in exchange for membership is a taxable supply. There are specific instances where an unincorporated association will be exempt from VAT. You should consult your tax adviser for advice on your specific business.

(e) Ongoing governance and regulatory obligations

As in the case of sole traders, unincorporated associations are not required to register with any regulatory body such as Companies House. Therefore, they do not have any ongoing governance or regulatory obligations, other than to keep full and proper records as required by HMRC. Consequently, unincorporated associations are often considered more flexible and less restrictive than companies with respect to governance and regulatory obligations.

(f) Corporate structure

As in the case of sole traders, unincorporated associations do not have legal identities separate from that of its members. This means that an unincorporated association cannot enter into agreements in its own name (its members must sign all contracts and apply for bank loans, etc). However, an unincorporated association may set up and hold a bank account in its own name.

(g) Finance and fundraising

The main source of funding for unincorporated associations is membership fees, which can be a considerable amount, especially for sports clubs and unincorporated associations with a large membership base. Members can also gift property or money to unincorporated associations. Please see the **Charities Guide** for Gift Aid implications for charitable unincorporated associations.

In addition, unincorporated associations, in much the same way as sole traders, can also raise money for the business out of the personal assets of the members. It may be that following establishment, the unincorporated association makes sufficient trading profit and does not require members to continue to fund it. However, it is often more difficult for unincorporated associations (when compared with private limited companies) to borrow money¹¹ and to obtain investment in their businesses. The members must enter into any loan agreements personally, and in most cases will be required to give personal guarantees. In addition, as unincorporated associations do not have shares,

¹¹ Note: the constitution or rules must expressly state that the unincorporated association has the power to borrow money (this does not apply to literary and scientific institutions, which have an implied power under the Literary and Scientific Institutions Act 1854).

they cannot issue shares in exchange for capital in the same way as a company limited by shares can.

However, unincorporated associations which hold property can use such property as security to raise finance. This is normally done by charging the property (i.e. a mortgage) to the trustees of the unincorporated association and limiting the repayment to the amount of funds held by the association (thus protecting its members from having to repay the mortgage personally). This will only be an option where the unincorporated association owns property outright.

Alternate sources of funding such as government grants or funds may also be available to unincorporated associations, such as grants from the Arts Council. You should check the individual criteria for any grants or funding that you think might be available to your business.

(h) Resources

For more information, visit:

<http://www.bis.gov.uk/>

<http://www.companieshouse.gov.uk/>

<http://www.hmrc.gov.uk/>

<http://www.artscouncil.org.uk/funding/standard-conditions-for-grants/>

2.3 INDUSTRIAL AND PROVIDENT SOCIETY (“IPS”)

Key advantages / disadvantages

ADVANTAGES

- Flexible: can be run for the mutual benefit of its members and any surplus used to further services for its members, or be run for the benefit of the community as a whole
- Cheaper and easier to administer than other company forms
- Share and loan interest receives more favourable tax treatment than companies

DISADVANTAGES

- Structure is very similar to a private company, therefore, if operated for the benefit of the community the IPS must have ‘special’ characteristics to justify use
- Must register with the Financial Services Authority and comply with ongoing reporting requirements
- Maximum shareholding is £20,000 per investor

Case study

THE PEOPLE'S SUPERMARKET

The People's Supermarket is a not-for-profit, co-operative food store that is community focused, owned and managed by its members, and provides healthy, local food at reasonable prices to the local community. It is committed to offering lower prices by reinvesting the profits back into the store.

Its aim is to provide good-quality food, especially fresh produce, at affordable prices to all. To that end, it sources as many lines as possible from within the UK as well as from British growers. It also aims to minimise food wastage by creating dishes from food coming up to its sell-by date, and by composting all other waste material.

For more information, visit <http://www.thepeoplessupermarket.org>.

(a) Overview

An IPS is similar to an unincorporated association in that it is a collection of individuals ('members') who have a common purpose, which can be business, trade or for the benefit of the community. However, an IPS is a structure incorporated under statute¹², and therefore must be registered and comply with ongoing compliance obligations.

IPSs are bodies corporate governed by statute and currently must be registered with the Financial Services Authority (**FSA**).¹³ They may, in general, operate any business or activity in the UK, except carrying out investment business for profit. This would require separate FSA regulation.

12 Old IPSs were registered under the Industrial and Provident Societies Act 1965 (as amended).

13 The Financial Services Authority will soon to cease to exist. The government's aim is to implement the Financial Services Bill by the end of 2012. As a result, the FSA will be split into three separate bodies:

- the Financial Policy Committee ('FPC'), whose objective will be to help the Bank of England with its financial stability objective under the Banking Act 2009. The aim is for the FPC to act in relation to the UK's financial system as a whole, i.e., on a wide scale and not specific to any particular firm;
- the Prudential Regulation Authority ('PRA'), whose objective will be to regulate the conduct of specific firms such as banks and investment firms; and
- the Financial Conduct Authority ('FCA'), which will inherit much of the FSA's existing functions, including regulating firms not regulated by the PRA. The FCA will become responsible for regulating IPSs.

IPSs do not need to be registered under the companies legislation and newly incorporated IPSs must be registered with the FSA¹⁴ on either one of two bases:

- (i) for the benefit of its members: the IPS is run as a co-operative for the mutual benefit of its members, with any surplus being utilised to provide better services for its members; or
- (ii) for the benefit of the community: the IPS operates for the benefit of the community at large.

One of the key features of an IPS is the set of restrictions on the distribution of profits. Where the IPS is run for the benefit of its members, profits may be distributed (if permitted by the IPS' rules). However profit distribution is not permitted in an IPS run for the benefit of the community, in such circumstances all profits must be retained by the IPS.

As an IPS is similar to a private company in terms of structure and characteristics, if the IPS is to operate for the benefit of the community, it must be able to demonstrate some special reason to organise as an IPS rather than as a private company. Situations where an IPS would be more suitable include, for example, where the members decide that the profits of the IPS should be used to further the IPS' objectives, rather than be distributed to the members; or where the members require each member to only have one vote regardless of the number of shares owned.

As in the case of unincorporated associations, IPSs are also governed by a set of rules created by the members. A management committee is normally appointed to run the IPS; however, it is considered to have a separate legal identity and therefore can enter into agreements and obtain loans in its own name.

IPSs cannot be charitable, except in limited circumstances. Common examples of IPSs are consumer, agricultural and housing co-operatives, Women's Institutes, mutual investment companies and housing associations. Please see section **Overview** in the section relating to unincorporated associations for further information.

(b) Establishment costs and documentation

Although IPSs require registration with the FSA, they are relatively simple and inexpensive to incorporate (depending on the complexity of the governing rules). 'Model Rules' have been created and are available on the FSA's website free of charge. If adopted in their entirety, the registration fee is currently £40. Registration fees increase on a sliding scale up to £950 where there are 11 or more amendments to the Model Rules.

¹⁴ As required by the Co-operative and Community Benefit Societies and Credit Unions Act 2010 (formerly the Industrial and Provident Societies Act 1965 (as amended) until its renaming in 2010), which reflects certain aspects of the Companies Act.

Applicants must complete a Form A, which provides information about the first members and directors of the IPS. For information regarding establishment and access to registration forms and notes, please visit:

http://www.fsa.gov.uk/pages/doing/small_firms/msr/societies/index.shtml

(c) Liabilities

As stated above, IPSs are treated as having a separate legal identity, therefore the IPS is responsible for its own debts and liabilities. However, the limited liability nature of an IPS will not protect members in all situations. Similar to the position for directors under company law¹⁵, any member who acts negligently, improperly, or does not fulfil their obligations under statute¹⁶ can be held responsible for the liabilities of the IPS. Members may also be held liable for the debts and obligations of the IPS in certain circumstances for example, where they are guilty of fraudulent or wrongful trading.

(d) Tax treatment

IPSs are considered corporate bodies and therefore are taxed in the same manner as companies and are subject to corporation tax on their profits in the normal way. The full rate of corporation tax is currently (at the time of writing) 24%, and will be reduced to 23% from 1 April 2013. The small companies' rate of corporation tax applies to companies with profits up to £300,000. The rate is currently 20%. An IPS will need to consider whether VAT registration is required. Generally, if taxable supplies made in the previous 12 calendar months exceed the threshold for registration, then the IPS must register. The registration threshold is currently £77,000.

An IPS that employs individuals is required to operate a PAYE system, under which the IPS must deduct from its employees' pay, the appropriate amount of income tax and national insurance contributions (**NICs**), and account for these deductions to HMRC. Employee's NICs are deducted from the earnings (primary NICs), while employer's NICs are charged on top of the earnings and paid by the employer (secondary NICs).

The key differences between the taxation of a company and a registered IPS is in the treatment of 'share and loan interest' paid by a society and, for those societies carrying on a trade, the treatment of dividends paid by reference to the transactions a member has with the society.

¹⁵ The Companies Act and the Insolvency Act 1986.

¹⁶ Industrial and Provident Societies Act 1965 (as amended).

Share and loan interest paid by a registered IPS is not treated as a distribution for corporation tax purposes and is therefore deductible in computing the trading profit and loss of the society. Share interest means any interest, dividend, bonus or other sum payable to a shareholder or the society by reference to the amount of his holding in the share capital of the society. Loan interest means any interest payable by the society in respect of any mortgage, loan, loan stock or deposit.

Dividends paid by a registered trading IPS, to a member of the IPS and by reference to the member's shareholding in the share capital of the IPS, are deductible for corporation tax purposes. Entrepreneurs' relief may be available on disposal of any shares in the IPS, provided that the qualifying conditions are met. Please see section **Tax treatment** in the section relating to private companies limited by shares for further information.

(e) Ongoing governance and regulatory obligations

IPSs must prepare and submit an annual return, for which no fee is currently payable. For more information and a copy of the annual return form, please visit: http://www.fsa.gov.uk/pages/Doing/small_firms/MSR/returns/index.shtml.

IPSs must also submit a copy of their annual accounts to the FSA.

(f) Corporate structure

Like a company limited by shares, IPSs have a share capital known as 'par value shares'. This means that shares are issued at par or face value, rather than any market value that may be calculated based on the financial position of the IPS. Commonly an IPS will set the par value of its shares at £1.00. Shares may only be redeemed (i.e., bought back by the IPS) at their par value, and only if permitted by the IPS' rules. The maximum individual shareholding is £20,000.

The shares typically act as a 'membership ticket', and voting is on a 'one member one vote' basis, rather than by reference to the number of shares held.

IPSs are not subject to the same regulatory obligations as some of the other structures, such as a private limited company, for example. Therefore one of the main advantages of an IPS is that it is easier and cheaper to administer. The share capital maintenance rules¹⁷ do not apply to IPSs, which means share capital can be withdrawn, subject to the IPS' rules.

¹⁷ Under the Companies Act.

(g) Finance and fundraising

IPSs are treated the same as any private company, whether limited by guarantee or shares, when it comes to establishing bank and building society accounts, and other financial services offered by the banking industry. An IPS can raise capital from its members, but no member can hold more than £20,000 in shares.

A key attraction of IPSs for groups raising capital for community projects is their potential exemption from regulation by the FSA under the Financial Services and Markets Act 2000 (as amended) (**FSMA**). When an IPS offers its own shares or debt, it falls within two exemptions of FSMA. As a result of these exemptions, IPSs can avoid the cost and other burdens of complying with the FSMA authorised persons and financial promotions regimes, making them attractive for small community capital raisings that wish to avoid large compliance and adviser costs.

(h) Resources

For more information, visit:

<http://www.companieshouse.gov.uk/>

<http://www.fsa.gov.uk/>

<http://www.hmrc.gov.uk/>

2.4 PRIVATE COMPANY LIMITED BY GUARANTEE

Key advantages / disadvantages

ADVANTAGES

- Separate legal entity, therefore liability of shareholders for the debts of the company are limited to their guarantee under the incorporation documentation
- Registration as a charity is more easily achieved with this structure
- Unlike companies limited by shares, no share transfer is required each time a member leaves

DISADVANTAGES

- Difficult to raise finance: cannot issue shares to investors
- More difficult to give investors a return on their investments
- Prescribed form of accounts (unless exempt) and certain company information must be made publicly available

Case study

THE WHITE RIBBON ALLIANCE FOR SAFE MOTHERHOOD LIMITED (‘WHITE RIBBON’)

White Ribbon is a company limited by guarantee, which has charitable status and is part of the global White Ribbon Alliance movement present in 155 countries. The movement is aimed at preventing the deaths of women who needlessly die in pregnancy and childbirth. White Ribbon seeks to ensure that women have access to optimal health care throughout pregnancy and childbirth for themselves and their newborns; are empowered to ask for the same and to help other women do so; have access to essential and life-saving motherhood services and information; that communities come together to address the effects of poverty, HIV/AIDS, armed conflict, violence against women and children, and gender inequalities on safe motherhood; and that governments set policies in collaboration with women, communities and others to implement programs in support of safe motherhood.

White Ribbon was initially set up as a company limited by guarantee and it then applied to the Charity Commission for charitable status. White Ribbon opted for a company limited by guarantee as its corporate structure as it is often the quickest and easiest corporate structure to adopt in order to obtain charitable status. To a large extent, White Ribbon adopted the Charity Commission’s model articles of association and memorandum of association, which also helped to expedite the process of attaining charitable status.

For more information, visit www.whiteribbonalliance.org

(a) Overview

A company may be either (i) limited by guarantee; (ii) limited by shares; (iii) a community interest company or (iv) unlimited in liability (this form is outside the scope of this Guide). A company may also be private or public. Private companies are prevented from offering their shares to the general public and so are unsuitable for companies looking to seek a listing.

A company limited by guarantee (**CLG**) is a type of private company that is often used by non-profit organisations such as social enterprises. Typically such

companies are also registered as charities. In addition, it is now possible to form a CLG as a community interest company (**CIC**). Please see section relating to CICs for further information.

CLGs do not have a share capital and therefore do not have shares that can be offered to the public. This means that it cannot be a public company.¹⁸ As it does not have a share capital, the company has members rather than shareholders and its profits cannot be distributed to the members through dividends. The members of the company may appoint directors, (where the CLG has also obtained charitable status they will often be called trustees) who are given the responsibility for creating and implementing policies for the company. For more information relating to the duties of a trustee, please see the **Charities Guide**.

CLGs which intend to be incorporated as a charity **must** include exclusively charitable objectives ('objects') in their articles of association as this is a legal requirement and the Charity Commission will look closely at this point. Please see the **Charities Guide** for further information. Non-charitable CLGs may decide to do so but are not obliged to, as unless otherwise stated in the articles of association, the objects of the company are unlimited.

All companies (whether limited by guarantee or shares) are legal entities in their own right. This means that the company's finances are separate from the personal finances of the members. The advantages of choosing a CLG is that each member's liability to the company's debt and liabilities on a winding up is limited to the amount that they have guaranteed in any incorporation documents. Therefore, generally members will not be responsible for the company's debts unless they have given guarantees such as a bank loan. Members may be individuals or other companies.

The rules of a private company (limited by either guarantee or shares) are contained in its articles of association, which set out the internal management structure and procedures, such as the role of members and directors, procedures for appointment and removal of directors, and conduct of meetings. The memorandum of association records the initial members on the company's establishment. The Companies Act prescribes various types of model articles of associations for private and public companies; please see the **Forms** section in the Bibliography for further information, although it is often advisable to check with a lawyer to ensure that the constitution is appropriate to the organisation.

¹⁸ CLGs incorporated with a share capital on or before 22 December 1980 may re-register as a public company, however this is not the most common use for this corporate form and in this Guide all references to CLGs are to CLGs without a share capital.

A CLG need not have the word 'limited' in its name if certain requirements are met. Like all private companies, a company secretary does not have to be appointed but if one is, this must be notified to Companies House. If a company secretary is not appointed, the traditional role of the company secretary will still have to be performed by someone else, usually a director. A private company must also have at least one member and at least one director. At least one director must be an individual (as opposed to a corporate director) and any individuals must be over 16 years of age. A person who is subject to a disqualification caution order¹⁹ cannot act as a director and will be personally liable for all the relevant debts of the company they are managing as well as potential criminal liability.

Like all companies, if a CLG generates profits it will be liable to corporation tax. When a company is incorporated at Companies House, a corporation tax account with HMRC is automatically generated and HMRC will send various forms to the company notifying it of its tax reference number, tax office. The company will be required to provide HMRC with information and must pay any corporation tax that is due and submit an annual company tax return to HMRC. Where the company also has PAYE for employers, VAT and Construction Industry Scheme²⁰ requirements to fulfil, it must notify HMRC of these separately.

(b) Establishment costs and documentation

Generally, all companies (including CLGs) can be formed by (i) incorporating 'from scratch', that is, drafting the incorporation documents specifically to their needs or by (ii) buying an 'off-the-shelf' company, which is a company that has already been incorporated (but has not begun trading), usually from a third-party incorporation agent, and which has a standard set of incorporation documents which the user will need to amend to meet their needs. Model articles of association have been established by legislation²¹ and can be used in either instance, or completely bespoke articles of association may be used. The Charities Commission have also published a set of model articles suitable for

19 Under the Directors Disqualification Act 1986.

20 The Construction Industry Scheme sets out the rules for how payments to subcontractors for construction work must be handled by contractors in the Construction Industry. Please see the HMRC website: <http://www.hmrc.gov.uk>.

21 The Companies (Model Articles) Regulations 2008 established separate model articles for private companies limited by guarantee, private companies limited by shares and public companies limited by shares.

companies limited by guarantee that intend to register as charities.²² Please see the **Forms** section in the Bibliography for further information.

To establish a CLG, the memorandum of association, articles of association and form IN01 (application for registration) must be lodged with the registrar at Companies House together with the prescribed filing fee. Details of the directors, members and company secretary (if one is appointed) must be included on the form IN01.

The company must also indicate on the form IN01 whether it is adopting model articles (either in their entirety or with amendment) or whether bespoke articles will be adopted. A copy of the amended model or bespoke articles must accompany the application for registration. Certain information about the directors and company secretary (if one is appointed) of the company must also be included on the form IN01. Please see the Companies House website: <http://www.companieshouse.gov.uk>

A statement of guarantee must also accompany the incorporation documents (this is provided for in the form IN01). The statement of guarantee is a statement given by each of the members of the company stating that in the event the company is wound up whilst they are a member (or within one year of them ceasing to be a member), they will contribute a specified amount to the assets of the company. This is normally a nominal amount, such as £10.00 per member.

The standard fee for electronic filing is currently £14 (or £30 for the 'same-day' service for applications received by 3.00 p.m. Monday to Friday). Paper documents, which must be sent to the appropriate Companies House office, take longer to process than electronic documents. The standard registration fee is currently £40 (or £100 for the 'same-day' service for applications received by 3.00 p.m. Monday to Friday).

Companies House in conjunction with Business Link offer an online incorporation service so you do not need to use an agent. For more information, please see <http://www.businesslink.gov.uk/bdotg/action/detail?itemId=1086687162&r.l1=1073858805&r.l2=1085161962&r.s=e&type=PIP>. However, where your structure or requirements are not straightforward, you should always obtain specialist legal advice.

In addition, there are certain restrictions in place which prevent certain names from being registered. These restrictions are set out in the Companies Act

²² Please see the Charities Commission website:
<http://www.charity-commission.gov.uk/Library/guidance/gd1textc.pdf>.

and include forming a company with an offensive name, forming a company which has a name suggestive of being connected with a government/public authority or forming a company with 'sensitive' words/expressions in the name.²³ A company cannot be formed with the same name (or one so similar that it would confuse the public) as a company already in existence. The only exceptions to this are if the existing company consents or if it is a new company that is going to be part of a group of companies.²⁴

Please note that names cannot be reserved at Companies House.

(c) Liabilities

1. MEMBERS

For a CLG, members' liabilities will be limited to the extent of their guarantee under the incorporation documentation if the company is wound up. In practice, the liability of members is usually capped at a nominal amount, (e.g., £10.00) meaning that any responsibility for outstanding obligations over and above the guaranteed sum specified lies with the company and not its members.

2. DIRECTORS

Directors of companies in general benefit from limited liability so that the company, and not the directors, is liable for its own debts. However, in exceptional circumstances the directors may be personally liable; for example, if the director has continued to trade after the company has become insolvent, known as 'fraudulent trading'.²⁵

In addition, it is important to note that a director can face both civil and criminal penalties. Many of the criminal offences which a director can commit arise as a result of their permitting the commission of an offence by the company. If a director knowingly or recklessly submits a false return to the registrar at Companies House, the director may incur

23 The Company, Limited Liability Partnership and Business Names (Sensitive Words and Expressions) Regulations 2009 sets out these 'sensitive' words which include words, such as accredited, dentistry and charity. These can also be found in Annexes A to C on the Companies House website at <http://www.companieshouse.gov.uk/about/gbhtml/gp1.shtml#appA>.

24 Companies House has a WebCheck facility whereby the availability of a name can be searched. This is available at: <http://wck2.companieshouse.gov.uk/f411b72b337dd66d18578324669f9ecc/wcframe?name=accessCompanyInfo>.

25 Under the Companies Act and the Insolvency Act 1986.

personal liability and it is also a criminal offence.

Directors can also be made liable for the defaults of their companies under numerous statutes regulating the conduct of business generally, although conviction of a director is usually only possible if the offence was committed with his consent or was attributable to his own neglect. Examples include certain breaches of health and safety legislation, environmental legislation and the trade descriptions legislation.²⁶

A director may, if the board so determines, or a member brings a derivative action²⁷, be sued for damages for a breach of his duties to the company.

If a director is directly involved in a tort (civil wrongdoing) committed by the company (e.g. fraud) he may be liable jointly with the company. To incur liability the director must generally either be negligent or in breach of his duties. Fraud is also a crime, for which a director may incur criminal liability if he was personally responsible for the fraud.

A director may also incur criminal liability for failure to make a report to the police or customs where the director knows or suspects that the company is concerned in any arrangement which facilitates the acquisition, retention, use or control of the proceeds of crime.²⁸

Criminal liability may also be incurred for false statements particularly in relation to false statements in invitations to invest in the company, but liability could also arise in relation to documents other than these and, in certain circumstances, in relation to an oral statement.²⁹

In addition, there is a separate offence of doing any act or engaging in any course of conduct which creates a false or misleading impression as to the market in or the price or value of any investments where the purpose is to create that impression and thereby to induce another person to agree to acquire or subscribe for securities.³⁰ Further, a

26 This relates to legislation imposed to cover fair trading, trade descriptions and trading standards when selling or offering products or services. Please see:

<http://www.businesslink.gov.uk/bdotg/action/detail?itemId=1073792289&type=RESOURCES>

27 This is a court claim brought by a shareholder on behalf of the company, against a director. A shareholder can apply to the court for this type of claim if it believes a director has breached one or more of their duties (duties as set out in this section).

28 Under the Proceeds of Crime Act 2002.

29 Under the Theft Act 1968 and, in certain circumstances, under the Fraud Act 2006.

30 Under FSMA 2000.

director may also incur liability where a company publishes financial reports or information relating to securities which contains untrue or misleading statements or omits material facts, and an investor invests in that company on the basis of that information and consequently suffers. The company may also be held liable in those circumstances.³¹

Directors should also be aware that they will have to exercise certain general duties in the carrying out of their functions. These duties are required by statute³² and are owed to the company, which are:

- to act within the powers stated by the company's objects and articles of association;
- to promote the success of the company (taking into account, for example, the company's employees, the long-term consequences to the company and the impact of a decision on the environment and the community);
- to exercise independent judgment;
- to exercise reasonable skill, care and diligence (this is measured in accordance with the skills that the director actually has and ought to have in relation to a position which they hold, for example, a solicitor will have a higher standard imposed);
- to avoid conflicts of interest;
- not to accept benefits from third parties; and
- to declare interests in any proposed transactions and a duty of confidentiality to the company.

(d) Director's and officers' liability insurance

It is possible to take out appropriate directors' and officers' liability insurance to cover such potential liabilities (if a company's articles of association permit this), but this will only cover a director for an honest mistake rather than a breach of duty where the company could successfully bring a claim against the director.

(e) Company indemnification

A director may be indemnified by the company for all liabilities, costs, charges and expenses incurred by him in the execution and discharge of his duties to the company. However, a company may not generally exempt a director from,

³¹ Under the Companies Act.

³² Chapter 2 of Part 10 of the Companies Act.

or indemnify him against, liability in connection with any negligence, default, breach of duty or breach of trust by him in relation to the company. This means that a company cannot exempt a director from liability for breach of one or more of his duties to the company or limit his liability for such a breach. In addition, a director cannot be indemnified for a fine imposed by criminal proceedings, a fine payable to a regulatory authority for non-compliance or for costs of defending criminal proceedings.

Such an indemnity, if given, would be contained in the articles of association of the company or in an indemnity agreement between the directors and the company.

While a company indemnity is comforting, it is only as valuable as the company's ability or willingness to pay. If the company becomes insolvent or refuses to indemnify for whatever reason, then the director will have to finance his defence. Also, as the law limits the company's ability to provide indemnification in certain circumstances, directors' and officers' liability insurance is often a good idea.

(f) Tax treatment

1. COMPANY

A CLG will be liable to corporation tax on its profits. It will also need to consider whether VAT registration is required.

All companies are liable to corporation tax on their profits. The full rate of corporation tax is currently (at the time of writing) 24%, which is to be reduced to 23% from 1 April 2013. The small companies' rate of corporation tax applies to companies with profits up to £300,000. The rate is currently 20%. A private CLG will need to consider whether VAT registration is required. Generally, if taxable supplies made in the previous 12 calendar months exceed the threshold for registration, then the company must register. The registration threshold is currently £77,000.

A CLG that employs individuals is required to operate the PAYE system, under which the company must deduct from its employees' pay, the appropriate amount of income tax and national insurance contributions (**NICs**), and account for these deductions to HMRC. Employee's NICs are deducted from the earnings ('primary NICs'), while employer's NICs are charged on top of the earnings and paid by the employer ('secondary NICs').

A CLG might find greater tax advantages using a 'hybrid' legal structure. These are described later in this Guide. CLGs that also register as charities will have different tax treatment. Please see the **Charities Guide** for further information.

2. MEMBERS

Generally speaking, members do not contribute anything in exchange for becoming a member of a CLG, except a promise to contribute to the assets of the company up to a capped amount (the amount set out in the statement of guarantee) on a winding up. In addition, members do not receive any income from the profits of the company, therefore there are generally no tax implications for members of CLGs.

Where members dispose of a share in the business and realise a chargeable gain, they may qualify for entrepreneurs' relief. Please see section **Tax treatment** in the section relating to private companies limited by shares for further information.

(g) Ongoing governance and regulatory obligations

Companies are required by law to make public certain information, such as an annual return and financial accounts, which need to be filed with the registrar at Companies House. The financial accounts must be audited unless the company is exempt. Details of changes of directors and the company secretary, amendments to the memorandum and articles of association, for example, also need to be filed, which can be done electronically using the Companies House WebFiling service. Fees may be payable for the filing of certain forms, and details of the forms and any associated fees can be found at: <http://www.companieshouse.gov.uk/forms/formsOnline.shtml>.

When a member leaves, his membership does not need to be transferred to another member; by contrast a shareholder's shares must be transferred to the new shareholder. Therefore, additional forms do not need to be filed or stamped by HMRC; however, the record of members will need to be kept updated.³³

33 Private companies limited by guarantee registered before 22 December 1980 and which opted to register with a share capital will still be required to complete a stock transfer form on the transfer of a share. Please see section 'Ongoing governance and regulatory obligations' in the section relating to private companies limited by shares for further information.

The documents filed at Companies House form the company's record, and members of the public may obtain copies of these documents from Companies House for a small fee.

ANNUAL RETURN

Every company must deliver an annual return to Companies House at least once every 12 months. An annual return is a snapshot of general information about a company's directors, secretary (where one has been appointed), registered office address, shareholders and either its share capital or membership.

The company's director(s) and the secretary (where applicable) are responsible for ensuring that they deliver the annual return to Companies House within 28 days after the anniversary of incorporation of a company or the anniversary of the made-up date of the last annual return. Failure to comply with this requirement is a criminal offence.

Failure to deliver the company's annual return may result in the registrar at Companies House assuming that the company is no longer carrying on business or in operation, and therefore taking steps to strike it off the register.

It is also important to remember that it is a criminal offence not to deliver the company's annual return within 28 days of the made-up date, for which Companies House may prosecute the company and its officers.

ACCOUNTING RECORDS

Every company must prepare accounts that report on the performance and activities of the company during the financial year. Accounting records must in particular contain:

- (i) entries showing all money received and expended by the company; and
- (ii) a record of the assets and liabilities of the company.

The level of detail required in the accounts is governed by statute.³⁴ Various exemptions also apply, and in the majority of cases, smaller companies will be able to take advantage of less onerous reporting requirements³⁵, provided that two of the following criteria are satisfied:

- annual turnover is not more than £6.5 million;

³⁴ Please see the Companies Act for requirements for accounts.

³⁵ Under the Companies Act and the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409).

- balance sheet total is not more than £3.26 million; and
- average number of employees is not more than 50.

If these conditions are met then the company will be exempt from various obligations, including the need to file audited accounts³⁶. If the company exceeds these thresholds, it should seek professional advice on its reporting requirements.

So called 'micro entities' may benefit from further reduction of their administrative requirements under new proposals³⁷. Provided that the entity meets certain criteria, it will be exempt from the requirement to prepare annual accounts, except for a simplified balance sheet. At the time of writing this Guide, these proposals have not yet been adopted in the UK.

Private companies must generally file their accounts with Companies House within nine months from the accounting reference date. A company must keep its accounting records at its registered office address or a place that the directors think suitable. The records must be open to inspection by the company's officers at all times.

Penalties will be levied where a company fails to file their accounts by the specified deadline³⁸. The level of penalty depends on how late the accounts are, and there is a higher penalty for public companies. For example, if a private company delivers accounts not more than one month after the deadline, it will incur a £150 penalty, however if the accounts are more than six months late the penalty rises to £1,500. For further information, please see Companies House website at <http://www.companieshouse.gov.uk/about/gbhtml/gp5.shtml#ch1>.

If the company holds the records at a place outside of the UK, it must send accounts and returns at least every six months and keep them in the UK. Those accounts and returns must disclose the financial position and enable the directors to prepare accounts that comply with the requirements of the Companies Act, including where the accounts are prepared using international accounting standards.

36 Under the Companies Act 2006 (Accounts and Reports) (Amendment) Regulations 2008 (SI 2008/393).

37 Fourth Company Law Directive 78/660/EEC was adopted by the Council of the European Union on 21 February 2012 which will allow member states to exempt 'micro-entities' from the publication of annual accounts. An entity will be a 'micro entity' if it meets two of the following criteria:

- balance sheet total does not exceed €350,000;
- net turnover does not exceed €700,000; and
- the average number of employees during the financial year does not exceed 10.

38 The main legislation which applies to penalties for late filing are The Companies (Late Filing Penalties) and Limited Liability Partnerships (Filing Periods and Late Filing Penalties) Regulations 2008 (SI 2008/497) and the Companies Act.

ROUTINE FILING REQUIREMENTS

All companies, whether public or private must comply with routine filing requirements such as filing of notifications of changes to the directors details. For further information of what notifications are required, please see www.companieshouse.gov.uk and www.businesslink.gov.uk.

There are also tax registration and filing requirements with HMRC depending on the type of entity structure. In most cases, you will need to speak to a professional adviser to determine what filing requirements will apply to your entity.

(h) **Corporate structure**

The structure of a CLG at board level is the same as for all private companies. All private companies must have at least one director and it is not compulsory to appoint a company secretary. The articles of association of a CLG may sometimes refer to the directors as executive officers or to a council of management, but the duties and responsibilities of the officers are the same as those of directors of any private company.

Private companies are now no longer required to have an annual general meeting; however, they can choose to do so if they wish, or if one is called by one or more members. This is particularly relevant to companies limited by shares, please see section **Corporate structure** in the section relating to private companies limited by shares and section **Corporate structure** in the section relating to **Public Companies Limited By Shares: Ethical Public Offerings** for further information.

(i) **Financing and Fundraising**

A CLG cannot raise money by issuing and allotting shares, as it does not have a share capital. Members instead agree to make a contribution to the assets of the company on a winding-up (this is generally a nominal amount such as £10.00 per member) and is only payable on dissolution of the company (this will therefore not form part of the assets of the company except on winding up). Members can also agree (via the articles of association) to pay a fee for membership, which can be a useful source of income.

Loans are a possibility but, as banks and other lenders will often ask for their money to be secured against certain assets of the company, can be difficult to obtain. This is why CLGs are often charities, as a charity can seek to raise capital through fundraising via, for example, public donation. However, it must become a registered charity or registered with HMRC as a small charity in order

to carry out fundraising activities³⁹. Charitable status may also make it easier to obtain grant funding.

(j) Resources

For more information, visit:

<http://www.charitiescommission.org.uk>

<http://www.companieshouse.gov.uk>

<http://www.fsa.gov.uk>

<http://www.hmrc.gov.uk>

2.5 PRIVATE COMPANY LIMITED BY SHARES

Key advantages / disadvantages

ADVANTAGES

- Separate legal entity therefore liability of shareholders for the debts of the company are limited to the amount paid for shares
- Company can easily enter into contracts in its own name
- Easier to raise finance: can issue shares to raise capital

DISADVANTAGES

- More complicated incorporation process: must follow prescribed procedure to incorporate.
- Ongoing reporting obligations.
- Prescribed form of accounts (unless exempt) and certain company information is publicly available

Case study

DIVINE CHOCOLATE LIMITED ("DIVINE")

Divine is a maker of Fairtrade chocolate bars and associated chocolate products such as hot chocolate. If a product carries a Fairtrade

³⁹ Please see the Charities Guide for further information.

mark it means that it has met certain fair trade standards. One set of standards applies to smallholders⁴⁰ that are working together in co-operatives or other organisations with a democratic structure. The other set applies to workers whose employers allow a decent wage, permission to join trade unions, and have adequate health and safety provisions. Fairtrade Standards also cover terms of trade. Most products have a 'Fairtrade Price', which is the minimum that must be paid to the producers. In addition producers get an additional sum, the 'Fairtrade Premium', to invest in their communities.

In the case of something such as chocolate, as it is made up of a mixture of ingredients, all ingredients for which there are Fairtrade Standards must be Fairtrade certified. So, in this case, the cocoa and the sugar must be certified. The percentage of the product which is Fairtrade is then put on the product's packaging.

Divine is organised in England as a private company limited by shares. There is also an associated US company called Divine Chocolate Inc which markets and distributes Fairtrade chocolate products in the USA. Divine owns a 31% interest in the share capital of Divine Chocolate Inc.

THE SHAREHOLDERS

1. [Twin Trading Limited has approximately 43% ownership](#)
Twin Trading Limited is a company limited by guarantee incorporated in England and Wales. Twin Trading is a producer-owned membership organisation dedicated to developing the fair trade supply chain for coffee, nuts, cocoa, sugar and fruit farmers.
2. [Kuapa Kokoo Farmers Union has approximately 45% ownership](#)
Kuapa Kokoo was set up in Ghana in the early 1990s by a number of leading farmers in order to sell their own cocoa to the Cocoa Marketing Company (CMC). CMC is a state-owned company and is the single exporter of Ghana cocoa.
3. [Oikocredit Ecumenical Development Cooperative Society has approximately 12% ownership](#)
Oikocredit is one of the world's largest sources of private

40 Typically a farm supporting a single family with a mixture of agricultural crops sold for profit and crops used to support the family.

funding to the microfinance sector. It also provides credit to trade cooperatives, fair trade organisations and small-to-medium enterprises (**SMEs**) in the developing world.

4. **Christian Aid has preference shares only and no voting rights**

Christian Aid is a UK charity which aims to alleviate poverty around the world, whilst promoting the Christian faith.

For more information, visit:

http://www.fairtrade.org.uk/what_is_fairtrade/faqs.aspx

<http://www.divinechocolate.com>

(a) Overview

The most common form of company is a company limited by shares, which can be either a private or public company. Private companies limited by shares cannot offer their shares to the general public (i.e. the main purpose of a public company limited by shares). Private companies limited by shares account for the vast majority of all companies registered in the UK.

As discussed in the previous section on CLGs, all companies (whether limited by guarantee or shares) are legal entities in their own right. However, the key advantages of a private company limited by shares are that it makes it easier for the company to raise capital by issuing these shares to private investors, and that each shareholder's liability is limited to the amount, if any, unpaid on the shares held by them. Consequently, for the vast majority of commercial enterprises with the purpose of operating a business for profit and dividing that profit among the shareholders, a private company limited by shares will be the appropriate vehicle.

Shareholders are not responsible for the company's debts unless they have given guarantees such as bank loans. However, they may lose the money they have invested in the company (being the amount they have paid for their shares) if the company fails. Shareholders may be individuals or other companies. However, a private company limited by shares cannot offer its shares to the general public in the same way that a public company can. You should consult with a lawyer should you wish to offer shares in your private company limited by shares to investors, so that they can explain to you the laws governing fundraising for private companies.

Again, as for CLGs, the articles of association set out the internal management structure and procedures of a private company limited by shares and a form of

model rules can be obtained free of charge from the Companies House website. You should however consult a legal adviser to ensure that the model rules are suitable for your company without modification. Please see the **Forms** section of the Bibliography for further information.

As in the case for CLGs, there is no requirement for private companies limited by shares to appoint a company secretary, but again if one is appointed, this must be notified to Companies House. Private companies limited by shares must also have at least one member and at least one director who is an individual, and all individual directors must be over 16 years of age.

Again, as in the case for CLGs, if the company is active, it must tell HMRC that it exists and that it is liable to corporation tax. Please see section **Overview** in the section relating to CLGs for further information.

(b) Establishment Costs and Documentation

Like CLGs, private companies limited by shares can be formed by (i) incorporating 'from scratch' i.e. drafting the incorporation documents specifically to suit the needs of the specific company or by (ii) buying an 'off-the-shelf' company, the documents for which can then be modified. Please see section **Establishment costs and documentation** in the section relating to CLGs for further information.

To establish a private company limited by shares from scratch, the same procedure as set out in the section **Establishment costs and documentation** in the section relating to CLGs must be followed: the memorandum of association, articles of association, form IN01 (application for registration) (except for Part 4 which is only completed by CLGs) and the prescribed filing fee must be lodged with the registrar at Companies House. Please see section **Establishment costs and documentation** in the section relating to CLGs for more information on the memorandum and articles of association and the **Forms** section of the Bibliography for details of model sets of articles of association suitable for private companies limited by shares.

The standard fees are the same as for CLGs: electronic filing is currently £14 (or £30 for the 'same-day' service for applications received by 3.00 p.m. Monday to Friday). Paper documents, which must be sent to the appropriate office, take longer to process than electronic documents. The standard registration fee is currently £40 (or £100 for the 'same-day' service for applications received by 3.00 p.m. Monday to Friday).

The restriction preventing certain names being registered as set out in the Company, Limited Liability Partnership and Business Names (Sensitive Words and Expressions) Regulations 2009 also applies. Please see section **Establishment costs and documentation** in the section relating to CLGs for further information.

(c) Liabilities

1. SHAREHOLDERS

Private companies limited by shares are usually incorporated with one class of shares, being ordinary shares, that have a designated nominal value. This nominal value can be whatever the person incorporating the company chooses but it is often set at one penny, or in some cases even lower. The company may issue shares for any price, provided that it can never be less than the nominal value, whatever that amount may be. Once shares have been issued by the company to a shareholder, that shareholder may sell the shares at any price (even if it is less than the nominal amount).

The shareholders' liability is limited to the amount of their investment in the company i.e. the amount paid for the shares. There is no additional liability to contribute to the assets of the company. If the shareholder has purchased the shares directly from the company but has not paid for them, they will be liable to contribute to the assets to the amount remaining unpaid on their shares, including any 'premium' (i.e. any amount above the nominal value of the shares) agreed to be paid for the shares.

Several different classes of shares can be issued to shareholders, each with its own rights to vote, share in the income and capital of the company, nominal value and even currency. The benefit of having different share classes is the flexibility to offer different shareholders shares to suit their needs, for example some shareholders may require a fixed guaranteed dividend rate and no voting rights whereas other shareholders may want the right to vote and require the company to redeem (i.e. buy back) the shares at a specified date for a specified price.

2. DIRECTORS

The directors of a private company limited by shares also benefit from limited liability so that the company, and not the directors, is liable for its own debts. However, as in the case for CLGs, in exceptional circumstances the directors may be personally liable, such as in case of 'fraudulent trading'.⁴¹

Similarly, directors can also face both civil and criminal penalties, for example where the company issues shares at a discount in contravention of the Companies Act, 'the company and every officer of the company who is in default' are guilty of an offence.

Please see section **Liabilities** in the section relating to CLGs for further information.

(d) Directors' and Officers' Liability Insurance

It is also possible to take out appropriate directors' and officers' liability insurance to cover such potential liabilities. Again, this will only be possible if a company's articles of association permit this, and normally will only cover situations where the director has made an honest mistake.

(e) Company indemnification

A director of a private company limited by shares may be indemnified by the company for all liabilities, costs, charges and expenses incurred by him in the execution and discharge of his duties to the company, in the same way as a director of a CLG. Please see section **Company indemnification** in the section relating to CLGs for further information.

(f) Tax Treatment

1. COMPANY

A private company limited by shares will be liable to corporation tax on its profits in the same way as a CLG. Please see section **Tax treatment** in the section relating to CLGs for further information.

A private company limited by shares might find greater tax advantages using a 'hybrid' legal structure. These are described in more detail in **Part 3** of this Guide.

⁴¹ Under the Companies Act and the Insolvency Act 1986.

2. SHAREHOLDERS

Shareholders must consider their individual tax consequences, which will largely depend on each individual's circumstances. For example, where the individual shareholder is also an employee or director of the company. The company should consider whether individual employees should acquire shares or be granted options to acquire shares (and the availability of tax-favoured share option plans) as the tax consequences for each will vary. Further, on the sale of shares in the company the individual is likely to be liable to pay capital gains tax on any gain he or she receives. The capital gains tax rate is currently 28% for those paying income tax at the higher and additional rate and 18% for basic rate income tax payers.

In addition, 'entrepreneur's relief' might be available to an individual employee or director of the company that holds at least 5% of the company's ordinary share capital, reducing the rate of tax payable to a rate of 10%, on the first £10 million of cumulative gains.

A private company limited by shares may also incentivise employees through share schemes. Companies may offer equity (share) incentives to their executive directors and employees to recruit, retain and motivate them. These types of incentives are also commonly used to align the interests of employees with those of shareholders. There are also valuable tax advantages to using HMRC approved share options schemes (for example, enterprise management incentive options or company share option plans). Unapproved option schemes may also be put in place to motivate individuals, but do not have the same tax advantages. There are various requirements and criteria for each type of approved option, including criteria relevant to the company granting the option, the individuals being granted options, the shares and certain limitations to the value of options granted. You should speak to your legal adviser in relation to the suitable option schemes available for your company.

(g) Ongoing governance and regulatory obligations

Companies are required by law to make public certain information, such as an annual return and financial accounts, which need to be filed with the registrar at Companies House. The financial accounts must be audited unless the company is exempt. Details of changes of directors and the company secretary, constitutional amendments and other disclosable matters also need to be filed,

which can be done electronically using the Companies House WebFiling service. Fees may be payable for the filing of certain forms, and details of the forms and any associated fees can be found at:

<http://www.companieshouse.gov.uk/forms/formsOnline.shtml>.

These documents form the Companies House record for the company, and members of the public may obtain copies of these documents from Companies House for a small fee.

ANNUAL RETURN

As discussed in the previous section on CLGs, every company must deliver an annual return to Companies House at least once every 12 months. Please see section **Ongoing governance and regulatory obligations** in the section relating to CLGs for further information.

ACCOUNTING RECORDS

Private companies limited by shares will need to keep and file accounts in the same way as CLGs. Please see section **Ongoing governance and regulatory obligations** in the section relating to CLGs for further information.

ROUTINE FILING REQUIREMENTS

Private companies limited by shares will also be required to make routine filing requirements. Please see section **Ongoing governance and regulatory obligations** in the section relating to CLGs for further information. Please also see <http://www.companieshouse.gov.uk> and <http://www.businesslink.gov.uk>.

(h) Corporate Structure

Private companies limited by shares are governed by both their board of directors and their shareholders under the Companies Act and the company's articles of association. The board of directors is responsible for the day-to-day running of the organisation and records its decisions in board minutes. The shareholders have a number of fundamental powers. In particular, the shareholders have the power to dismiss the board.

Certain decisions and changes relating to the company will require shareholder approval either as an ordinary or a special resolution. A special resolution requires shareholders holding at least 75% of the total issued shares of the company to agree, whereas an ordinary resolution requires shareholders holding at least 50% of the total issued shares of the company to agree. By

way of example, company name changes and the acceptance of new articles of association require special resolutions.

Where there are different classes of shares and there is a proposal to vary the rights of that class, only shareholders of that class of shares may vote on such proposals.

Private companies limited by shares are no longer required to hold an annual general meeting. Please see section **Corporate structure** in the section relating to **Public Companies Limited By Shares: Ethical Public Offerings** for further information on holding an annual general meeting.

(i) Finance and fundraising

The primary advantages of a private company limited by shares are (i) its ability to raise capital from external investors by the issue of shares; and (ii) its limited liability, which means that it can enter into commercial contracts without its directors or shareholders risking personal liability in relation to these.

A private company limited by shares will often raise money through the following methods:

- (i) A small company set up by an individual might rely on that individual's savings or those of friends or family. In this instance, it is once again noted that if the company becomes insolvent, money invested may not be recoverable in full or at all.

There are also additional rules and reporting requirements where loans are made to or from directors. Directors must declare such loans as the director is an interested party, and there are special taxation implications. In some cases these loans also require shareholder approval. You should speak to your advisers if you are a director and you wish to make or receive a loan from your company.

- (ii) A company will often raise money by selling its shares. As discussed in section **Liabilities** above, shares in a company are normally sold for their 'nominal value' but may also be issued at a price above the nominal amount, especially if the nominal value is very low. The difference between the price paid for the share and the nominal value is called the share premium. The nominal value is set out in the articles of association. Following the purchase of the shares, and the issue and allotment by the company of the shares to the person buying them, that person will become a shareholder in the company, and their details will be entered onto the register of members and filed at Companies House.

As discussed previously in section **Overview** above, shares in a private

company limited by shares cannot be offered to the public at large. However, the shares may be offered to friends and family, provided that the company complies with certain regulations regarding financial promotions.⁴² If you wish to offer shares either to the public or a group of investors (including friends and family), you should speak to your legal adviser for further advice.

- (iii) A company can look to raise money through a loan. It is important to note that banks and other lenders will nearly always ask to see a business plan before lending and may ask for their money to be secured to certain assets of the company such as its premises. In the current economic environment it has become difficult for small companies to borrow money, especially where the company has few assets. Loans may also be available from a community development finance institution (**CDFI**). Please see the following link: <http://cdfa.org.uk/> for further information.
- (iv) A company may be eligible for a grant, if for example the business is being set up in a deprived area. Useful information can be found at: <http://www.businesslink.gov.uk/bdotg/action/detail?itemId=1076795362&type=RESOURCES>

Private companies limited by shares may also raise money by issuing bonds. These are essentially a promise to pay a certain amount, in addition to interest, to an investor. Bonds are a material instrument that can be bought and sold. For this reason, they are often only a useful fundraising option for public companies listed on an exchange. If you are considering issuing a bond, you should seek specialist legal advice.

(j) **Resources**

For more information, visit:

<http://www.businesslink.gov.uk>

<http://www.cdfa.org.uk>

<http://www.companieshouse.gov.uk>

<http://www.hmrc.gov.uk>

⁴² Under FSMA, there is a general prohibition against people not authorised by the FSA to communicate any invitation or inducement to engage in investment activity. The offer of shares in a private company limited by shares would constitute such a communication and is therefore generally prohibited unless an exemption applies such as a financial promotion to high net worth individuals or 'business angels'.

2.6 PUBLIC COMPANIES LIMITED BY SHARES: ETHICAL PUBLIC OFFERINGS

Key advantages / disadvantages

ADVANTAGES

- Able to issue shares to the general public to raise finance
- Raises public profile of company and therefore attracts more investors /business
- Shareholders can sell their shares on a 'market'

DISADVANTAGES

- More of the company's information must be made public to attract shareholders which leads to increased costs
- Costs of public offerings can be considerable
- Generally listed on a matched bargain market rather than a main exchange therefore no guarantee of liquidity

Case study

CAFÉDIRECT

Cafédirect is a UK-based social enterprise. It is currently one of the largest Fairtrade⁴³ hot drinks companies in the world. As well as coffee, Cafédirect has a hot beverage range that includes 100% Fairtrade tea and hot chocolate. Cafédirect works with more than 260,000 coffee, tea and cocoa growers in 38 registered Fairtrade producer organisations across 12 countries, affecting the lives of more than 1.8 million people in developing countries.

Cafédirect is a publicly listed company with a board of directors and 4,500 shareholders. Growers play a key role in every aspect of Cafédirect life and 75% of Cafédirect grower partners own Cafédirect shares. There are also two Grower Directors on the board, one from Africa and one from Latin America, ensuring that growers are involved in all decisions that Cafédirect makes.

43 Fairtrade was discussed above in the Divine Chocolate case study.

Cafédirect established the Gold Standard, a guarantee to pay above the world market price for coffee, and support the development of producers. Since 2004, Cafédirect has paid more than £9.1 million above the market price to growers (including Fairtrade premiums), invested more than £4.5 million in tailor-made programmes to strengthen growers' businesses and in total, has paid more than £13.6 million towards the businesses and communities of their grower partners.

Cafédirect sells its tea, coffee and hot chocolate throughout all of the major supermarkets within the UK and through major foodservice distributors.

CAFÉDIRECT'S STRUCTURE

Cafédirect is a publicly listed company with a board of directors and 4,500 shareholders. Its shares are traded directly between buyers and sellers using a 'matched bargain' system run by Brewin Dolphin.

For more information, visit <http://www.cafedirect.co.uk>.

(a) Overview

An initial public offering (**IPO**) is the process by which a public company obtains a listing for the first time of its securities on an investment exchange and offers those securities to the public. A number of social enterprises such as Traidcraft, Cafédirect, Ethical Property Co, ICOF and Centre for Alternative Technology have all turned to raising sums via ethical public offerings (**EPOs**) as a means of raising finance. This means that they appeal to supporters and others who are committed to their ethical aims rather than just to the general public as a whole, and to those who are seeking an investment that does not solely provide a financial return.

Instead of listing on one of the more common main markets such as the Alternative Investment Market (**AIM**) or the main market of the London Stock Exchange (**LSE**), these companies will usually list on a 'matched bargain market' where likeminded buyers and sellers can be matched up for the transferring of shares in such companies. A number of brokers operate matched-bargain markets including Fairfax plc and Brewin Dolphin. Matched-bargain markets cannot guarantee liquidity, as shareholders will only be able to sell their shares provided that a seller can be found.

(b) Establishment costs

Public companies have the same establishment costs as private companies. They are normally incorporated from scratch and can either adopt model articles of association (as available from the Companies House website) or use bespoke articles of association. A memorandum of association setting out the initial shareholder(s) must also be prepared and filed at Companies House together with form IN01 and the articles of association.

As for private companies, electronic filing is cheaper and easier and is currently £14 (or £30 for the 'same-day' service for applications received by 3.00 p.m. Monday-Friday) or £40 for paper documents (£100 for the equivalent 'same-day' service).

Although matched-bargain markets are not a Recognised Investment Exchange (**RIE**) or a regulated market for regulatory purposes, companies who choose to list on these exchanges will still have ongoing administrative and regulatory costs albeit on a lower level than on AIM or the main market of the LSE.

(c) Liabilities

1. DIRECTORS

In addition to the same general duties/liabilities of directors of private companies limited by shares, directors of public companies whose shares are admitted to trading on AIM or the main market of the LSE can also incur liability where the company has not complied with the disclosure rules.⁴⁴ Please see section **Liabilities** in the section relating to CLGs for further information.

In addition, directors must ensure that their behaviour does not amount to 'market abuse', which includes misusing information relevant to dealing in investments, creating a false or misleading impression about the demand, supply, price or value of an investment; or making misleading statements about investments. Such behaviour will result in both criminal and civil penalties (currently the penalty for the civil offence is an unlimited fine).

⁴⁴ Under the Disclosure Rules and Transparency Rules ('DTR'). Note that only DTR 5 applies to companies admitted to trading on AIM.

2. SHAREHOLDERS

As noted above, the vehicle used for an EPO will generally be a public company limited by shares. Consequently the liability of members is limited to the amount, if any, on the unpaid shares held by them.⁴⁵ Investors choose to invest in public companies because they desire liquidity for their investment, that is, the ability to buy and sell their shares easily. In theory, it is not as easy for investors in private companies to find a willing buyer for their shares.

EPOs fall somewhere between a public company listed on a market such as AIM or the main market of the LSE, and a private company, in terms of liquidity. Some companies who have undertaken EPOs, such as Café Direct deal with liquidity as follows; buyers and sellers who have registered are matched when shares become available. That is the shares are traded on a matched-bargain market. However, matched-bargain markets do not facilitate trading as easily as on recognised stock markets, as it can be difficult to put like-minded buyers and sellers together. This means investors may find it difficult to subsequently sell their shares and so finding investors to put in the amount of capital initially required may be difficult.

(d) Tax treatment

Public companies are liable to corporation tax in the same way as private companies. Please see section **Tax treatment** in the section relating to CLGs and section **Tax treatment** in the section relating to private companies limited by shares for further information. Public companies are also able to put in place share schemes for its employees to incentivise, recruit, retain and motivate them. You should speak to your adviser in relation to the suitability of approved or unapproved option schemes to your circumstances.

(e) Ongoing governance and regulatory obligations

A public company is subject to the same ongoing reporting and compliance requirements as a private company limited by shares. However, annual accounts must be filed with Companies House within six months of the company's accounting reference date. In addition, a public company must have a minimum

⁴⁵ Note, that under the Companies Act, public companies cannot allot shares unless at least one-quarter of its nominal value and the whole of any premium is paid up.

of £50,000⁴⁶ in allotted share capital in order to obtain a trading certificate, which must be maintained.

The reporting requirements under the AIM Rules and the Listing Rules and the Prospectus Rules will only apply to those companies listed on AIM or the main market of the LSE. Therefore, those companies that cannot or do not meet the more stringent listing requirements for either of these recognised investment exchanges, and who choose to instead operate and trade through a matched bargain market, will not have corresponding ongoing reporting requirements.

(f) Corporate structure

This is the same as for a normal public company. Only a public company is permitted to offer its shares to the public. Any private company contemplating such an offer must therefore first re-register as a public company in accordance with the relevant provisions of the Companies Act. This requires a special resolution⁴⁷ and satisfaction of various statutory conditions, including conditions as to share capital and name. If you are considering re-registration, you should speak to your advisers for further information.

Unlike private companies, public companies are required to hold an annual general meeting. At least 21⁴⁸ clear days' written notice must be given to shareholders, and the notice to shareholders must contain certain information⁴⁹ as required by the Companies Act. Annual general meetings may be called on shorter notice, if all the shareholders entitled to attend and vote at the meeting agree to the shorter notice.

(g) Finance and fundraising

A public company is the only form of company that may issue its shares to the general public. This means that, in theory, it can attract a wider investor group than private companies and therefore can raise funds more easily. However, in practice, it can be difficult to find investors willing to invest in the company,

⁴⁶ The amount of the authorised minimum is currently prescribed as £50,000 or €57,100 by the Companies Act and Regulation 2 of the Companies (Authorised Minimum) Regulations 2009 (SI 2009/2425).

⁴⁷ This means that at least 75% of the shareholders of the company entitled to vote on the matter must agree to re-registration as a public company.

⁴⁸ In certain circumstances for public companies traded on a RIE a minimum of 20 working days' notice is required but a discussion of this situation is beyond the scope of this Guide.

⁴⁹ Section 311 of the Companies Act requires a notice of a general meeting to state the time, date, place and (under subsection (2)) the general nature of the business to be dealt with at the meeting. Subsection (2) has effect subject to any provision of the company's articles of association. Section 337 also requires a notice calling an annual general meeting of a public company to state that the meeting is an annual general meeting.

unless there is a strong market presence or the company is already well known, as in the case of Cafédirect. In addition, there are considerable associated costs (legal, brokers and accountants fees) therefore unless a significant amount of cash is raised, the costs are likely to outweigh any funds raised. In addition, it can take several months to prepare for an EPO, and therefore can place a considerable strain on the board of directors, who must also concentrate on the business during this period.

For these reasons, and the limited liquidity on matched-bargain markets where most EPOs are traded, very few social enterprises would be suitable for an EPO.

(h) Resources

For more information, visit:

<http://www.brewin.co.uk>

<http://www.companieshouse.gov.uk>

http://www.fairfaxplc.com/matched_bargain_market.htm

<http://www.stocktrade.co.uk/>

3 LEGAL STRUCTURES SPECIFICALLY DESIGNED FOR SOCIAL ENTERPRISES

3.1 COMMUNITY INTEREST COMPANY (“CIC”)

Key advantages / disadvantages

ADVANTAGES

- Protections of assets — asset lock means the CIC’s assets and profits must be retained within the CIC or transferred to another organisation with an asset lock (normally another CIC or a charity)
- Benefit of the community rather than private gain. On a winding up the CIC’s assets must be transferred to another asset locked body i.e. so that the assets remain for the benefit of the community
- Ability to issue shares may make this structure attractive to external investors, subject to the dividend lock and asset lock. Shares can also benefit from EIS tax relief

DISADVANTAGES

- Capped dividends and the asset lock mean there is limited return for investors
- Additional layer of regulation compared to limited companies by virtue of having to comply with the CIC Regulations (as defined below), which includes submitting an annual report to the Regulator (as defined below), who has wide powers to regulate CICs
- No specific tax advantages, but may be able to apply for other sources of aid such as regional and lottery funding

Case study

COOL2CARE (‘C2C’)

C2C is a childcare introductory service that recruits, screens and trains care-workers or ‘personal assistants’ to support families with disabled

children or young adults so that families can find trusted and skilled people to care for their disabled child. C2C works closely with these families to identify their specific needs and then places the right people with each family, who are, importantly, chosen by the families themselves. The family then becomes the carer's employer, agreeing a mutually suitable working arrangement and rate of pay.

Once a carer is placed with a family, C2C continues to support both family and carer throughout their time together. The support provided by C2C is dependent upon each family's needs, whether full or part-time care, holiday cover or support for a few hours a week, and is operating in around 20 different areas throughout the UK with new offices opening all the time.

In addition, C2C also offers Workforce Development Training and Volunteer Befriending projects in certain locations.

C2C was founded in 2007 by Phil Conway, whose eldest son is severely disabled, and has trained over 1,000 carers since that time. It is a private company limited by shares, incorporated as a CIC. Approximately 20% of C2C's income is generated from grants and fundraising, the remaining income is generated through contracts with local authorities, and placement and match fees from the families using C2C.

So why did C2C choose a CIC? Phil Conway explains that there were several reasons:

- Governance structure is suited to an entrepreneur-led enterprise.
- The CIC allows a business to manage business risk. For example, take on loans.
- Can raise initial funds as equity rather than debt, which helps the balance sheet.
- Also able to blend income streams, as can benefit from trading income as well as grants.
- Less administration and bureaucracy than a charity — good for a start-up.

Phil felt that a company limited by shares would not have access to grant funding, and a charity would be too unwieldy and not suitable for an entrepreneur wanting to have control of his own enterprise. So in this case, a CIC was the perfect solution.

For further information, visit <http://www.cool2care.co.uk>

(a) Overview

A CIC is a relatively new corporate form which was introduced in 2005.⁵⁰ It is essentially a limited company (either by shares or guarantee) and can be public or private. The difference between a CIC and an ordinary company is the special additional features which are designed to ensure that the business or other activity conducted by the CIC, is conducted for community benefit, and not purely for private advantage.

The special additional features include a 'community interest test' and 'asset lock'. This means that the CIC must produce an annual community interest company report setting out what the CIC has achieved in the year in furtherance of its community interest objectives, and which must be made publicly available.

The assets of the CIC are also 'locked' so profits and assets must be retained within the CIC or transferred to another asset locked body for not less than full market value (unless permitted by statute). Assets of a CIC must also be transferred to another asset locked body on a winding up, which ensures that the assets remain for the benefit of the community. Subject to the provisions of its articles of association, directors may declare a dividend payable to shareholders (who are not asset-locked bodies). However, such dividends are subject to a capped rate stipulated by the Regulator of Community Interest Companies (the 'Regulator') and must be agreed by a special resolution of the shareholders⁵¹. The Regulator has wide powers to ensure that the CIC fulfils its community interest, and can remove or appoint directors, transfer the CIC's property or shares or take action in the name of the CIC.

There are additional rules relating to voting, in particular the chairman does not have the right to a casting vote at a board meeting.

It is important to note that a CIC cannot be a charitable company. Charitable entities that convert to CICs will lose their charitable status. A charity, however, may have a subsidiary that is organised as a CIC.

For further information, please visit: <http://www.bis.gov.uk/cicregulator>.

⁵⁰ By the Companies (Audit, Investigations and Community Enterprise) Act 2004 and the Community Interest Company Regulations 2005 (the 'CIC Regulations'), as amended by the Companies Act 2006 (Consequential Amendments, Transitional Provisions and Savings) Order 2009, which was a result of the implementation of the Companies Act.

⁵¹ This requires the consent of at least 75% of the shareholders entitled to vote.

(b) Establishment costs and documentation

Establishment of a CIC is similar to that of a limited company. New organisations can register by filing the form IN01 and memorandum and articles of association together with a form CIC36 (application to form a community interest company) with the registrar at Companies House together with payment of the filing fee (currently £35). The registrar will then forward the form CIC36 to the Regulator. The Regulator has produced various model memoranda and articles of association that may be used. These can be found at: <http://www.bis.gov.uk/cicregulator/forms-introduction/constitution-guidance/model-constitutions>.

Existing companies can convert to a CIC by satisfying the Regulator that they meet the CIC requirements. In doing so, it must pass a special resolution⁵² to amend its articles of association to state that the company is to be a CIC and to ensure that the articles of association comply with the CIC Regulations. It must also pass a special resolution to change the company's name to include the appropriate CIC designation. Copies of these documents must be filed with the Regulator, together with a filing fee (currently £25) and a completed form CIC37 (application to convert a company to a community interest company).

All of the forms required to establish and maintain a CIC can be found at: <http://www.bis.gov.uk/cicregulator/forms-introduction/index>.

(c) Liabilities

1. COMPANY

As a CIC is a limited company, liability will depend on whether it is a company limited by guarantee or by shares. If limited by guarantee, the members' liabilities will be limited to the extent of their guarantee as set out in the constitutional documentation in the event of a winding up. In practice this means that the members' liability is usually capped at a nominal amount (e.g. £1.00) and therefore liability for any amounts above the nominated amount lie with the company.

2. SHAREHOLDERS

If limited by shares, the members' liabilities will be limited to the amount, if any, unpaid on their shares, including any premium agreed to be paid on the shares.

⁵² This requires the consent of at least 75% of the shareholders entitled to vote.

3. DIRECTORS

Directors also benefit from limited liability, however, in certain circumstances they can be held liable for the actions of the company, most particularly where the director has committed fraud. The directors can be required to contribute to the company's assets in such a situation. Please see section **Liabilities** in the section relating to private companies limited by shares for further information

(d) Tax treatment

CICs do not receive tax benefits by virtue of their legal status. A CIC is liable to corporation tax on any trading profits (though it will be a question of fact whether or not a particular CIC is trading) and on its investment income and gains. A CIC is eligible for any reliefs which are available to all companies but there are no specific tax exemptions/reliefs available.

(e) Ongoing governance and regulatory obligations

CICs are regulated by the Regulator. It must file a community interest report, known as the CIC34, which is submitted to the Regulator's office on an annual basis along with a fee (currently £15). It also has obligations to file accounts and an annual return in the same way as other private companies. Depending on whether the CIC has been incorporated as a CLG or a private company limited by shares, section **Ongoing governance and regulatory obligations** in the section relating to CLGs or section **Ongoing governance and regulatory obligations** in the section relating to private companies limited by shares will be relevant.

(f) Corporate structure

CICs can be public or private companies limited by shares or a CLG and are incorporated under the Companies Act. Please see section **Corporate structure** in the section relating to CLGs and section **Corporate structure** in the section relating to private companies limited by shares for further information.

(g) Finance and fundraising

Grants may be available depending on the CICs expected activities and impact of its work. Grants are usually targeted at specific projects and one off capital purchases. However, as CICs are essentially companies, one of their main advantages is the ability to raise finance through the issuing of shares to external investors. The shares are normally sold for their 'nominal value' as set

out in the CIC's articles of association (but can be sold for any amount above the nominal value, known as selling at a 'premium'). However, unlike shares in an ordinary private company limited by shares, shares in a CIC will be limited by the 'asset lock' on the payment of dividends, which will make returning value on their shares more difficult. This may be unattractive to some potential investors.

Shares in a CIC can also be structured in a way to attract Enterprise Investment Scheme (**EIS**) relief. For more information, please see section **Tax treatment** in the section relating to other hybrid structures.

(h) Resources

For more information, visit:

<http://www.bis.gov.uk>

3.2 CHARITABLE INCORPORATED ORGANISATIONS (CIOs)

CIOs were created by provisions in the Charities Act 2006 and are expected to be implemented in stages following a government consultation which is currently under way. CIOs are a new corporate structure designed specifically for charities and will provide a potential alternative to other structures such as charitable companies, charitable trusts, CLGs and unincorporated associations.

It is envisaged that the CIO will primarily appeal to medium-sized charities which employ staff and/or enter into contracts because, like a company, a CIO has a separate legal status and limited liability (although it will mean more registration and regulation requirements). Charitable companies may also consider becoming a CIO to benefit from reduced regulation and administration. This is because, and it is the main advantage of the CIO, the new CIO will be regulated only by the Charity Commission, and will not also be registered with and regulated by Companies House (meaning no duplication of administration requirements, such as the annual report) or by company law as currently happens for charities which are incorporated as companies. CIOs will have a separate legal personality which means that the CIO will still be able to enter into contracts in its name and will benefit from reduced personal liability for its trustees and members.

A CIO must be a charity before becoming a CIO so the same procedure as that for setting-up must be followed as a charity. This means that the charity must first be registered with the Charity Commission. Please see the **Charities Guide** for further information.

It will be relatively simple to convert to a CIO. Charitable companies and CICs can convert to a CIO by a simpler re-registration process. Unincorporated associations will first need to set up a CIO and then transfer assets to the new CIO, notifying suppliers, banks and funders of the transfer.

This structure is not yet available. It is expected to be available in 2012, although no firm date has been announced by the government. The Charity Commission has published model constitutions on its website for use when the legislation comes into force. The foundation model is for charities whose only voting members will be the charity trustees and the association model is for charities that will have a wider membership, including voting members other than the trustees. These model constitutions are available from the following link:

http://www.charitycommission.gov.uk/Start_up_a_charity/Do_I_need_to_register/CIOs/model_constitutions.aspx.

The above is designed to give a brief overview of the forthcoming CIO structure only and if you are considering a CIO structure you should ensure that you obtain legal advice once the rules have been finalised.

4 HYBRIDS

4.1 PUBLIC CHARITY AS PARENT AND FOR-PROFIT ENTITY AS SUBSIDIARY

Key advantages / disadvantages

ADVANTAGES

- Tax benefits of gift aiding all profits from the trading subsidiary to the parent
- More flexibility in using a corporate structure for trading activities
- Ability to separate risk associated with running a business from the operation of the charity

DISADVANTAGES

- Increased compliance costs: separate accounts and reporting obligations for trading subsidiaries
- Separate administration costs and procedures for each entity
- Difficulty in raising finance: charity may not be permitted to invest its funds in the trading subsidiary and as all profits are likely to be distributed to the charity the subsidiary is unlikely to attract investors

Case study

FURNITURE RESOURCE CENTRE

ABOUT FURNITURE RESOURCE CENTRE

Furniture Resource Centre ('FRC') is a CLG and a registered charity established in 1988. FRC supplies new furniture and other household items to registered social landlords, supported living schemes and other schemes and projects to help low income families, long-term unemployed individuals and previously homeless individuals in and around Liverpool.

FRC GROUP STRUCTURE

The FRC group ('FRC Group') consists of FRC and its wholly owned operating subsidiary called Bulky Bob's ('BB'). BB is organised as a

private company limited by shares and was established in 2000. BB is a for-profit commercial business offering two main services:

- acting as a waste management business running local authority contracts to collect, reuse and recycle bulky household waste such as furniture and appliances; and
- selling and/or giving away second-hand furniture it collects to low income families and individuals through its shops called 'Bulky Bob's Furniture World'.

Not only is BB helping to fulfil FRC's charitable purposes and providing a social service to the local community, it is also acting to reduce the amount of items taken to landfill and promoting recycling. In addition, any profits generated by BB and distributed to FRC will benefit from Gift Aid.

Operating as a charity with a trading subsidiary is the most appropriate structure for the FRC Group, as not only can FRC fulfil its charitable purposes at the parent company level, the FRC Group can also generate profits in its trading subsidiary to help further those charitable purposes and to help fund its other social enterprises.

FURNITURE RESOURCE CENTRE'S OTHER SOCIAL ENTERPRISE ACTIVITIES

The FRC Group also runs a number of other social enterprise schemes to help people in and around Liverpool and was named 'Impact Champion' in the 2010 Social Enterprise 100 competition which was sponsored by the Royal Bank of Scotland plc and Society Media .

FRC Group has run a salaried training programme to provide long-term unemployed people with the experience, qualifications, skills and confidence needed to find sustained employment since the mid-1990s. The main training programme provided is called 'Driving Change' which prepares previously long-term unemployed people for a career as a professional driver. Driving Change was the UK Winner at the National Training Awards in 2008 with over 80% of trainees going into further employment over the last 10 years.

FRC Group also runs a placement programme for individuals for which the salaried training programme is not the best route into employment. These may be individuals who have little or no skills or experience or a lack of confidence or for whom employment is not their aim. The placement programme offers the individuals the chance to gain

genuine experience in a supportive work environment that can provide a platform into more formal training.

For more information, visit <http://www.furnitureresourcecentre.co.uk/>.

(a) Overview

PUBLIC CHARITY AS PARENT ("PARENT COMPANY") – Establishing the Parent company is a two stage process. Firstly, a company (normally either a CLG or a private company limited by shares) is incorporated at Companies House and secondly an application is made to the Charity Commission for registration as a charity. For more information on registering as a charity, please see the **Charities Guide**.

A CLG is often the preferred structure for not-for-profit organisations because typically such organisations are not seeking investment from shareholders but rather engaging in fundraising and seeking grants. Therefore a share capital is not required. We have assumed that the CLG is the chosen structure for the Parent company in this section. Please see sections **Overview** and **Finance and fundraising** in the section relating to CLGs for more information generally on CLGs.

FOR PROFIT ENTITY AS SUBSIDIARY ("SUBSIDIARY COMPANY") – Generally this will be a private company limited by shares because the purpose of establishing a subsidiary is to generate a profit through trading activities which can then be distributed to the parent by way of dividend. This is the most tax efficient method of transferring profits from the Subsidiary company to the Parent company and is discussed in more detail in section **Tax treatment** below. For the purposes of this section, we have assumed that the Subsidiary company is a private company limited by shares.

The Subsidiary company will be incorporated at Companies House in exactly the same way as any other private company limited by shares with the Parent company as the sole shareholder of the Subsidiary company. Charities typically use a subsidiary trading company to:

Charities can use a subsidiary trading company to:

- (i) carry out non-primary purpose trading on a larger scale than a charity would be allowed to;
- (ii) carry on commercial activities that would place the Charity's assets at significant risk if it carried on the trading activity itself i.e. to protect a charity's assets from the risks of trading;

- (iii) set up a separate central administrative unit for accounting or management purposes; and
- (iv) reduce the tax liability arising on profits made from the trading activities.

Please see the **Charities Guide** for more information.

(b) Establishment costs

PARENT COMPANY – The first stage of the incorporation process is to form the CLG. Please see section **Establishment costs and documentation** in the section relating to CLGs for further information relating to the procedure and costs of incorporation.

It is important to note however, that a company's purposes, or objects, will be unrestricted unless the articles of association provide otherwise. Therefore, as the company is also a charity, its objects must be entirely charitable.

Once the CLG has been incorporated, it must then register as a charity by using the online application service of the Charity Commission⁵³. The online application can be found at: <https://www.charitycommission.gov.uk/officeforms/OLARPortal.ofml>.

The completed application form will need to be accompanied by:

- (i) a signed trustee declaration form for each trustee;
- (ii) a copy of the governing document i.e. the memorandum and articles of association; and
- (iii) evidence of income.⁵⁴

In order to be recognised as a charity by the Charity Commission the company must:

- (i) be established for exclusively charitable purposes; and
- (ii) meet the public benefit requirement.

A charity must be established exclusively for charitable purposes; it cannot have some purposes that are charitable and some that are not. These purposes are also referred to as the charity's 'aims' and are usually expressed in the objects clause of its articles of association. All charities, without exception, must be able

53 www.charity-commission.gov.uk/start_up_a_charity/Guidance_on_registering/The_registration_process_index.aspx

54 Note that the Charities Commission will require evidence of a minimum funding of £5,000 to register a charity. Please see www.charitycommission.gov.uk/Start_up_a_charity/Set_up/Things_to_think_about.aspx and the Charities Guide for further information.

to demonstrate that the activities they carry out in pursuance of their charitable purposes are for the benefit of the public (the 'public benefit requirement'). A charity must not provide disproportionate levels of private benefit to any particular group or person. Any private benefit must be incidental to achieving its charitable purposes.

In addition to the registration costs above, the maintenance of appropriately and diligently prepared company accounts may result in the incurrence of accountancy fees. Please see the **Charities Guide** for further information on charitable objects and registering as a charity in England and Wales.

SUBSIDIARY COMPANY – The Subsidiary company will be incorporated in the same way as any other private company limited by shares. Please see section **Establishment costs and documentation** in the section relating to private companies limited by shares for further information relating to the procedure and costs of incorporation.

(c) Liabilities

PARENT COMPANY – As in the case for any CLG, the members of the Parent company will have no liability to contribute to the Parent company's capital while it is operating as a going concern. The members will only be liable on a winding up and only to the extent of their guarantees to the Parent company (usually a nominal sum such as £10.00).

Directors of companies (where the CLG has also obtained charitable status they will often be called trustees) in general benefit from limited liability so that the company is liable for its own debts, and not the directors. However, in exceptional circumstances the directors may be personally liable, for example, if the director has committed fraud, and it is important to note that a director can face both civil and criminal penalties.

For further information on the liability of members and trustees of the Parent company, please see section **Liabilities** in the section relating to CLGs.

SUBSIDIARY COMPANY – The liability of shareholders of a private or public company limited by shares to contribute the assets of the company on a winding up is limited to the amount, if any, that remains unpaid to the company for their shares (including any premium agreed to be paid). Each share in a company limited by shares (whether public or private) must have a fixed nominal value, for example £1.00.

The liabilities of the directors of the Subsidiary company will be the same as discussed above for the Parent company.

For further information, please also see section **Liabilities** in the section relating to private companies limited by shares.

(d) Tax treatment

CORPORATION TAX

PARENT COMPANY – Technically, the Parent company will be liable to corporation tax on its profits. However, there are a number of exemptions available for charities from corporation tax:

- a ‘primary purpose’ trading exemption (which is available provided that a charity is trading in a way that is related to their charitable purpose);
- an exemption for trading activities that are mainly carried out by the people benefiting from the charity i.e. its beneficiaries;
- a ‘small trading’ exemption (as long as raising money on a small level and on a level that does not impact significantly on the charity’s assets);
- an exemption on profits from fundraising events;
- an exemption on profits from charity lotteries; and
- an exemption on the income it receives from the Subsidiary company by way of Gift Aid.

The Parent company must also be careful that any investment it makes in the Subsidiary company is for a charitable purpose or for its benefit. If it does not meet these criteria then the investment will cause the Parent company to lose some or all of its tax exemptions as the investment will be seen as non-charitable expenditure.

SUBSIDIARY COMPANY – The Subsidiary company would ordinarily be liable for corporation tax on its profits, however usually in this type of structure and as in the case with the FRC Group, the Subsidiary company enters into a Gift Aid arrangement with the Parent company under which they agree to pay to the Parent company a sum of money equivalent to the Subsidiary company’s taxable profits. When a charity owned subsidiary company makes such a payment, it is not treated as a distribution of profit but as a qualifying donation under the company Gift Aid rules and therefore is effectively deducted from its income. The Subsidiary company therefore may eliminate its profits so that no corporation tax is payable. Further, Gift Aid payments to the Parent company from the Subsidiary company will be exempt from corporation tax in the Parent

company to the extent that they are applied to further the charitable purposes of the Parent company.

The Subsidiary company can claim tax relief on the donations it makes to the Parent company by way of Gift Aid at any time from the start of a relevant accounting period until nine months after the end of that period. It is up to the directors of the Subsidiary company when to make the payments to the Parent company. It is important to note however that the nine months' time limit is only available to subsidiaries wholly owned by one or more charities which is why the Parent company is normally the sole shareholder of the Subsidiary company.

VAT

PARENT COMPANY – Charities are generally subject to the same VAT rules as any other organisation therefore if the Parent company's taxable income is above the VAT registration threshold (currently £77,000) then it must register for VAT in the normal way. There are, however, a number of VAT reliefs available for charities, subject to certain conditions and restrictions. For more information, please see <http://www.hmrc.gov.uk/charities/vat/intro.htm>.

SUBSIDIARY COMPANY – HMRC treats subsidiary trading companies owned by charities as normal commercial enterprises for VAT purposes. If the trading subsidiary makes taxable sales in excess of the VAT registration threshold it must register for VAT, otherwise it may register voluntarily.

There are two exceptions that may apply:

- (i) if the profit from the selling of the goods is going to the Parent company then this will cause no VAT charge to arise; or
- (ii) if it is a fundraising event that is occurring on behalf of the Parent company but undertaken by the Subsidiary company then no VAT charge will arise.

(e) Ongoing governance and Regulatory obligations

PARENT COMPANY – The Parent company as a CLG must comply with all governance obligations relating to private companies in addition to those requirements applicable to charities.

All companies are required by law to make public certain information, such as an annual return and financial accounts (although these will be in a form prescribed by the accounting principles and standard applicable to charities), which need to be filed with the registrar at Companies House. Details of changes of trustees and the company secretary, and amendments to the

memorandum and articles of association also need to be filed. Please see section **Ongoing governance and regulatory obligations** in the section relating to CLGs for further information.

As a charity the Parent company will also be required to comply with the requirements of the Charity Commission including filing annual returns and accounts with the Charity Commission. For further information on these requirements, please see the **Charities Guide**.

SUBSIDIARY COMPANY – As discussed above for the Parent company, the Subsidiary company will also be required to comply with all governance obligations relating to private companies. Please see section **Ongoing governance and regulatory obligations** in the section relating to private companies limited by shares for further information.

(f) Corporate structure

PARENT COMPANY – As a CLG the Parent company is an incorporated organisation and therefore has a legal identity separate from its members enabling it to enter into contracts or own property in its own name.

A CLG must have at least one director who will be responsible for the running of its day-to-day affairs, and it is not required to appoint a company secretary. The articles of association may sometimes refer to the directors as executive officers or to a council of management, but the duties and responsibilities of the officers are the same as those of directors.

Where the CLG is also registered as a charity the directors are often known as trustees, and generally a number of such trustees should be appointed. Most trustees are volunteers and therefore do not receive remuneration (except for any out-of-pocket expenses incurred as a result of carrying out their duties). The trustees are responsible for ensuring that the Parent company utilises its resources to further its charitable objectives.

The members of a CLG will be those persons registered in the register of members. The articles of association will set out the rights of the members and admission criteria. Unlike shares, the members' interests in the company are generally not transferable. In addition, CLGs which are also registered as charities are prohibited from distributing profits to their members therefore the members' only right will usually be the right to vote.

SUBSIDIARY COMPANY – Similarly to the Parent company, the Subsidiary company as a private company limited by shares also has a legal identity

separate from its shareholders and therefore will be able to enter into contracts or own property in its own name.

As with any private company limited by shares, the Subsidiary company will also need at least one director, if not a board of directors, who will be responsible for the running of its day-to-day affairs. These directors are sometimes the same as the directors/trustees of the Parent company, however care must be taken to ensure that there is no conflict of interest and no circumstances in which charitable resources are used for non-charitable purposes.

The Parent company is the sole shareholder of the Subsidiary company, and therefore will have sole voting rights and the right to receive any dividends from the Subsidiary company.

(g) Finance and fundraising

PARENT COMPANY – The biggest source of finance for a non-profit entity will be gifts and donations that it receives from the general public. Trustees have an overriding duty to act in the interests of the charity and must balance adequately resourcing the charity against not exposing it to too much risk. The trustees' duty of care requires that they exercise reasonable care and skill in carrying out their responsibilities.

Where members of the public or volunteers are fundraising on behalf of the charity or where the charity employs a professional fundraiser, trustees should ensure that they have proper and appropriate control of funds. This includes ensuring that funds are only spent for the purpose for which they were raised.

SUBSIDIARY COMPANY – The Parent company can freely make a nominal subscription of share capital when the Subsidiary company is formed. However the Subsidiary company will usually require more than a nominal amount of capital in order to operate effectively. Most companies fund their business through a mixture of share capital, loan capital, and retention of profits.

As discussed above the tax system encourages the transfer of the Subsidiary company's profits to its parent charity as Gift Aid. Consequently the Subsidiary company's need for funding will, in most cases, be met mainly out of share capital and/or loan capital. This capital is normally, though not always, provided by the Parent company. In providing this capital the Parent company must first assess if it is permitted to assess whether it is a suitable investment of its assets – the interests of the Parent company are paramount. Thus, sometimes, outside investment may be sought as an alternative.

If outside investment is sought then certain factors must be considered. As the Subsidiary company will normally pay all of its taxable profits to the Parent company as Gift Aid there will be no distributable profits for a dividend payment so share capital investment is unlikely to be popular with outside investors as they will not get a regular income from such an investment. Thus, outside investment is likely to be in the form of a loan. When any such outside investment is sought, the Parent company must consider whether the investment is in the Parent company's interests.

Another aspect for the Parent company to consider when financing the Subsidiary company is that it must not provide support to the Subsidiary company on terms which involve a greater or lesser element of gift. For example:

- a parent charity must not make donations to the trading subsidiary, in cash or in kind, whether by purchasing stock for the subsidiary, and donating that stock to the trading subsidiary, or otherwise;
- a parent charity must not settle the debts of a trading subsidiary; and
- a charity must, if allowing the use of its staff, buildings or equipment by a trading subsidiary, make fair charges for those uses.

(h) Resources

For more information, visit:

<http://www.companieshouse.gov.uk>

<http://www.charitycommission.gov.uk>

4.2 NON-PROFIT SUBSIDIARY OF FOR-PROFIT ENTITY

Key advantages / disadvantages

ADVANTAGES

- Large companies can utilise some of their profits to further a social aim
- Method for large companies to make donations to and support other social enterprises/charities
- PR benefit/increasing interest of corporates in social enterprise or contribution to the communities that support them

DISADVANTAGES

- Dividing the social enterprise from the purely for-profit part of the business may be difficult
- Ensuring the independence of the assets allocated to the social enterprise/charitable entity
- Additional costs of running a separate entity

Case study

BIG SOCIETY CAPITAL GROUP

ABOUT BIG SOCIETY CAPITAL GROUP

Big Society Capital was launched in April 2012 as an independent financial institution to develop and shape a sustainable social investment market in the UK by providing finance to organisations tackling major social issues. It is run independently from government with decisions around funding being made by an impartial investment committee.

BIG SOCIETY CAPITAL GROUP STRUCTURE

- The group is made up of three entities:
- Big Society Trust ('BST') which is a company limited by guarantee and is the parent of the group. BST is responsible for ensuring that the group as a whole remains true to its mission.
- Big Society Capital Limited ('BSC') which is a private company limited by shares and is the operating subsidiary in the group.
- Big Society Foundation, which will be established as a company limited by guarantee with charitable status and will receive charitable donations and surpluses generated by BSC.

THE BIG SOCIETY TRUST

BST is the majority shareholder in BSC and holds a 60% equity stake with the remaining 40% owned equally by the four 'Merlin' banks (Barclays, HSBC, Lloyds Banking Group and RBS). BST will always hold at least 80% of the voting rights in BSC and the Merlin banks will always be a minority shareholder and their collective voting rights will never exceed 20%. However, the 'Merlin' banks' shares carry a

preference right on a winding up and also a right to a seat on the Board. The 'Merlin' banks also have a right of veto over changes to BSC in which they have a material interest, including BSC's mission and the rights attached to their shares, although any change to BSC's social mission requires the consent of at least 75% of the BST board.

BSC reports regularly to the BST board on its financial performance; new investments (and how they further the aims of BSC); the performance and monitoring of existing investments; material breaches of investment principles or responsible business principles; and the details of senior management appointments and remuneration. The BST board contains a balance of expertise from both the social and financial sectors as well as a nominated Government representative to ensure that BST is able to carry out its role effectively.

BST will fund its equity investment in BSC through the funding it receives from dormant accounts and by the four Merlin banks. Under the Dormant Bank and Building Society Accounts Act 2008, banks and building societies can voluntarily transfer money from bank accounts which have been dormant for 15 years or more to a reclaim fund. A proportion of these funds will be retained to meet demands from customers, and the remainder will be transferred to the Big Lottery Fund to distribute for social purposes.

The reclaim fund was established by the Cooperative Banking Group and is regulated by the FSA. Its independent board determines the amount to be transferred to the Big Lottery Fund (subject to FSA approval) and the money transferred is divided up between England, Scotland, Wales and Northern Ireland. The English proportion will be transferred to BST.

In addition, the Merlin banks have agreed to invest £50m each in BSC. If BSC decides to distribute a dividend, the Merlin banks will have a right to a share proportionate to their equity contribution to BSC.

BIG SOCIETY CAPITAL LIMITED

BSC's purpose is to achieve its social mission rather than to maximise profits for shareholders. The board of BSC (the 'Board') is mainly made up of non-executive directors, with one executive director, the CEO. This is to ensure that the Board reflects the purpose of BSC and includes a balance of financial and social sector expertise and to provide overall

leadership and accountability for BSC's performance. The Board has the right to delegate to formal committees it established, including an investment committee.

BSC is run by an executive management team which leads the five key areas of the business: investments; impact and operations; strategy and market development; finance; and communications and marketing. An advisory board made up of prominent practitioners from the social, financial and business sectors provides advice to the CEO of Big Society Capital and currently comprises 23 members, meeting approximately three times a year. The Board is expected to grow with the portfolio of investments.

Big Society Capital invests in social investment finance intermediaries which are organisations that provide appropriate and affordable finance and support to social entrepreneurs, including charities, voluntary and community organisations, cooperatives and mutuals. Big Society Capital chooses to invest through intermediaries rather than directly in social entrepreneurs because it believes that by supporting intermediaries to grow and become more sustainable, it will be able to bring more sources of investment and finance to the social sector which will create sustainable financing for social entrepreneurs rather than just BSC acting alone.

BIG SOCIETY FOUNDATION

The Big Society Foundation will be used to develop complementary grant programmes to support the group's mission.

For more information, visit:

<http://www.cabinetoffice.gov.uk/sites/default/files/resources/big-society-bank-outline-proposal.pdf>

<http://www.bigsocietycapital.com>

(a) Key overview

Another example of a hybrid structure is a for-profit parent entity having a non-profit subsidiary. Where the for-profit parent entity has been in operation for a period of time, or has a considerable investor base (especially in the case of a public company listed on a stock exchange), it cannot in most cases compromise the return for those investors or the value of the company. However,

by setting up a charitable foundation as part of its commitment to corporate social responsibility, it can utilise some of its profits/resources to contribute to the benefit of society and the community in general.

By setting up such a philanthropic organisation, the for-profit entity can have a dedicated part of its business model focused on non-profit objectives, as this part of the business will have its own board of trustees and members who are responsible for its activities. This allows the for-profit company to continue to focus on making profits for its shareholders whilst the non-profit company can focus on gaining grants, fundraising and contributing to the social good. The separation allows the two entities to focus on their separate aims whilst also allowing the non-profit entity to utilise the resources and reputation of the parent to further achieve its goals.

FOR-PROFIT PARENT COMPANY – The for-profit parent could be either a public or private company limited by shares. It will therefore be a legal entity separate from its owners (shareholders) and so can, amongst other things, enter into contracts and hold property in its own name. This also ensures that the liability of the company's shareholders is limited to the amount, if any, unpaid on their shares in the company.

For the purposes of this section, we have assumed that the for-profit parent company is a private company limited by shares. However, the for-profit parent company could also be a public company limited by shares, and in such circumstances, please see section relating to **Public Companies Limited By Shares: Ethical Public Offerings** for more information.

NON-PROFIT SUBSIDIARY – The most likely form for the non-profit subsidiary entity would be a private company which may or may not also be registered as a charity. A CLG or a CIC are likely to be the most usual types of entity used for the non-profit subsidiary as these two structures are widely seen as most appropriate where a return to shareholders is not required, or at least such return can be capped. These two structures are also more commonly used where charitable status is also sought. For further information, please see section **Overview** in the section relating to CLGs and section **Overview** in the section relating to CICs, and the **Charities Guide** for information relating to registering as a charity in England and Wales.

For the purposes of this section, we have assumed that the non-profit subsidiary is a CLG and has registered as a charity.

(b) Establishment costs

FOR-PROFIT PARENT COMPANY – The for-profit parent company will be incorporated in the same way as any other private company limited by shares. Please see section **Establishment costs and documentation** in the section relating to private companies limited by shares for further information

NON-PROFIT SUBSIDIARY – The first stage of the incorporation process is to form the CLG. Please see section **Establishment costs and documentation** in the section relating to CLGs for further information relating to the procedure and costs of incorporation.

It is important to note however, that a company's purposes, or objects, will be unrestricted unless the articles of association provide otherwise. Therefore, to be eligible to register as a charity, its objects must be entirely charitable. For more information, please see section **Establishment costs** in the section relating to public charity as a parent and a for-profit entity as subsidiary hybrid.

Once the CLG has been incorporated, it must then register as a charity by using the online application service of the Charity Commission⁵⁵. The online application can be found at: <https://www.charitycommission.gov.uk/officeforms/OLARPortal.ofml>. Please see the **Charities Guide** for further information on charitable objects and registering as a charity in England and Wales.

(c) Liabilities

FOR-PROFIT PARENT COMPANY – The liability of shareholders of a private or public company limited by shares to contribute the assets of the company on a winding up is limited to the amount, if any, that remains unpaid to the company for their shares (including any premium agreed to be paid). Each share in a company limited by shares (whether public or private) must have a fixed nominal value, for example £1.00. Please see section **Liabilities** in the section relating to private companies limited by shares for further information.

Directors of all companies (whether public or private) in general benefit from limited liability so that the company is liable for its own debts, and not the directors. However, in exceptional circumstances the directors may be personally liable, for example, if the director has committed fraud, and it is important to note that a director can face both civil and criminal penalties.

⁵⁵ www.charity-commission.gov.uk/start_up_a_charity/Guidance_on_registering/The_registration_process_index.aspx

For further information on the liability of shareholders and directors of the for-profit parent company, please also see section **Liabilities** in the section relating to private companies limited by shares.

NON-PROFIT SUBSIDIARY – As in the case of any CLG, the members of the non-profit subsidiary will have no liability to contribute to the non-profit subsidiary's capital while it is operating as a going concern. The members will only be liable on a winding up and only to the extent of their guarantees to the non-profit subsidiary (usually a nominal sum such as £1.00).

The liabilities of the directors (where the CLG has also obtained charitable status they will often be called trustees) of the non-profit subsidiary will be the same as discussed above for the for-profit parent company. For further information, please also see section **Liabilities** in the section relating to CLGs.

(d) Tax treatment

CORPORATION TAX

FOR-PROFIT PARENT COMPANY – The for-profit parent company will be liable to corporation tax as usual. For further information on the tax implications, please see section **Tax treatment** in the section relation to private companies limited by shares.

NON-PROFIT SUBSIDIARY – Technically, the non-profit will be liable to corporation tax on its profits. However, there are a number of exemptions available for charities from corporation tax, and essentially to qualify the non-profit subsidiary must use all income and gains solely to further its charitable purposes. Please see section **Tax treatment** in the section relating to a public charity as parent and a for-profit entity as subsidiary hybrid for further information on the relevant exemptions.

VAT

FOR-PROFIT PARENT COMPANY – Charities are generally subject to the same VAT rules as any other organisation therefore if the Parent company's taxable income is above the VAT registration threshold (currently £77,000) then it must register for VAT in the normal way. There are, however, a number of VAT reliefs available for charities, subject to certain conditions and restrictions. For more information, please see <http://www.hmrc.gov.uk/charities/vat/intro.htm>.

NON-PROFIT SUBSIDIARY – Charities are generally subject to the same VAT rules as any other organisation therefore if the non-profit subsidiary's taxable income is above the VAT registration threshold (currently £77,000) then it must register

for VAT in the normal way. There are, however, a number of VAT reliefs available for charities, subject to certain conditions and restrictions. For more information, please see <http://www.hmrc.gov.uk/charities/vat/intro.htm>.

(e) Ongoing governance and regulatory obligations

FOR-PROFIT PARENT COMPANY – The for-profit parent company as a private company limited by shares must comply with all governance obligations relating to private companies.

All companies are required by law to make public certain information, such as an annual return and financial accounts, which need to be filed with the registrar at Companies House. Details of changes of directors and the company secretary, and amendments to the memorandum and articles of association also need to be filed. Please see section **Ongoing governance and regulatory obligations** in the section relating to private companies limited by shares for further information.

NON-PROFIT SUBSIDIARY – The non-profit subsidiary as a CLG must comply with all governance obligations relating to private companies in addition to those requirements applicable to charities.

As discussed above for the for-profit parent company, the non-profit subsidiary company will also be required to comply with all governance obligations relating to private companies. All companies are required by law to make public certain information, such as an annual return and financial accounts (although these will be in a form prescribed by the accounting principles and standard applicable to charities), which need to be filed with the registrar at Companies House. Details of changes of trustees and the company secretary, and amendments to the memorandum and articles of association also need to be filed. Please see section **Ongoing governance and regulatory obligations** in the section relating to CLGs for further information.

As a charity the non-profit subsidiary will also be required to comply with the requirements of the Charity Commission including filing annual returns and accounts with the Charity Commission. For further information on these requirements, please see the **Charities Guide**.

(f) **Corporate structure**

FOR-PROFIT PARENT COMPANY – As a private company limited by shares, the for-profit parent company is an incorporated organisation and therefore has a legal identity separate from its members enabling it to enter into contracts or own property in its own name.

As with any private company limited by shares, the for-profit parent company will also need a board of directors who will be responsible for the running of its day-to-day affairs.

The shareholders of the for-profit parent company will have the voting rights and the right to receive any dividends from the for-profit parent company. Therefore, if any proportion of the profits of the company are to be distributed or gifted to the non-profit subsidiary, the shareholders must ultimately approve such allocation.

Please see section **Corporate structure** in the section relating to private companies limited by shares for further information.

NON-PROFIT SUBSIDIARY – Similarly to the for-profit parent company, the non-profit subsidiary as a CLG also has a legal identity separate from its members and therefore will be able to enter into contracts or own property in its own name.

A CLG must have at least one director who will be responsible for the running of its day-to-day affairs, and it is not required to appoint a company secretary. The articles of association may sometimes refer to the directors as executive officers or to a council of management, but the duties and responsibilities of the officers are the same as those of directors.

Where the CLG is also registered as a charity, the directors are often known as trustees, and generally a number of trustees should be appointed. Most trustees are volunteers and therefore do not receive remuneration (except for any out-of-pocket expenses incurred as a result of carrying out their duties). The trustees are responsible for ensuring that the non-profit subsidiary utilises its resources to further its charitable objectives.

The members of a CLG will be those persons registered in the register of members. The articles of association will set out the rights of the members and admission criteria. Unlike shares, the members' interests in the company are generally not transferable. In addition, CLGs which are also registered as charities are prohibited from distributing profits to their members so the members' only right will usually be the right to vote.

(g) Finance and fundraising

FOR-PROFIT PARENT COMPANY – One of the main advantages of a private company limited by shares is its ability to raise capital from external investors by the issue of shares. For small companies set up by an individual, they will in most cases rely on their own savings or those of friends or family. However, for larger companies, there may be a larger investor base and even backing from a private equity investor. Private companies limited by shares may also raise money by issuing bonds. These are essentially a promise to pay a certain amount, in addition to interest, to an investor. Please see section **Finance and fundraising** in the section relating to private companies limited by shares for further information.

Public companies have the additional advantage of being able to offer their shares to the public. Please see section **Finance and fundraising** in the section relating to **Public Companies Limited By Shares: Ethical Public Offerings** for further information.

NON-PROFIT SUBSIDIARY – Unlike companies limited by shares, the members of a CLG do not contribute to the company's capital. Therefore, its main source of income is either through membership fees, or charitable donations that it receives from the general public.

Charities and other non-profit organisations can also benefit from grants, although charities may be more successful in securing grants as their objects are entirely charitable. The government and the EU are common grant providers, as are charitable foundations themselves. Please see the **Charities Guide** for further information on raising funds through charitable donations and the availability of grants for charitable entities.

(h) Resources

For more information, visit:

<http://www.companieshouse.gov.uk>

<http://www.hmrc.gov.uk>

<http://www.charitycommission.gov.uk>

4.3 MINORITY OWNERSHIP STAKES IN FOR-PROFITS BY NON-PROFITS (AND OTHER AFFILIATE RELATIONSHIPS)

Key advantages / disadvantages

ADVANTAGES

- Charitable entities can get involved in higher risk/higher return investments which may be outside their own risk profiles
- Charitable entities can invest in other businesses and entities which have the same charitable/social objectives
- Ability to generate income from another source rather than just through donations or trading activities

DISADVANTAGES

- Experienced investment committee must be in place to ensure that investments are suitable
- Higher risk profile for the charitable entity
- Increased costs in engaging specialised investment advice in order to manage investments

Case study

THE CARBON TRUST

ABOUT THE CARBON TRUST

The Carbon Trust was created in 2001 and is an independent, organisation that helps businesses, governments and public sector organisations reduce their carbon emissions, implement energy-saving strategies and develop and deploy low-carbon technologies. The Carbon Trust's mission is to 'tackle climate change by creating a vibrant low-carbon economy that delivers jobs and wealth'. It provides a number of services to clients including advice on developing low-carbon strategies, early stage cleantech venture incubation, and company and supply chain 'footprinting', i.e. measuring and certifying the environmental footprint of an organisation, its supply chain and final products or services. The Carbon Trust has also set international

standards for carbon emission measurement, and more than 600 organisations have now achieved the Carbon Trust Standard. Additionally, the Carbon Trust provides finance for energy efficiency projects and creates and invests in low-carbon companies as discussed below.

The Carbon Trust is organised as a CLG and as such recycles profits into its mission rather than paying dividends. For the period ended 31 March 2011 it had retained profits of £10.38 million. Until 31 March 2012, the Carbon Trust was primarily funded by the Department of Energy and Climate Change and the Devolved Administrations through grants, as well as receiving grant funding from the Foreign and Commonwealth Office, the Department for the Environment, Food and Rural Affairs, and the Department for Transport. Although the Carbon Trust is still a recipient of government funding for certain of its activities, it has moved to a primarily commercial funding model by generating income through sales and licensing agreements, payment for the services it provides, and returns on the investments it makes.

THE CARBON TRUST'S ENERGY EFFICIENCY IMPLEMENTATION AND INVESTMENTS

Since 2003, the Carbon Trust has provided almost 4,000 businesses with a total of £190 million for the implementation of energy efficiency projects through its loan programme. The Carbon Trust has also created and brought third-party co-investment into a number of for-profit low-carbon companies such as Partnerships for Renewables; Low Carbon Workplace; InSource Energy; Solar Press; Eight19; and FutureBlends. The Carbon Trust has also provided early stage venture capital and seed financing to various cleantech businesses in the UK.

For more information, visit <http://www.carbontrust.com/>.

(a) Key overview

As noted in section relating to the non-profit subsidiary of for-profit entity hybrid, above, charitable and other non-profit organisations often find it difficult to raise finance to fund their charitable or philanthropic work. One common way for these types of entities to increase their income is to invest in for-profit, trading entities, sometimes by way of direct invest into these entities, for both philanthropic and profit making motives, similar to the business model employed by the Carbon Trust.

(b) Establishment Costs

In most cases, the non-profit entity will be a CLG and also a registered charity. The first stage of the incorporation process is to form the CLG. Please see section **Establishment costs and documentation** in the section relating to CLGs for further information relating to the procedure and costs of incorporation.

It is important to note however, that a company's purposes, or objects, will be unrestricted unless the articles of association provide otherwise. Therefore, as the company is also a charity, its objects must be entirely charitable. Please see the **Charities Guide** for further information on charitable objects and registering as a charity in England and Wales.

Once the CLG has been incorporated, it must then register as a charity by using the online application service of the Charity Commission. Please see section **Establishment costs** in the section relating to public charity as a parent and a for-profit entity as subsidiary hybrid for further information.

(c) Liabilities

As in the case of any CLG, the members of the non-profit entity will have no liability to contribute to the non-profit entity's capital while it is operating as a going concern. The members will only be liable on a winding up and only to the extent of their guarantees to the non-profit entity (usually a nominal sum such as £10.00).

Directors of companies (where the CLG has also obtained charitable status they will often be called trustees) in general benefit from limited liability so that the company is liable for its own debts, and not the directors. However, in exceptional circumstances the directors may be personally liable, for example, if the director has committed fraud, and it is important to note that a director can face both civil and criminal penalties.

For further information on the liability of members and trustees of the non-profit entity, please see section **Liabilities** in the section relating to CLGs.

(d) Tax treatment

The extension of Gift Aid treatment does not apply to companies which are only partly owned by a charity. These companies can still make donations to charities and obtain corporation tax relief as long as payments are not distributions in respect of shares in the company.

Whether a payment made by a company to a charity is a distribution in respect of shares is a question of fact. Broadly, any payment made by a company to a

charity in its capacity as a shareholder is regarded as a distribution in respect of shares in the company, and as such will not qualify as a Gift Aid donation. For example, where a commercial shareholder receives a distribution of profit from the company, HMRC may challenge the use of Gift Aid to make a payment to the charity, and classify the payment as a distribution to the charity.

(e) Ongoing governance and regulatory obligations

The non-profit entity, as a CLG, must comply with all governance obligations relating to private companies in addition to those requirements applicable to charities.

All companies are required by law to make public certain information, such as an annual return and financial accounts (although these will be in a form prescribed by the accounting principles and standard applicable to charities), which need to be filed with the registrar at Companies House. Details of changes of trustees and the company secretary, and amendments to the memorandum and articles of association also need to be filed. Please see section **Ongoing governance and regulatory obligations** in the section relating to CLGs for further information.

As a charity, the non-profit entity will also be required to comply with the requirements of the Charity Commission including filing annual returns and accounts with the Charity Commission. For further information on these requirements, please see the **Charities Guide**.

(f) Corporate structure

As a CLG the non-profit entity is an incorporated organisation and therefore has a legal identity separate from its members enabling it to enter into contracts or own property in its own name.

A CLG must have at least one director who will be responsible for the running of its day-to-day affairs, and it is not required to appoint a company secretary. The articles of association may sometimes refer to the directors as executive officers or to a council of management, but the duties and responsibilities of the officers are the same as those of directors.

Where the CLG is also registered as a charity the directors are often known as trustees, and generally a number of such trustees should be appointed. Most trustees are volunteers and therefore do not receive remuneration (except for any out-of-pocket expenses incurred as a result of carrying out their duties).

The trustees are responsible for ensuring that the non-profit entity utilises its resources to further its charitable objectives.

The members of a CLG will be those persons registered in the register of members. The articles of association will set out the rights of the members and admission criteria. Unlike shares, the members' interests in the company are generally not transferable. In addition, CLGs which are also registered as charities are prohibited from distributing profits to their members, therefore the members' only right will usually be the right to vote.

Non-profit entities which invest minority stakes in for-profit companies usually have an investment portfolio managed by an external investment manager. The directors together with an Investment Committee will agree an investment policy for the company in order to generate returns while effectively managing risk.

The shares or other assets invested may be held by a trading subsidiary of the non-profit entity.

(g) Finance and fundraising

Companies using this structure are less reliant on grants as they will have access to the returns generated by the investments. This also makes them more attractive to banks and other lending institutions willing to lend as the lenders can take security over the company's assets, including its investments.

(h) Resources

For more information, visit:

<http://www.companieshouse.gov.uk>

<http://www.hmrc.gov.uk>

4.4 OTHER HYBRIDS

Key advantages/disadvantages

ADVANTAGES

- Different corporate forms can be combined, to take advantage of the benefits of each different form
- Different parts of the business can be separated, and incorporated into different entities, to fulfil different aims
- Different tax implications for each of the entities

DISADVANTAGES

- Structures can become more cumbersome, and more time consuming to administer
- Increased costs where more than one entity is used
- Splitting the focus of the core management team

Case study

DOGWOOF LIMITED ('DOGWOOF') AND DOGWOOF PRODUCTIONS LIMITED ('DPL')

Dogwoof is a UK film distributor of social issue films, focussing mainly on ethical documentaries. Founded in 2004, Dogwoof releases films nationwide, acquiring all rights for exploitation through theatrical, DVD, TV, Mobile and online platforms and backing their releases with major marketing campaigns.

Many commercial businesses would consider themselves to have social objectives, however Dogwoof is distinctive because its social purpose remains central to their operation. It is achieved by reinvesting the majority of the profits back into the business.

So why did Dogwoof choose to be incorporated as a private company limited by shares rather than a charity, CLG or a CIC? The legal structure of a private company limited by shares works best for Dogwoof for a number of reasons: Dogwoof has its own separate legal identity, can enter into commercial contracts, such as licensing

agreements and employment contracts and can raise funds by the issue of shares to private investors. In addition, Dogwoof is able, should it so choose, to make a profit which can be distributed as it chooses. In this case, Dogwoof is committed to its social purpose and chooses to put profits back into the company, but it could choose to distribute to shareholders (subject to any restrictions in its constitutional document). It does not have external investors.

DPL is a newly incorporated company limited by shares. It aims to produce films and documentaries that contribute to building a sustainable and better world and funding will be primarily targeted at feature length documentaries for theatrical exploitation. It will contract with Dogwoof to distribute these films.

In order to fulfil these aims, DPL is organising its share capital to qualify for EIS relief (please see section **Tax treatment** in this section for further information relating to EIS relief). Investors will receive shares in DPL which, provided the investor meets the qualifying criteria, will enable them to claim EIS relief against their income tax, up to an annual investment limit, in respect of funds they have used to subscribe for the shares. Organising DPL as a private company limited by shares was the most straightforward way of qualifying for EIS treatment, although other structures can be used for the same purpose. Dogwoof will have a very small shareholding in DPL, as the shareholding will not qualify for EIS relief.

For more information, visit:

<http://www.dogwoof.com>

<http://www.dogwoofproductions.com>.

(a) Key overview

The typical structure in these circumstances is a group of private companies limited by shares. One of the companies will normally be the 'parent' company, and will either hold the entire share capital of its subsidiary (a wholly owned subsidiary) or simply an interest in the associated company, such as Dogwoof and DPL above.

The advantage of having a wholly owned subsidiary is that the parent can control the subsidiary and therefore direct how the business is run. However, in some cases, such as in the case of Dogwoof and DPL, this cannot work due for tax reasons. In order to qualify for EIS treatment, DPL cannot be a subsidiary of any other company.

(b) Establishment costs

Each of the entities in the structure will incur their own establishment costs. Generally, all companies can be formed by (i) incorporating 'from scratch' i.e. drafting the incorporation documents specifically to their needs or by (ii) buying an 'off-the-shelf' company which is a company that has already been incorporated (but has not begun trading), usually by a third party incorporation agent, and which has a standard set of incorporation documents which the user will need to amend to meet their needs. Model articles of association have been established by statute⁵⁶ and can be used in either instance, or completely bespoke articles of association may be used. The Charities Commission have also published a set of model articles suitable for companies limited by guarantee who intend to register as charities.⁵⁷ Please see the **Forms** section of the Bibliography for further information.

Please see section **Establishment costs and documentation** in the section relating to CLGs and section **Establishment costs and documentation** relating to private companies limited by shares for further information relating to the procedure and costs of incorporation.

(c) Liabilities

Liability will depend on the structure that has been utilised. For incorporated entities, each will be responsible for its own debts and liabilities. However, where the entity is part of a group and has provided a guarantee for any other member of the group, either to a lender or an investor, that entity will also be liable for the debts and liabilities of the other group member to the extent of that guarantee.

In addition, where the businesses of the various entities are heavily integrated, the success or failure of one entity could have a corresponding impact on

⁵⁶ The Companies (Model Articles) Regulations 2008 established separate model articles for private companies limited by guarantee, private companies limited by shares and public companies limited by shares.

⁵⁷ Please see the Charities Commission website:
<http://www.charity-commission.gov.uk/Library/guidance/gd1textc.pdf>

the rest of the entities in the group. Therefore, each of the entities could assume liability for the debts and obligations of its fellow group members to ensure the continued success of the group as a whole.

The liability of the shareholders will depend on the corporate forms that have been utilised in the hybrid structure. In the Dogwoof example, all the entities are companies limited by shares. Shareholders of a private company limited by shares will only be liable for the debts and obligations of the entity they have invested in. Please see section **Liabilities** in the section relating to private companies limited by shares for further information.

(d) Tax treatment

1. ENTITY

Again, tax treatment of the entities utilised in a hybrid structure will depend on the type of corporate form that has been used. In the Dogwoof example, all the entities are companies limited by shares. Each of the entities will be subject to tax on trading profits in the normal way. Please see section **Tax treatment** in the section relating to private companies limited by shares for further information.

2. GROUP RELIEF

In addition, the group, if qualifying, can take advantage of group relief. Tax legislation gives special tax treatment to certain transactions between group company members. Generally, a company is in the same group relief group as another company if one is a 75% subsidiary of the other. A company can surrender certain particular types of corporation tax loss to another company in its group and the claimant company can then use this relief, to set against its taxable profits. This reduction in profits means a lower corporation tax liability for the claimant company.

3. VAT

Further, the VAT legislation recognises that there will often be a vast number of supplies of goods and services between group company members. The VAT legislation allows members of the a group to be treated as a single entity for VAT purposes. Broadly, this means that supplies of goods or services by one

member of a group to another are disregarded for VAT purposes. Note that in order to qualify for a VAT group, there is an application process.

In the above case study, Dogwoof and DPL would not qualify for group relief or qualify as a VAT group. You should speak to your tax adviser if you think your social enterprise might qualify for a VAT group.

4. SHAREHOLDER

EIS income tax relief (at a current rate of 30%), and an exemption from capital gains tax, is available for qualifying individuals who subscribe for new ordinary shares in companies that qualify under the EIS scheme. The relief is available up to an annual investment limit, and shares must be held for at least three years. Generally, the investor cannot hold a stake in the issuing company exceeding 30% of the issued share capital.

For the company to qualify for the EIS scheme it must meet a gross assets test, generally exist wholly for the purpose of carrying on a qualifying trade and must not be a 51% subsidiary of another company or under the control of another company (or another company together with persons connected with that other company). Note that the particular circumstances of the company and the company's group, as well as the circumstances of the individual, must be considered in detail so as to determine whether the company, the individual and the shares qualify for relief. There is also an approval process to be undertaken with HMRC.

(e) **Ongoing governance and regulatory obligations**

Each of the entities will be responsible for complying with ongoing regulatory and filing requirements. All companies are required by law to make public certain information, such as an annual return and financial accounts, which need to be filed with the registrar at Companies House. Details of changes of directors and the company secretary, and amendments to the memorandum and articles of association also need to be filed. Please see section **Ongoing governance and regulatory obligations** in the section relating to private companies limited by shares for further information

(f) **Corporate structure**

Each of the entities will have their own corporate structure and be governed by the relevant legislation.

Private companies limited by shares are governed by both their board of directors and their shareholders under the Companies Act and the company's

articles of association. The board of directors is responsible for the day-to-day running of the organisation and records its decisions in board minutes. The shareholders have a number of fundamental powers: in particular, the power to dismiss the board and to change the articles of association. Certain decisions and changes relating to the company will require shareholder approval either as an ordinary or a special resolution. A special resolution requires shareholders of at least 75% of the total shareholding of the company to agree, whereas an ordinary resolution requires at least 50% of the total shareholding of the company to agree. By way of example, company name changes and the acceptance of new articles of association require special resolutions.

Please see section **Corporate structure** in the section relating to CLGs and section **Corporate structure** relating to private companies limited by shares for further information

(g) Finance and fundraising

The use of a hybrid structure gives the social entrepreneur the ability to use a variety of corporate forms to obtain finance. In this case, as a private company limited by shares, the main method of raising capital will be through the issue of shares. At the Dogwoof level, this has been solely at the level of the entrepreneur. Dogwoof could however choose to obtain finance from other sources. Please see section **Finance and fundraising** in the section relating to private companies limited by shares for further information.

However, in addition to the traditional method of raising finance through issuing shares, by organising DPL to qualify for EIS treatment, DPL can attract investors hoping to take advantage of EIS relief on their investment in the company. This means that potentially a wider investor base will be interested in investing in DPL, as the increased risk can be outweighed by the immediate tax savings for the investor. The shares in Dogwoof would not be eligible for EIS treatment as currently structured, therefore the ability for DPL to qualify for EIS treatment has increased the number of available sources of finance for the group as a whole. Please see section **Tax treatment** in this section for further information.

(h) Resources

For more information, visit:

<http://www.companieshouse.gov.uk/>

<http://www.hmrc.gov.uk/EIS>

5 GLOSSARY

“**ACT**” or “**COMPANIES ACT**” means the Companies Act 2006.

“**AIM**” means the AIM Market of the London Stock Exchange.

“**AIM RULES**” means the AIM Rules for Companies issued by the London Stock Exchange as amended from time to time.

“**ARTICLES OF ASSOCIATION**” or “**ARTICLES**” are the rules of a company which set out the internal management structure and procedures, such as the role of members and directors, procedures for appointment and removal, conduct of meetings and so on.

“**ARTS COUNCIL**” means the Arts Council England, a body that among other things provides funding for arts activities that engage people in England, or that help artists and art organisations carry out their work.

“**BUSINESS ANGEL**” means a high net worth individual who provides start-up capital to new business.

“**CHARITIES GUIDE**” means ‘**I want to run a charity, where do I start?: A guide to establishing a charity in England and Wales**’, a TrustLaw publication by Morrison & Foerster (UK) LLP for the Thomson Reuters Foundation.

“**CHARITY COMMISSION**” means the body that registers and regulates charities in England and Wales.

“**COMPANIES HOUSE**” means the registry for companies in England and Wales.

“**CONSTITUTION**” means a contract setting out how the company/body will run i.e. the rules.

“**FSA**” means the Financial Services Authority. The Financial Services Authority is soon to cease to exist. The aim is to implement the Financial Services Bill by the end of 2012. As a result, the FSA will be split into three separate bodies:

- the Financial Policy Committee (**FPC**) whose objective will be to help the Bank of England with its financial stability objective under the Banking Act 2009. The aim is for the FPC to act in relation to the UK’s financial system as a whole i.e. on a wide scale and not specific to any particular firm.
- the Prudential Regulation Authority (**PRA**) whose objective will be to regulate the conduct of specific firms such as banks and investment firms; and
- the Financial Conduct Authority (**FCA**) which will inherit much of the FSA’s existing functions including firms not regulated by the PRA. The FCA will become responsible for regulating IPSs.

“**FSMA**” means the Financial Services and Markets Act 2000 (as amended).

"GIFT AID" means the tax effective method of donating to registered charities in England and Wales

"GUIDE" means the Guide to Social Enterprise in England and Wales.

"HMRC" means HM Revenue and Customs.

"LISTING RULES" means the UKLA's Listing Rules published by the Financial Services Authority as amended from time to time.

"LSE" means London Stock Exchange.

"MEMORANDUM OF ASSOCIATION" or **"MEMORANDUM"** records the initial members on the company's establishment.

"PAYE" means Pay As You Earn and is a scheme that HMRC use to collect income tax and national insurance contributions from employees as they earn it. The company deducts the appropriate sums for each and accounts for these deductions to HMRC.

"PROSPECTUS RULES" means the Prospectus Rules issued by the Financial Services Authority as amended from time to time.

"REGISTRAR" means the Registrar for Companies for companies incorporated in England and Wales.

"REGULATED MARKET" means a financial market regulated by a government appointed body e.g. LSE, PLUS limited market, The London Metal Exchange. A full list can be found at www.fsa.gov.uk/register/exchanges.do.

"REGULATOR" means the Community Interest Company Regulator.

"RIE" means Recognised Investment Exchange. Recognition allows an exemption from the need to be authorised to carry on regulated activities in the UK.

"SECURITY" means the process by which, under law, an obligation can be enforced. For example, using personal assets as security would allow the person owed money to claim any unpaid sum via the claiming of the value of the sum in that person's assets.

"UKLA" means the UK Listing Authority which is the FSA, acting as the competent authority under Part VI of FSMA. In this role, the FSA is a securities regulator, focused on the companies which issue the securities traded in financial markets.

"VAT" means Value Added Tax.

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Companies Act 2006 (Consequential Amendments, Transitional Provisions and Savings) Order 2009 (SI 2009/1941)

Company, Limited Liability Partnership and Business Names (Sensitive Words and Expressions) Regulations 2009 (SI 2009/2615)

Companies (Model Articles) Regulations 2008 (SI 2008/3229)

Co-operative and Community Benefit Societies and Credit Unions Act 1965

Corporation Tax Act 2009

Directors Disqualification Act 1986

Dormant Bank and Building Society Accounts Act 2008

Financial Services and Markets Act 2000 (as amended)

Fourth Company Law Directive 78/660/EEC

Fraud Act 2006

Friendly Societies Act 1992

Income Tax Act 2007

Industrial and Provident Societies Act 1965 (as amended)

Insolvency Act 1986

Literary and Scientific Institutions Act 1854

Proceeds of Crime Act 2002

Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409)

The Companies (Late Filing Penalties) and Limited Liability Partnerships (Filing Periods and Late Filing Penalties) Regulations 2008 (SI 2008/497)

Websites

<http://www.bigsocietycapital.com>
<http://www.bis.gov.uk>
<http://www.businesslink.gov.uk>
<http://www.cabinetoffice.gov.uk>
<http://www.cafedirect.co.uk>
<http://www.carbontrust.com>
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<http://www.charity-commission.gov.uk>
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<http://www.companieshouse.gov.uk>
<http://www.divinechocolate.com>
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<http://www.fairtrade.org.uk>
<http://www.fsa.gov.uk>
<http://www.furnitureresourcecentre.co.uk>
<http://www.givemetap.co.uk>
<http://www.hmrc.gov.uk>
<http://www.thepeoplesupermarket.org>
<http://www.wellcome.ac.uk>
<http://www.whiteribbonalliance.org>

Forms

STRUCTURAL AND CONSTITUTIONAL

Companies House forms: <http://www.companieshouse.gov.uk/forms/formsOnline.shtml>

Model Articles: <http://www.companieshouse.gov.uk/about/modelArticles/modelArticles.shtml>

- private company limited by shares
- private company limited by guarantee
- public company

Registration form for Friendly Society: http://www.fsa.gov.uk/smallfirms/your_firm_type/friendly/registration.shtml

Application form for IPS: http://www.fsa.gov.uk/pages/doing/small_firms/msr/societies/index.shtml

Annual return form for IPS: http://www.fsa.gov.uk/pages/Doing/small_firms/MSR/returns/index.shtml

Application and other forms for CIC: www.bis.gov.uk/cicregulator/forms-introduction/index

Model Articles for CIC: <http://www.bis.gov.uk/cicregulator/forms-introduction/constitution-guidance/model-constitutions>

Model Articles for charitable companies (without share capital): <http://www.charity-commission.gov.uk/Library/guidance/gd1textc.pdf>

Registering as a Community Amateur Sports Club (CASC): http://search2.hmrc.gov.uk/kb5/hmrc/forms/view.page?record=oUtzzRsur_g&formid=3417

TAX

VAT online registration: <https://online.hmrc.gov.uk/registration>

Registering for self-assessment and National Insurance contributions (self-employed sole trader): <https://online.hmrc.gov.uk/shortforms/form/CWF1ST?dept-name=CWF1&sub-dept>

NOTES

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FRONT COVER PHOTO A wind turbine is pictured in a field of miscanthus at Kings Langley. Luke MacGregor / Reuters



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