SOCIAL VENTURES:
WHICH LEGAL STRUCTURE SHOULD I CHOOSE?

A GUIDE FOR SOCIAL ENTREPRENEURS IN ENGLAND AND WALES

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THOMSON REUTERS FOUNDATION

UnLtd

MORRISON FOERSTER

ACKNOWLEDGEMENTS

The Thomson Reuters Foundation is immensely grateful to Morrison & Foerster LLP for their dedication and the extensive resources they have provided to making this Guide possible. Their commitment to the social enterprise sector has paved the way both in the UK and the US for new ways of thinking in relation to how traditional corporate forms can be used or adapted to accommodate businesses that want to achieve social and environmental goals.

MORRISON
FOERSTER

A special thank you goes to UnLtd for their contribution to the preparation of this Guide.

DISCLAIMER

This Guide is an overview only, which is intended to help social entrepreneurs to select the most appropriate legal structure for their social venture. This Guide reflects the law in force in England and Wales as at 1 July 2016. The Guide is general in nature and may not apply to the particular factual or legal circumstances which a social venture faces, and we therefore recommend that independent legal advice is sought. The Guide does not constitute legal advice and should not be relied on as such.

ABOUT US

THOMSON REUTERS FOUNDATION

The Thomson Reuters Foundation acts to promote socio-economic progress and the rule of law worldwide. The organisation runs initiatives that inform, connect and ultimately empower people around the world: access to free legal assistance, media development and training, editorial coverage of the world's under-reported stories, and the Trust Women conference.

TrustLaw, the global pro bono programme of the Thomson Reuters Foundation, supports over 800 social entrepreneurs across 175 countries with access to free legal assistance. In 2016, in partnership with Deutsche Bank and UnLtd, the Foundation released a high-impact poll ranking 'The Best Places to be a Social Entrepreneur'. The poll – the very first of its kind - surveyed almost 900 experts in the world's 45 biggest economies to establish trends, opportunities and challenges related to social entrepreneurship.

www.trust.org

UnLtd

UnLtd is the leading provider of support to social entrepreneurs in the UK and offers the largest such network in the world. It resources hundreds of individuals each year through its core Awards programme and operates a unique model by investing directly in individuals and offering a complete package of resources; from awards of funding to ongoing advice, networking and practical support.

www.unltd.org.uk

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FOREWORD

Around the world, social entrepreneurship is thriving. This is particularly the case in the UK, where the government has played an active role in the sector's evolution; investment continues to blossom; and supporters are diversifying their offerings to help more social entrepreneurs.

As a consequence, the sector has moved well beyond the dichotomy of for-profit and not-for-profit legal structures. For many social entrepreneurs, generating revenue and profit from their enterprises is a key driver, ensuring financial sustainability, generating returns for investors and avoiding the need to rely on charitable donations or grants. However, at the heart of their work, social entrepreneurs are focused on creating and measuring social impact. The legal structure they choose for their organisation can have a significant bearing on their pursuit of this dual mission.

As the lines between 'doing good' and running a commercial business continue to blur, new and innovative ways of structuring social ventures are now common practice in the UK, however the multitude of options available can make identifying the most appropriate entity a bewildering task. This Guide is designed to help social entrepreneurs navigate their way through the different options available to them, and to act as a resource for lawyers and other advisers to social entrepreneurs.

Encompassing the dynamic nature of the social entrepreneurship space, the Guide covers recent changes including reforms to the Community Interest Company, the introduction of Social Investment Tax Relief, and the launch of B corps in the UK. It also reflects the increasing use of the private company limited by shares structure, and describes ways social ventures can embed and protect their social mission.

We hope the Guide acts as a valuable tool to support social entrepreneurs across the UK who are shaping the future of the social impact space. We also wish to acknowledge the outstanding effort and extensive resources that Morrison & Foerster provided in preparing this Guide, and the social entrepreneurs who kindly agreed to be featured.

Monique Villa
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INTRODUCTION

This Guide gives an overview of the range of legal structures that are available to social entrepreneurs when establishing a social venture, and the advantages and disadvantages associated with each.

Social ventures are businesses or other organisations which are established with the primary purpose of a social cause, rather than maximising profits for investors as is the case with a commercial venture.

There are many considerations which will inform the choice of legal structure for a social venture, including:

- the size of the social venture and its planned growth trajectory;
- the planned ownership or membership of the social venture;
- set-up costs and ongoing reporting and compliance requirements;
- how the social venture is intended to be financed;
- how the profits generated by the social venture be used;
- whether the social venture is a trading business or employs people; and
- the tax implications of the structure.

This Guide is divided into three parts:

- Part 1 is a decision tree/flowchart which is intended to be a starting point to assist social entrepreneurs in selecting the most appropriate legal structures for further consideration;
- Part 2 describes each legal structure in more detail, including advantages and disadvantages with that structure, case studies, and details about liabilities, tax treatment, ongoing regulatory obligations and possible implications for financing and fundraising; and
- Part 3 sets out details of hybrid structures, that is to say two or more structures used for the benefits more particularly described in that section.

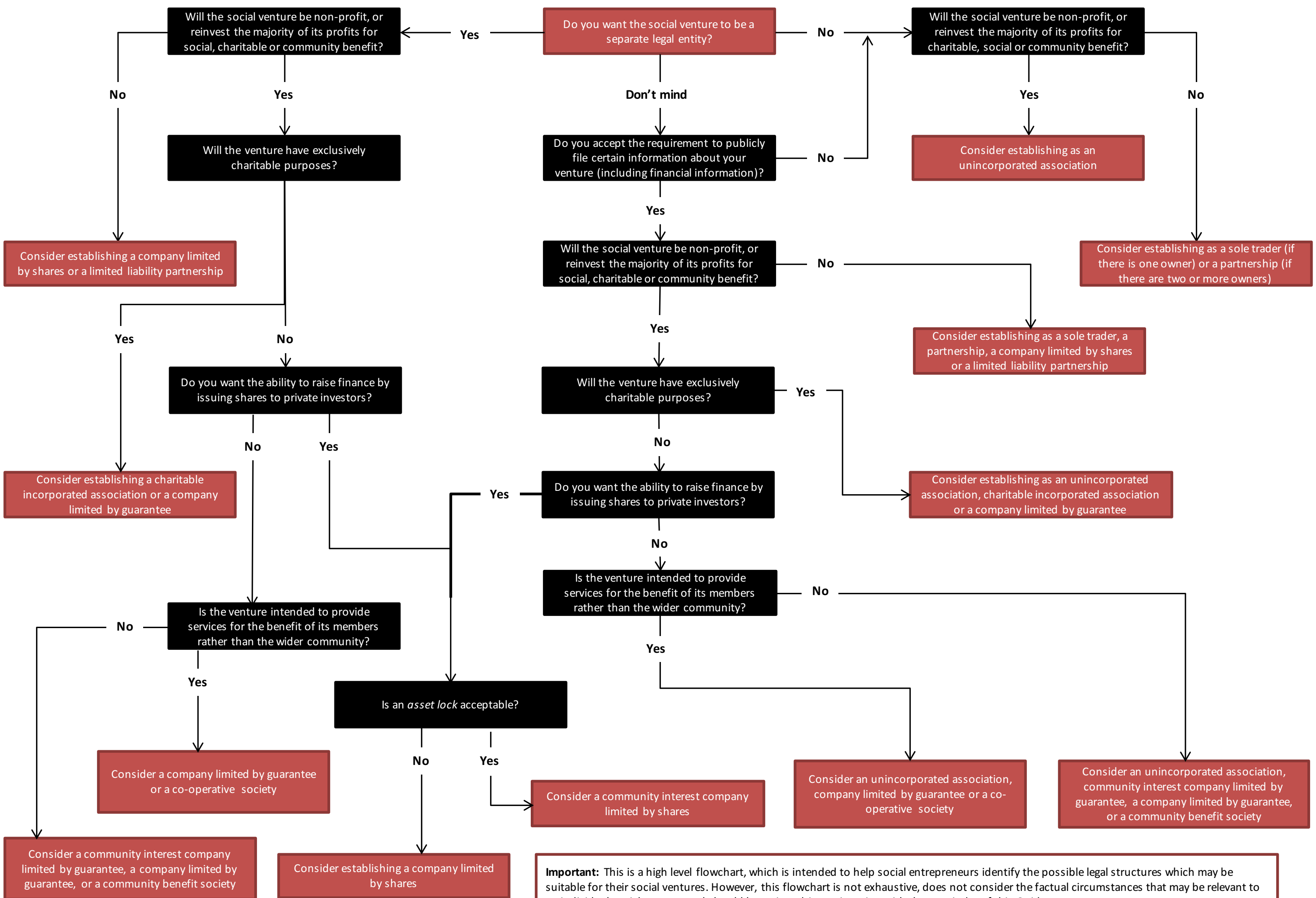
Please note that the regulation of charities is not covered by this Guide. Charitable status is a designation sometimes sought by social ventures due to their tax benefits where the venture has a charitable purpose. They are, however, subject to extensive regulation as they are governed not only by the Companies

Act 2006 (the 'Companies Act'), but also the Charities Act 2006 and the Finance Act 2010 and are regulated by the Charity Commission. In determining which type of legal structure is right for a social venture, if your social venture has a charitable purpose, then we suggest that you refer to the UK government's guidance on 'setting up a charity' on their website[1] or the material on the Charity Commission's dedicated website[2] in conjunction with this Guide.

This Guide is an overview only, which is intended to help social entrepreneurs to select the most appropriate legal structure for their social venture. This Guide reflects the law in force in England and Wales as at 1 July 2016. The Guide is general in nature and may not apply to the particular factual or legal circumstances which a social venture faces, and we therefore recommend that independent legal advice is sought. The Guide does not constitute legal advice and should not be relied on as such.

1. Please see the UK Government's website: https://www.gov.uk/setting-up-charity/set-up-a-charity
2. Please see the Charity Commission's website: https://www.gov.uk/government/organisations/charity-commission

1. WHICH TYPE OF LEGAL STRUCTURE IS RIGHT FOR MY SOCIAL VENTURE?



Important: This is a high level flowchart, which is intended to help social entrepreneurs identify the possible legal structures which may be suitable for their social ventures. However, this flowchart is not exhaustive, does not consider the factual circumstances that may be relevant to an individual social venture, and should be reviewed in conjunction with the remainder of this Guide.

LEGAL STRUCTURES

REUTERS/ JOHN NAZCA

SOLE TRADER

REUTERS/ ADEEL HALIM

SOLE TRADER

AT A GLANCE

SUMMARY

A sole trader is one person carrying on a business on their own without any separate legal identity.

ADVANTAGES

- ✓ Easy to start up: no formal set-up is required
- ✓ Very flexible structure: the individual can decide if profits are retained by them or reinvested in the business/social purpose
- ✓ No public reporting requirements: information/accounts are not made publicly available

DISADVANTAGES

- ☒ No limited liability for the individual: if the business fails, the individual is responsible for the debts and other obligations of the business
- ☒ Risk of losing 'goodwill' in business name as the business name is not registered at Companies House
- ☒ Difficult to raise finance: unsuitable for equity finance, and difficult for large loans
- ☒ Other legal structures may be more immediately identifiable as social ventures (such as a CIO, CIC or cooperative and community benefit society) and gain the commercial benefit such identification brings more readily

CASE STUDY

WELL GROUNDED

Well Grounded is a social enterprise established by UnLtd Award Winner, Eve Wagg, which provides unemployed young people with a career in the coffee industry, training them as baristas and finding permanent work within the hospitality industry. Building on the success of a pilot scheme, Well Grounded is rolling out a 12-week Speciality Barista programme in September 2016 to provide more young people with the opportunity to gain a career in one of the fastest growing markets in the world.

Eve initially ran Well Grounded as a sole trader, as she wanted to test the concept and value proposition of the business quickly, in order to identify demand from her target customer base before incorporating.

After the pilot, Eve decided to incorporate Well Grounded as a CIC in January 2016 as she had found that operating as a sole trader was restricting the funding and investment she could obtain.

Eve chose the CIC model as she wanted the legal structure to make the venture's social impact very explicit, while still developing a commercially viable business. Further, Eve feels that being a CIC provides entry into a wider movement and community that is committed to proving that business can be social.

She considered charity status too, which would have enabled her to access a number of other funding grants and gift aid, but ultimately decided that charity status is not consistent with Well Grounded's long term business model.

SOLE TRADER

a. OVERVIEW

A sole trader is one person carrying on a business on their own, with complete control over its operations. There is no separate legal entity for the business. A sole trader can employ other people in their business, but generally speaking, sole trader businesses are small in scale, with low turnovers, and few (if any) employees.

Being a sole trader is one of the most straightforward ways to establish a business. It does not require any documents to set up the business, nor payment of any registration fees, and there are no formal requirements for business 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). All profits generated by the business belong to the sole trader personally.

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 2.4(c) 'Liabilities' in the section relating to private companies limited by guarantee and section 2.5(c) 'Liabilities' in the section relating to private companies limited by shares.

b. ESTABLISHMENT COSTS AND DOCUMENTATION

Unlike companies, sole traders do not need to prepare any documents to establish their business, and do not register their business with Companies House. Sole traders can simply start trading or carrying out their business activities immediately.

A sole trader can trade using their own name, or under a business name of their choosing. If a sole trader uses a business name of their choosing, there are restrictions on what names may be used, and requirements as to what information the sole trader must be displayed at its place of business and in correspondence. For further information, visit https://www.gov.uk/choose-company-name.

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. Further, it is not possible to reserve names at Companies House.

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. For more information on establishing a sole trader business, visit https://www.gov.uk/set-up-sole-trader.

c. LIABILITIES

As a sole trader does not have a separate legal entity for their business, the sole trader does not benefit from limited liability. The sole trader will be personally liable for all of the debts and obligations of their business. This means that a sole trader's home 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 2.4(c) 'Liabilities' in the section relating to private companies limited by guarantee and section 2.5(c) 'Liabilities' in the section relating to private companies limited by shares for more information on limited liability.

d. TAX TREATMENT

Sole traders should register with HM Revenue & Customs ('HMRC') as soon as possible after starting business. At the latest, sole traders should register by 5 October of the business's second tax year or face a penalty. 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. To register for self-assessment, visit https://www.gov.uk/register-for-self-assessment.

Sole traders may be required to register for value added tax ('VAT'). If taxable supplies made by the sole trader's business in the previous 12 calendar months exceed the threshold for registration (currently £83,000), 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 hire employees, in which case they are responsible for deducting income tax from salaries paid to employees and accounting to HMRC for both employer's and employee's national insurance contributions.

For further information on the taxation of sole traders, please visit: https://www.gov.uk/working-for-yourself and https://www.gov.uk/business-legal-structures/sole-trader.

Individuals who sell their business may be eligible to claim entrepreneurs' relief on the disposal proceeds if they sold 'qualifying assets', which has the effect of applying a reduced rate of capital gains tax (currently 10%) to the qualifying gains.[1] Where a sole trader disposes of the whole or part of their 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 entrepreneurs' relief on the capital gains made.[2] 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 corporate structures. In particular, the business of the sole trader is not required to file a confirmation statement or annual accounts with Companies House. However, this does not mean that the sole trader does not have to keep any records; the sole trader must ensure that complete and proper records of the income and expenses of the business are kept.

f. CORPORATE STRUCTURE

A sole trader's business does not have a separate legal personality from the sole trader. In other words, the sole trader is the business. This means that the sole trader is personally liable for the liabilities of the business, as discussed in section 2.1(c) 'Liabilities' above. Contracts and applications for loans must be made in the personal name of the sole trader.

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. Recent years have also seen the successful use of crowdfunding as a means to raise capital

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

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

for starting a business. Sole traders can raise funds through donations-based and rewards-based crowdfunding. However, as sole traders do not have shares that can be issued to investors in return for cash, equity-based crowdfunding is not an option. Loan-based crowdfunding may be difficult as the obligation to repay a loan is a substantial liability and many lenders will insist on incorporation and may require security for that loan.

UNINCORPORATED ASSOCIATION

REUTERS/ RICARDO MORAES

UNINCORPORATED ASSOCIATION

AT A GLANCE

SUMMARY

An unincorporated association is a group of people who have formed for a particular purpose. Social clubs and voluntary associations are typical examples of unincorporated associations.

ADVANTAGES

EASY TO SET UP AND LOW ESTABLISHMENT COSTS

- ✓ Very flexible structure, as the association is governed by its own rules or bylaws
- ✓ Relatively straightforward to run, and administrative requirements are low
- ✓ Can have more than one person involved in the day-to-day running of the business
- ✓ Capable of being registered as a charity where appropriate

DISADVANTAGES

- ☒ No separate legal identity from the individuals who are members of the association, so no limited liability for entrepreneur
- ☒ Generally unsuitable for borrowing money or seeking investment
- ☒ Generally only suitable for clubs and associations, and less appropriate for organisations which intend to trade or earn significant revenue from their activities

CASE STUDY

MAPESBURY DELL TRUST

Mapesbury Dell Trust (the 'Trust') is an unincorporated association which runs a community-led public park called Mapesbury Dell, located in North West London near Cricklewood Broadway. The Trust is governed by a formal constitution and run by trustees who are elected by its members each year. There are approximately 400 members of the Trust.

The land of Mapesbury Dell is legally owned by Brent Council ('Brent'). As landowner, Brent retains responsibility for all health and safety issues and must also fulfil its statutory duties as a local authority in relation to Mapesbury Dell as a public park. However, there is a formal 'partnership' agreement between Brent and the Trust under which Brent is required to ensure that Mapesbury Dell remains an open space available to the public at large and the Trust and Brent each assume responsibility for specific tasks for the maintenance of Mapesbury Dell. The members of an unincorporated association are personally liable for the debts and other obligations of the association; however, the Trust has obtained various protections from liability under its agreement with Brent.

Mapesbury Dell is governed by a Steering Committee of six people. Half of the Steering Committee is chosen by the trustees and the other half is chosen by Brent. The Steering Committee has the final say on what happens in Mapesbury Dell with the exception of the implementation of health and safety regulations, the fulfilment of Brent's statutory duties as a local authority and any expenditure by Brent. In the event of a deadlock between the members of the Steering Committee from Brent and the Trust, the Trust members have the casting vote.

The constitution of the Trust sets out the charitable purpose of the Trust, which is:

> the enhancement, maintenance and improvement of open space, within the Mapesbury Conservation Area known as Mapesbury Dell and Children's Park for its use:
>
> (a) as a recreational facility for the public at large;
>
> (b) for the advancement of education of children; and
>
> (c) for the conservation of rare and endangered species of wildlife.

As the trust has charitable purposes, it has registered to be able to claim Gift Aid.

The Trust intends to remain an unincorporated association. As an entirely voluntary organisation, with no paid staff, this structure meets its needs, and reflects its community and member-led nature.

UNINCORPORATED ASSOCIATION

a. OVERVIEW

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

Being 'unincorporated' simply means that the founding members have not formed a separate legal entity for the association. This may be to avoid the administrative requirements and expenses in operating a legal entity such as a company. Common examples of unincorporated 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)[3], then it may wish to consider applying to the Charity Commission to be registered as a charity. To register an unincorporated association as a charity, visit https://www.gov.uk/charity-recognition-hmrc.

Unincorporated associations with charitable purposes can also be friendly societies.[4] The governing rules for friendly societies are prescribed by statute[5], 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 insurance[6], during times of sickness, unemployment or at retirement. All friendly societies must be registered with the FCA[7], which keeps records of filings, memoranda and rules for each of the friendly societies. Regulation of friendly societies is a specialist area and is outside the scope of this Guide. For further information, visit https://www.the-fca.org.uk/friendly-societies-introduction.

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3. The Charity Commission will require evidence of a minimum funding of £5,000 to register a charity. Please see https://www.gov.uk/topic/running-charity/setting-up and the Charities Guide for further information.
4. Unincorporated associations wishing to register as a friendly society must now do so under the Friendly Societies Act 1992 (as amended). Incorporated entities can also be friendly societies.
5. The Friendly Societies Act 1974 or the Friendly Societies Act 1992 (as amended).
6. Often the friendly society will provide life insurance (insurance of a long-term nature) but they 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 FCA authorisation under the Financial Services and Markets Act 2000 (as amended).
7. Under the Financial Services and Markets Act 2000 (as amended).

Unincorporated associations which have literary or scientific interests and wish to change the objectives set out in their constitutions may require the consent of the Department of Business Innovation & Skills.[8]

b. ESTABLISHMENT COSTS

Unincorporated associations are relatively straightforward to establish and run, and there is no requirement to register at Companies House. A governing document (known as the association's 'constitution' or 'rules') sets 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 may, by way of example, provide for the election of a management committee to run the organisation on behalf of its members.

c. LIABILITIES

An unincorporated association does not have a legal identity which is separate from that of its members. It therefore cannot hold assets in its own name, and its members will be personally liable for the debts and other obligations of the association. For this reason, much in the same way as sole traders, unincorporated associations are less desirable than a corporate form from a liability management standpoint. Therefore, if a social venture intends to employ staff, enter into substantial contracts, acquire property, or there is the potential for the association to be exposed to liabilities which it could not pay from its own funds, then an entity with a separate legal identity is likely to be more appropriate for the social venture.

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. For further information on the taxation of charities, visit https://www.gov.uk/charities-and-tax or to register as a CASC, visit https://www.gov.uk/government/publications/charities-community-amateur-sports-club-registration-form-casc-a1.

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

8. Under the Literary and Scientific Institutions Act 1854.

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 associations 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 if their UK trading income does not exceed £30,000, 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.

An unincorporated association making taxable supplies to its members will also be subject to VAT in the same way as sole traders. Please see section 2.1(d) 'Tax treatment' in the section relating to sole traders for further information. It is important to note that any membership fees payable by members are a taxable supply. There are specific instances where an unincorporated association will be exempt from VAT. You should consult a tax adviser for advice on your specific circumstances.

An unincorporated association that employs individuals (through its members or management committee) is required to operate the PAYE system, under which the entity must deduct from its employees' pay the appropriate amount of income tax and national insurance contributions ('NICs'), and account for these deductions to HMRC. Employees' NICs are deducted from their earnings ('primary NICs'), while employer's NICs are charged on top of earnings and paid by the employer ('secondary NICs').

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 and, where they are also a charity, the Charity Commission. Consequently, unincorporated associations are often considered more flexible and less restrictive than companies with respect to governance and regulatory obligations.

f. CORPORATE STRUCTURE

An unincorporated association does not have a legal identity which is separate from that of its members. This means that an unincorporated association cannot enter into contracts in its own name; contracts must be entered into by all of the association's members, or such other people as are referred to in its constitution or rules, such as its trustees.

g. FINANCE AND FUNDRAISING

The main source of funding for unincorporated associations is typically the membership fees it collects from its members as well as any grant funding which may be available. Unincorporated associations may also generate income through any trading revenue. Members can also gift property or money to unincorporated associations, such as its trustees.

It is often more difficult for unincorporated associations (when compared with private limited companies) to borrow money[9] and to obtain investment in their businesses. The members must enter into any loan agreements personally, and in some cases may be required to give personal guarantees. In addition, as unincorporated associations do not have shares, they cannot issue shares in exchange for capital in the same way as a company limited by shares can. For this reason, equity-based crowdfunding is not an option open to unincorporated associations, much the same as sole traders.

However, unincorporated associations which own property (held for the association by its trustees) can use such property as security to raise finance. This is normally done by charging the property (via a mortgage) for the benefit of 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 method can be used as a way of participating in loan-based crowdfunding where the investors may require security to be given by the unincorporated association for such loan. This is however a relatively unusual situation and specialist legal advice should be sought for such an arrangement.

Unincorporated associations can participate in donation-based and rewards-based crowdfunding. Other alternate sources of funding such as government grants or funds may also be available to unincorporated associations, such as grants from the Arts Council. Social entrepreneurs should check the individual criteria for any grants or funding that they think might be available to their social venture.

9. 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).

COOPERATIVE AND COMMUNITY BENEFIT SOCIETIES

REUTERS/ BAZ RATNER

COOPERATIVE AND COMMUNITY BENEFIT SOCIETIES

AT A GLANCE

SUMMARY

Cooperative societies are corporate entities formed for the benefit of their members. Community benefit societies are corporate entities formed for a community benefit. Both types of society generally give their members an equal stake and equal say in the management of the society.

ADVANTAGES

- ✓ Separate legal entity, therefore liability of members of the society for its debts are limited to their share capital
- ✓ Flexible governance arrangements
- ✓ Share and loan interest receives more favourable tax treatment than companies
- ✓ Issue of shares or loan capital to the public falls within exemptions from certain statutory requirements which apply to private companies

DISADVANTAGES

- ☒ Must register with, and be approved by, the Financial Conduct Authority
- ☒ Restrictions on distribution of profits
- ☒ Requirement to comply with ongoing reporting requirements; financial information may be publically available
- ☒ Maximum 'withdrawable' shareholding of £100,000 per member

CASE STUDY

GREENSLATE COMMUNITY FARM

Greenslate Community Farm ('GCF') set out to turn a plot of land back into a local asset and also enable local communities to become self-dependent, mutually supportive and environmentally aware. In early 2013, a long-term lease of the land was secured and in August 2013 the farm incorporated as a community benefit society ('CBS').

The founder, UnLtd Award Winner, Mandy Wellens-Bray, decided to establish GCF as a CBS as she felt it was the most inclusive community model and she also wanted the option to raise money via a community share issue. GCF accessed specialist support from an organisation called Making Local Food Work, who dealt with the Financial Conduct Authority on Mandy's behalf. They decided to use model governing documents, termed the 'model rules', which are templates that can be used by new organisations to make sure they set off on the correct legal footing.

GCF was unlikely to realise significant profits from its venture, and any profits it did realise would be reinvested into the venture rather than paid to its members. Therefore, GCF has chosen to offer non-profit making membership shares at £25 for lifetime membership.

GCF expects to stay as a CBS for the foreseeable future; they feel that it best reflects the community's ownership and involvement in the running of the farm.

COOPERATIVE AND COMMUNITY BENEFIT SOCIETIES

a. OVERVIEW

Cooperative and community benefit societies (previously known as 'industrial and provident societies' ('IPS')) are collections of individuals ('members') who have a common purpose, which can be business, trade or for the benefit of the community. A cooperative or community benefit society is a structure incorporated under statute[10], and therefore must be registered and comply with ongoing compliance obligations.

The Cooperative and Community Benefit Societies Act 2014 ('CCBS 2014') has replaced the IPS legal form with two new legal forms, namely, the cooperative society and the community benefit society. In this chapter, 'society' will be used to refer collectively to both types of registered society.

Societies are bodies corporate governed by statute and must be registered with the Financial Conduct Authority ('FCA'). A society wishing to carry out certain regulated activities is required to register with the Prudential Regulation Authority ('PRA'). Each category of society must carry on an 'industry, trade or business'. An organisation that only holds shares in another organisation without carrying on any activity of its own cannot, therefore, be registered as a registered society.

Societies must register with the FCA[11] on either one of two bases:

- as a **cooperative society**: run for the mutual benefit of its members, with any surplus being utilised to provide better services for its members; or
- as a **community benefit society**: run for the benefit of the community at large.

One of the key features of a society, which differentiates it from a company limited by shares, is the profits of the society. In the case of a cooperative society, it may not carry on business with the object of making profits mainly for the payment of dividends, or payment of interest on money invested with or lent to the society by any person. Any profits distributed should reflect the member's trading with the society, and must be done in line with the society's rules. A community benefit society is not permitted to distribute profits to its members; all profits must be retained by the society and applied to further

10. Registered under the Cooperative and Community Benefit Societies Act 2014 which came into force on 1 August 2014. Old IPSs were registered under the Industrial and Provident Societies Act 1965 (as amended).

11. As required by the Cooperative 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.

its community purpose. Where profits are used in part for another purpose, that purpose should be similar to the main object of the society, for example philanthropic or charitable purposes.

As in the case of unincorporated associations, societies are also governed by a set of rules. A management committee is normally appointed to run the society.

Societies cannot be charitable, except in limited circumstances. A community benefit society which has objects which are charitable in law may be accepted as a charity. Such a society would be subject to the legal rules generally applicable to charities and to certain provisions of the Charities Acts. The possibility of being a charity is a reason to use a community benefit society over a community interest company; as the latter cannot be a charity. Some examples of cooperative societies being charities are consumer, agricultural and housing cooperatives, Women's Institutes, mutual investment companies and housing associations. Please see section 2.2 'Overview' in the section relating to unincorporated associations for further information. For further information on societies, visit https://www.the-fca.org.uk/firms-sectors/mutual-society and http://www.uk.coop/developing-co-ops/start-co-operative/plan-your-co-op.

b. ESTABLISHMENT COSTS AND DOCUMENTATION

A society is registered with the FCA instead of Companies House. The FCA will only register a society where it is satisfied that the society meets the definition of a cooperative society or community benefit society, and meets the FCA's other criteria for societies[12].

A governing document (known as the society's 'rules') sets out how the society will be run. Model rules have been created ('Model Rules') and are available on the FCA's website. If adopted in their entirety, the registration fee is currently £40. Registration fees increase on a sliding scale up to £950 depending on the number of amendments to the Model Rules.

Applicants must complete a Form A, which provides information about the first members and directors of the society. For information regarding establishment and access to registration forms and notes, please visit https://www.the-fca.org.uk/register-mutual-society.

12. Section 2 of the Cooperative and Community Benefit Societies Act 2014.

c. LIABILITIES

A society is treated as having a separate legal identity to that of its members, and therefore the society is responsible for its own debts and liabilities. As with companies limited by shares, the liability of the members of the society is limited to the share capital they have invested in the society, and the amount (if any) of any of their unpaid share capital. Similar to the position for directors under company law[13], any member of the governing committee of a society who acts negligently, improperly, or does not fulfil their obligations under statute[14] can be held responsible for the liabilities of the society. Directors may also be held liable for the debts and obligations of the society in certain circumstances for example, where they are guilty of fraudulent or wrongful trading.

d. TAX TREATMENT

Cooperative and community benefit societies are considered corporate bodies and are taxed in the same manner as companies and are subject to corporation tax on their profits in the normal way.

Societies 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 society must register. The registration threshold is currently £83,000. You should consult your tax adviser for advice on your specific circumstances.

A society that employs individuals is required to operate a PAYE system, under which the society must deduct from its employees' pay, the appropriate amount of income tax and NIC, 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 society 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.

Share and loan interest paid by a society 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.

13. The Companies Act and the Insolvency Act 1986.
14. Cooperative and Community Benefit Societies Act 2014.

Loan interest means any interest payable by the society in respect of any mortgage, loan, loan stock or deposit.

Dividends paid by a society carrying on a trade, to a member of the society and by reference to the member's shareholding in the share capital of the society, are deductible for corporation tax purposes.

A community benefit society which has certain objects that are charitable in law may be accepted by HMRC as an exempt charity and enjoy certain exemptions from taxation. Investors in a community benefit society may qualify for Social Investment Tax Relief. For more information, please see section 2.6.

e. ONGOING GOVERNANCE AND REGULATORY OBLIGATIONS

Societies must pay an annual fee of between £60 and £460, depending on the society's total assets. Societies 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: https://www.the-fca.org.uk/mutual-societies-annual-returns-and-accounts.

Societies must submit their annual return and also a copy of their annual accounts to either the FCA (or the Prudential Regulation Authority ('PRA') where the society carries on certain regulated activities (outside the scope of this Guide)).

f. CORPORATE STRUCTURE

Like a company limited by shares, societies 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 society. Commonly a society will set the par value of its shares at £1. Shares may only be redeemed (i.e., bought back by the society) at their par value, and only if permitted by the society's rules. The maximum shareholding of a member that may be redeemed (known as 'withdrawable shares') is £100,000. Under recent legislative changes, there is no limit in relation to shares which are not withdrawable shares.

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

g. FINANCE AND FUNDRAISING

A society may raise capital from its members, but no member can hold more than £100,000 in withdrawable shares. A society may also borrow money in the same way as a private company, subject to the society's rules.

A key attraction of societies for groups raising capital for community projects is their potential exemption from regulation by the FCA under FSMA. When a society offers its own shares or debt, it falls within two exemptions of FSMA. As a result of these exemptions, societies 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.

PRIVATE COMPANY LIMITED BY GUARANTEE

REUTERS/ KIERAN DOHERTY

PRIVATE COMPANY LIMITED BY GUARANTEE

AT A GLANCE

SUMMARY

A form of corporate entity which has members who do not hold shares in the company.

ADVANTAGES

- ✓ Separate legal entity, therefore liability of shareholders for the debts of the company are limited to their guarantee under the incorporation documentation
- ✓ Company may enter into contracts, and hold assets, in its own name
- ✓ Registration as a charity is more easily achieved with this structure and the structure is commonly associated with not-for-profit organisations
- ✓ Unlike companies limited by shares, no share transfer is required each time a member leaves
- ✓ Incorporation is fast
- ✓ The social mission can be embedded in the constitution of the social venture

DISADVANTAGES

- ☒ May be difficult to raise finance, as the company cannot attract investors by issuing shares
- ☒ Suitable for non-profits only, as profits cannot be distributed to the members of the company
- ☒ Prescribed form of accounts (unless exempt) and certain company information must be made publicly available
- ☒ Ongoing reporting obligations; financial information may be publicly available
- ☒ Company may not be immediately identifiable as a social venture and may not readily gain the commercial benefit that such identification brings

CASE STUDY

IGNITION BREWERY

Ignition Brewery (‘Ignition‘) is an early stage but very ambitious micro-brewery, founded by UnLtd Award Winner, Nick O’Shea. What makes Ignition different is that the brewing team have learning disabilities.

Ignition incorporated as a company limited by guarantee. They felt they needed the same legal structure as other breweries so that they could compete on a level playing field, but they still wanted to embed their social mission. They achieved this by making a constitution which states that all profits made will be distributed back into the community, and specifically to people with a learning disability.

At the moment, charitable status is not something Ignition aspires to. This is because Ignition seeks to employ people who receive state benefits and also works in the highly regulated industry of alcohol production, as a result the administrative requirements that Ignition must observe are substantial. Ignition feels that adding the administrative requirements of charitable status would cause the bureaucratic burden on the company to be too high.

Ignition has a longer term aim to become a community interest company (‘CIC‘). The key advantage of a CIC would be a clear indication to the world that Ignition is ‘for good’ and has a social mission. However, they plan to explore this further once they have a well-established and sustainable business model.

PRIVATE COMPANY LIMITED BY GUARANTEE

a. OVERVIEW

A company limited by guarantee ('CLG') is a type of private company that is often used by non-profit organisations.

CLGs do not have a share capital. The CLG has members rather than shareholders and its profits cannot be distributed to the members through dividends. The members of the CLG may appoint directors who are given responsibility for creating and implementing policies for the CLG.

CLGs may apply for charitable status. CLGs which intend to apply for charitable status must include exclusively charitable objectives ('objects') in their constitutional documents, which is a legal requirement and the Charity Commission will look closely at this point.

Non-charitable CLGs may decide to include a charitable or social objective in the CLGs' constitutional documents but are not obliged to as, unless otherwise stated in the constitutional documents, the objects of the CLG are unlimited.

A CLG has a separate legal identity from that of its members. This means that the company's finances are separate from the personal finances of the members. The advantage of choosing a CLG is that each member's liability for the CLG's debt and liabilities is limited to the amount that they have guaranteed when they became a member of the CLG (which is usually a nominal sum such as £1). Therefore, save for this guarantee amount, members will not ordinarily be responsible for the CLG's debts simply by virtue of being a member of the CLG. Members may be individuals or corporate entities.

The governance rules of a CLG 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 of the CLG.

A CLG need not have the word 'Limited' at the end of its name if certain requirements are met. 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 entity acting as a director) and any individuals must be over 16 years of age, and not subject to any order disqualifying them from acting as a director. Like all private companies, a company secretary does not have to be appointed but if one is Companies House must be notified.

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. For further information on charitable structures, including CLGs, visit https://www.gov.uk/guidance/charity-types-how-to-choose-a-structure and http://www.fca.org.uk/your-fca/documents/forming-a-social-enterprise.

b. ESTABLISHMENT COSTS AND DOCUMENTATION

A CLG may be formed by (i) incorporating 'from scratch', that is, drafting the incorporation documents specifically to their needs, or (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 may need to be amended to suit the needs of the CLG going forwards. Model articles of association have been established by legislation[15] which may be used (with or without amendment), or alternatively bespoke articles of association may be used. The Charity Commission have also published a set of model articles suitable for companies limited by guarantee that intend to register as charities.[16]

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

The CLG must also indicate on the form IN01 whether it is adopting model articles (either in their entirety or with amendment) or whether bespoke articles of association will be adopted. A copy of the amended model or bespoke articles of association 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 for more details:

https://www.gov.uk/government/organisations/companies-house

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 CLG stating that in the event the CLG is wound up whilst they are a member (or within one year of them ceasing to be a member), they will contribute a

15. 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, available at: https://www.gov.uk/guidance/model-articles-of-association-for-limited-companies.

16. Please see the Charity Commission website: https://www.gov.uk/government/publications/setting-up-a-charity-model-governing-documents.

specified amount to the assets of the CLG. This amount is usually a nominal sum of money such as £1. To register a CLG online, visit https://www.gov.uk/limited-company-formation/register-your-company.

The standard fee for paper filing is currently £40, and £13 for electronic filing.

In addition, there are certain restrictions in place which prevent certain names from being registered. These restrictions are set out the in the Companies Act 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.[18] Unless they are part of the same group of companies, 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.

Companies House has a free facility whereby the availability of a name can be searched.[18] Company names cannot be reserved at Companies House.

c. LIABILITIES

Members

A member's liability will be limited to the amount of their guarantee under the statement of guarantee if the CLG is wound up. In practice, the liability of members is usually capped at a nominal amount, meaning that members' liability is limited to this small nominal amount.

Directors

The directors of a company are generally not personally liable for the debts of a company, unless they have voluntarily accepted such personal liability, for example by giving a personal guarantee.

However, there are situations in which the directors of a company may incur personal liability because of their conduct.

Directors are generally under a duty to act in the best interests of the company and its members as a whole. There are certain general duties involved in carrying out their functions as directors.[19] These duties are:

- to act within the powers stated by the company's objects and articles of association;

17. 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.
18. This is available at: https://www.gov.uk/get-information-about-a-company.
19. Part 10, Chapter 2 of the Companies Act.

- 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 the position that they hold, for example, a solicitor will have a higher standard imposed due to their awareness of the law);
- to avoid conflicts of interest;
- not to accept benefits from third parties;
- to declare interests in any proposed transactions; and
- to maintain a duty of confidentiality to the company.

If a director breaches any of these duties, then the company may bring a claim against that director for breach of his duties.

In the case where a company is in financial difficulty, the directors should pay particular regard to the company's creditors. For example, if a director allows a company to continue to incur liabilities at a time when they know, or ought to know, that there is no reasonable prospect of the company avoiding an insolvent liquidation or insolvent administration (known as 'wrongful trading'), a liquidator or administrator can apply for a court order requiring that director to make a contribution to the assets of the company[20]. The director may also be disqualified from acting as a director. For this reason, where a company is in financial difficulty, it is important that the board receives professional advice at an early stage.

There are also a range of offences where a director may incur civil and/or criminal liability. Examples include:

- breaches of certain company legislation (such as failure to deliver required information to Companies House);
- breaches by the company of certain health and safety legislation, environmental legislation and trade descriptions legislation;[21]
- failure to make a report to the police or customs where the director knows or suspects that the company is involved in any arrangement which facilitates the

20. Under the Companies Act and the Insolvency Act 1986.

21. 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.tradingstandards.uk/advice/guidanceforbusinessontradingstandardslaw.cfm

acquisition, retention, use or control of the proceeds of crime;[22]

- the making of false statements, including false statements to attract investment in the company;[23] and
- acting 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 of creating such impression is to induce another person to invest in the company.[24]

An individual who is not officially a director of a company, but acts and is treated as if they are a director (known as a 'de facto director'), or routinely instructs one or more directors what to do (known as a 'shadow director'), may be similarly liable as an official director.

d. 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, 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. 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. The company may, however, indemnify a director against defence costs provided that the director repays the costs if he is unsuccessful.

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.

e. DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

In addition to indemnification by the company, it is possible to take out directors' and officers' liability insurance to protect directors of a company from loss resulting from claims made against them in relation to the discharge of their duties as directors.

22. Under the Proceeds of Crime Act 2002.
23. Under the Theft Act 1968 and, in certain circumstances, under the Fraud Act 2006.
24. Under FSMA 2000.

f. TAX TREATMENT

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. A 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 £83,000.

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 NIC, and account for these deductions to HMRC. Employee's NICs are deducted from their earnings ('primary NICs'), while employer's NICs are charged on top of 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.

Members

Generally speaking, members do not contribute anything in exchange for becoming a member of a CLG, other than a promise to contribute to the assets of the company up to the guarantee 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.

g. ONGOING GOVERNANCE AND REGULATORY OBLIGATIONS

Companies are required by law to make public certain information, such as a confirmation statement and financial accounts, which need to be filed with 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, and other changes to the company, also need to be filed (this can be done electronically using the Companies House WebFiling service). Fees may be payable for the filing of certain forms. Details of the forms and any associated fees can be found at:

https://www.gov.uk/topic/company-registration-filing/forms.

When a member leaves, his membership does not need to be transferred to another member, and there is no requirement for a stock transfer form as with a company limited by shares. The record of members will need to be kept updated.

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.

Confirmation Statement

Every company must deliver a confirmation statement to Companies House at least once every 12 months. A confirmation statement is a snapshot of general information about a company's directors, secretary (where one has been appointed) and registered office address.

The company's director(s) and the secretary (if one has been appointed) are responsible for ensuring that they deliver the confirmation statement to Companies House by company's filing deadline.

As well as being an offence, failure to deliver the company's confirmation statement may result in 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.

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:

- a record of income and expenses of the company; and
- a record of the assets and liabilities of the company.

The level of detail required in the accounts is prescribed in the Companies Act. Various exemptions also apply, and in the majority of cases, smaller companies will be able to take advantage of less onerous reporting requirements, and may be exempt from the requirement for an audit of those accounts, provided that at least two of the following three criteria are satisfied:

- annual turnover is not more than £6.5 million;
- balance sheet total is not more than £3.26 million; and
- average number of employees is not more than 50.

Note that certain types of company are excluded from the above small companies exemptions (such as companies in financial/insurance sector), and professional advice should be sought regarding the company's accounting reporting requirements.

There are further exemptions from certain financial reporting requirements for micro-entities preparing Companies Act individual accounts. To qualify as a micro-entity, at least two of the following qualifying conditions must be met:

- annual turnover must not be more than £632,000;
- balance sheet total must not be more than £316,000; and
- average number of employees must not be more than 10.

Note that certain types of company are excluded from the above micro-entity exemptions (such as companies in financial/insurance sector), and professional advice should be sought regarding the company's accounting reporting requirements.

Private companies must generally file their accounts with Companies House within nine months from the company's financial year end.

Penalties will be levied where a company fails to file their accounts by the specified deadline. The level of penalty depends on how late the accounts are, and is higher 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 the Companies House website at:

https://www.gov.uk/government/publications/late-filing-penalties.

Routine filing requirements
All companies must comply with routine filing requirements, such as filing notifications of changes to the directors of the company.

For further information of what notifications are required, please see https://www.gov.uk/government/publications/life-of-a-company-event-driven-filings

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

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 'trustees' or 'executive officers', or to the board of directors as '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, although they can choose to do so if they wish, or if one is called by one or more members.

i. FINANCE AND FUNDRAISING

Members typically fund a CLG through a membership fee and grant funding may be available to certain social ventures.

A CLG cannot raise money by issuing and allotting shares to its members, as it does not have a share capital; therefore equity-based crowdfunding is not a possibility. Members instead agree to make a contribution to the assets of the company on a winding-up (this will therefore not form part of the assets of the company except on winding up).

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, the possibility of obtaining a loan will be dependent on the assets of the CLG.

CLGs are sometimes also a registered charity, or registered with HMRC as a small charity, in order to carry out fundraising activities. Donation-based and rewards-based crowdfunding (where nominal rewards are given to investors who pledge investment) are viable methods of fundraising for a CLG.

PRIVATE COMPANY LIMITED BY SHARES

REUTERS/ LUKE MACGREGOR

PRIVATE COMPANY LIMITED BY SHARES

AT A GLANCE

SUMMARY

The most common form of corporate entity, in which the members hold shares in the company.

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 and hold assets in its own name
- √ Easier to raise certain types of finance: can issue shares to raise capital
- √ The social mission can be embedded in the constitution of the social venture
- √ Company can have employees and offer share ownership incentives to them if desired

DISADVANTAGES

- ☒ Ongoing reporting obligations; financial information may be publicly available
- ☒ For social ventures, constitutional documents may need to be tailored in order to ensure the assets and profits of the company are preserved for the social mission, and to prevent drift from the social mission
- ☒ Company may not be readily identifiable specifically as a social venture and therefore may not gain the commercial benefit that such identification brings
- ☒ Unlikely to be eligible for certain grants and other forms of support that are available for charities and other non-profit organisations

CASE STUDY

TALENTINO

Talentino was founded by UnLtd Award Winner, Jenny Connick. It is a young, dynamic, award winning, career development company based in Reading and working across England. Talentino offers two career development programmes and trains people from schools, Special Schools, housing associations, local authorities, children's homes and businesses to deliver these programmes.

Talentino was established as a company limited by shares because Jenny wanted to reflect the entrepreneurial, business-like approach they were taking to the career development programmes, which she felt were often lacking in innovation and professionalism. The model suited them well, because while it was important to express Talentino's social values – which they achieved by embedding the social mission in Talentino's constitution – they did not want to deny their objective to also be successful commercially.

Jenny acknowledges that, for certain funding streams, such as grants, it is a disadvantage to be a company limited by shares, but this depends on where a venture's income is going to come from, and the specific marketplace it operates in. Talentino generates most of its income through sales and a small proportion from grant funding. Investment funding has come in three forms, revenue participation[25], debt financing and income generated through granting exclusive licensing in exchange for the development, marketing and ongoing maintenance of a new online product.

In addition, Jenny has created a registered charity and granted a free license to it for Talentino's products. It is still early days but the purpose of the charity is to provide extended career coaching and personal development support that would not be funded commercially.

25. Revenue participation is a type of financial instrument that allows both the investor and investee to share the risk and reward of enterprise more flexibly than debt allows and in situations in which equity financing may not be possible.

PRIVATE COMPANY LIMITED BY SHARES

a. OVERVIEW

A private company limited by shares ('CLS') is a type of private company that is often used by for-profit companies. CLSs account for the vast majority of all companies registered in the UK. Although a CLS is principally a 'for-profit' legal structure, some social entrepreneurs are increasingly choosing this form for their social ventures.

A CLS has a separate legal identity from that of its shareholders. This means that the company's finances are separate from the personal finances of the shareholders. This means that, ordinarily, each shareholder's liability towards the CLS is limited to the amount that they have invested when they became a shareholder of the CLS and the amount, if any, unpaid on the shares held by them. Therefore, save for their investment, shareholders will not ordinarily be responsible for the CLS's debts simply by virtue of being a shareholder of the CLS.

The governance rules of a CLS are contained in its articles of association which set out the internal management structure and procedures, such as the role of shareholders and directors, procedures for appointment and removal of directors, and conduct of meetings. A form of model governance rules can be obtained free of charge from the Companies House website. You should consult a legal adviser in order to determine whether or not the model rules are suitable for your company without modification or entrenched of the concepts noted above

One of the main considerations which social entrepreneurs will need to consider when they choose a for-profit legal structure like a CLS is how they will protect the social mission of the CLS. There are various protections a CLS could include in its articles of association to embed the social mission of the venture, and these are described in more detail in section 2.5(c) 'Protecting the social mission' below.

A CLS must have at least one shareholder and at least one director. At least one director must be an individual (as opposed to a corporate entity acting as a director) and any individuals must be over 16 years of age, and not subject to any order disqualifying them from acting as a director. Like all private companies, a CLS does not have to appoint a company secretary, but if one is appointed, Companies House must be notified. 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.

b. ESTABLISHMENT COSTS AND DOCUMENTATION

A CLS can be formed by: (i) incorporating 'from scratch' i.e. drafting the incorporation documents specifically to suit the needs of the specific company, or; (ii) buying an 'off-the-shelf' company, the documents for which can then be modified. Please see section 2.4 'Establishment costs and documentation' in the section relating to CLGs for further information.

To establish a CLS, the same procedure as set out in section 2.4(b) '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.

The standard fee for paper filing is currently £40 and £13 for electronic filing.

The restriction preventing certain names being registered as set out in the Company, Limited Liability Partnership and Business Names (Sensitive Words and Expressions) Regulations 2014 also applies. Please see section 2.4 'Establishment costs and documentation' in the section relating to CLGs for further information. For further information and resources in respect of the setting up and running of a CLS, visit http://www.companieshouse.gov.uk.

c. PROTECTING THE SOCIAL MISSION

One of the main considerations which social entrepreneurs will need to consider when they establish a for-profit legal structure like a CLS is how they will protect the social mission of the CLS. In order to resolve this, a social venture which is incorporated as a CLS may wish to consider protecting the balance between its social mission and the requirement to realise a return for its shareholders, by including various protections in its articles of association.

Examples of the protections that could be included in the articles of association include:

- an **asset lock** – this is similar to the 'asset lock' concept which is discussed in section 2.6 in relation to CICs, but is contractual in nature, being set out in the CLS's articles of association. An asset lock could prohibit the distribution of some or all of the assets/profits of the CLS to its shareholders, so that such surplus of assets/profits can be retained and used for the benefit of the social mission the CLS was established to serve; and/or

- a **statement of the objects** of the CLS – this would clearly identify the mission of the social venture and the directors would be bound to act in accordance with this statement of the objects.

As the articles of association of a CLS can usually be amended by a special resolution of the shareholders (i.e. 75% of the shareholders of the CLS), social entrepreneurs may wish to consider taking steps to 'enshrine' or make permanent the social mission or asset lock in the CLS's constitution. One way of doing this is to have a golden share which is held by an independent organisation or individual aligned with the social purpose of the CLS. This golden share may, for example, have the rights to vote on decisions such as a change in the nature of the social mission or any change to the asset lock. A golden share is a nominal share in the CLS which is able to out-vote all other shares in certain specified circumstances. This should provide investors and other funders with comfort that the CLS will not deviate from its social mission. Professional advice should be obtained on these types of structures.

d. LIABILITIES

Shareholders

A CLS is usually incorporated with one class of shares, being ordinary shares, each share having a designated nominal value. This nominal value can be whatever the person incorporating the company chooses, but it is commonly set at £1 or £0.01 per ordinary share. 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 value).

A shareholder's liability is ordinarily limited to the amount of their investment in the company, i.e. the amount paid for the shares, or if these shares have not been fully paid, the amount unpaid on the shares.

A company may issue different classes of shares to shareholders, each with its own rights, such as rights to vote and to participate in the profits and capital of the company. Different classes of shares may have different nominal values and even different currencies. The benefit of having different share classes is the flexibility to offer different investors shares which suit their needs, for example some investors may require a preferential dividend right.

Directors

The directors of a CLS are generally not personally liable for the debts of a CLS, unless they have voluntarily accepted such liability, for example, by giving a personal guarantee. However, the same considerations as apply to the personal liability of directors of a CLG apply to directors of a CLS.

Please see section 2.4 'Liabilities' in the section relating to CLGs for further information.

e. COMPANY INDEMNIFICATION

A director of a CLS 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 2.4 'Company indemnification' in the section relating to CLGs for further information.

f. 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. Please see section 2.4 'Directors' and officers' liability insurance' in the section relating to CLGs for further information.

g. TAX TREATMENT

Company

A CLS will be liable to corporation tax on its profits in the same way as a CLG. Please see section 2.4 'Tax treatment' in the section relating to CLGs for further information.

Shareholders

Shareholders must consider their individual tax consequences, which will largely depend on each individual's circumstances.

In the case of employees, 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. 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 (less the individual's annual exemption).

Share options are commonly granted to offer equity incentives to a company's directors and employees in order to recruit talent, and 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.

In addition, three types of tax relief might be available to qualifying investments in social ventures. These reliefs are designed to encourage investment into smaller, higher risk enterprises, by offering tax relief on new shares in qualifying entities. Typically, these tax reliefs (set out below) would be available to shareholders investing directly into the relevant social venture, provided the social venture is a qualifying entity.

EIS relief

The Enterprise Investment Scheme ('EIS') provides qualifying investors with income tax relief and the right to defer capital gains tax when subscribing for new ordinary shares in companies that qualify under the EIS. The investor may claim income tax relief of 30%, with the total relief being capped at £1,000,000 per year, provided that the shares are held for 3 years. For example, if the individual invested £100,000 into a qualifying company, his or her income tax liability would be reduced by £30,000 (30% of £100,000) for that tax year. The investor would also be entitled to an exemption from capital gains tax on any gains made when disposing of those shares, so long as he or she has owned the shares for the requisite 3 years. Additionally, any losses suffered by the investor upon the disposal of the shares can be offset against the investor's income or capital gains, the net effect of which is to limit the investment exposure of the investor.

There are a number of criteria to be met for qualification under the EIS scheme. These include that the company must: (i) be unquoted when the shares are issued; (ii) have gross assets of less than £15 million immediately prior to the shares being issued (and no more than £16 million immediately after the investment); (iii) have under 250 full time employees; (iv) generally exist wholly for the purpose of carrying on a qualifying trade; (v) issue the shares within 7 years from the date of the company's first commercial sale; and

(vi) 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). In addition, there must be no 'connection' between the investor and the company (meaning that the investor cannot control or hold more than 30% of the share capital or voting rights, nor be a partner, director, employee or 'associate' of the company (with exceptions for 'business angels')). The maximum that can be raised under the EIS (together with other venture capital schemes) is £5 million in any 12 month period.

SEIS relief

The Seed Enterprise Investment Scheme ('SEIS'), like the EIS, provides income tax relief and a partial exemption from capital gains tax on gains realised on the disposal of assets that are reinvested through SEIS in the same year (50% relief from 2014/15 tax year onwards). The investor may claim relief from income tax of 50%, with a maximum tax relief per investor per year of £100,000, provided that the shares are held for 3 years. For example, if an individual invested £100,000 into a qualifying company, his or her income tax liability would be reduced by £50,000 (50% of £100,000) for that tax year. The investor would also be entitled to an exemption from capital gains tax on any gains made when disposing of those shares, so long as he or she has owned the shares for the requisite 3 years. Additionally, if there is a loss on the investment, those losses can be offset against the investor's income or capital gains, the net effect of which is to limit the investment exposure of the investor.

Like EIS, there are a number of criteria to be met for qualification under the SEIS scheme. These include that the company must: (i) be unquoted when the shares are issued; (ii) have gross assets of less than £200,000 immediately prior to the shares being issued; (iii) have under 25 full time employees (and the investor may not be an employee of the company); (iv) generally exist wholly for the purpose of carrying on a qualifying trade; (v) have commenced the trade less than 2 years before the shares were issued; and (vi) 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). In addition, there must be no 'connection' between the investor and the company (meaning that the investor cannot control or hold more than 30% of the share capital or voting rights, nor be an employee of the company). The maximum that can be raised under the SEIS is £150,000.

Please 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 either EIS or SEIS relief. A company that has raised money under the EIS scheme cannot then raise money under the SEIS scheme. There is also an approval process to be undertaken with HMRC. You should speak to your tax adviser if you think your social venture might qualify for the EIS or SEIS.

For more information on EIS and SEIS, visit https://www.gov.uk/government/publications/the-enterprise-investment-scheme-introduction and https://www.gov.uk/guidance/seed-enterprise-investment-scheme-background.

SITR relief

The Social Investment Tax Relief ('SITR') scheme provides investors with income tax relief and an exemption from capital gains tax when investing in social ventures. Please see section 2.6 'Tax Treatment' in the section relating to CICs for further information.

h. ONGOING GOVERNANCE AND REGULATORY OBLIGATIONS

The ongoing filing requirements for a CLS are similar to the ongoing filing requirements of a CLG. Please see section 2.4 'Ongoing governance and regulatory obligations' for more information.

i. CORPORATE STRUCTURE

A CLS will have one or more shareholders who are its owners, and one or more directors who are responsible for the day-to-day running of the CLS. A CLS is governed by its articles of association. Whilst most day to day decisions are taken by the board of directors of the CLS, certain decisions and changes relating to the company will require shareholder approval.

j. FINANCE AND FUNDRAISING

A CLS will often raise money through the following methods:

- Issuing shares to investors. In the initial stages, a small company set up by an individual may raise financing from that individual's savings and/or their family or friends. To help the company grow, additional financing may need to be raised from external investors.

  As discussed previously in section 2.5(a) 'Overview', shares in a CLS cannot be offered to the public at large. 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.[26]

- A CLS may 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 against some or all of the assets of the company. In some cases they may ask for the directors or shareholders to give personal guarantees, in which case legal advice should be obtained on the implications of this. Loans may also be available from a community development finance institution ('CDFI'). Please see the following link: http://responsiblefinance.org.uk/ for further information.
- A CLS 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. If you are considering issuing a bond, you should seek specialist legal advice.

  A company may be eligible for grant funding, if for example the business is being set up in a deprived area. Useful information can be found at:

https://www.gov.uk/business-finance-support-finder/search

All the main forms of crowdfunding (including donation-based, rewards-based, equity-based and loan-based crowdfunding) are viable methods of fundraising for a CLS.

k. CERTIFIED B CORPORATIONS ('B CORPS')

B Lab is a non-profit organisation set up in the US in 2006 with the aim of creating a global movement of purpose-led entrepreneurs. B Lab established a certification process pursuant to which qualifying enterprises can be certified as a B Corp. B Corps are not a legal form in the UK; rather, they are for-profit businesses that have social and/or environmental impact as part of their mission, and which have met B Lab's performance, accountability and transparency requirements. In the UK, B Corp certification can apply to any for-profit business, which for this purpose includes those registered as CICs. There are now almost 2000 certified B Corps across the world, including over a hundred in the UK.

B Corp certification may be seen as external validation of a venture's commitment to its social mission which could help with potential investors, making B Corp certification a

26. Under FSMA, there is a general prohibition against communicating any invitation or inducement to engage in investment activity unless authorised by the FCA. 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'.

potentially attractive option for social entrepreneurs where a social venture wishes to have the flexibility of using a CLS, but wants to be independently recognised as a mission-led business.

In order to certify as a B Corp, a business needs to score at least 80 points on the B Impact Assessment ('BIA') and pass a legal test. The BIA adapts according to the sector and market in which the business operates and surveys several categories such as governance, workers, community, environment and socially and environmentally-focused business models to come up with both overall and targeted sub-ratings.

In addition, the UK Legal Test requires any business wishing to become a B Corp to amend or adopt governing documents which include a commitment to a 'triple bottom line' approach to business. In other words, the business would need to have an objects clause which states that it exists to promote the success of the business for the benefit of its shareholders but also to have a material positive impact on society and the environment. The governing documents must also require directors to consider a range of 'stakeholder interests' - including those of employees, suppliers, the community and the environment – as equal to those of the shareholders when making decisions.[27] A full explanation of the UK Legal Test, with examples of suggested language to be used for the governing documents, can be found at http://www.bcorporation.net/sites/default/files/documents/uk/Legal_Test_Final_August_2015.pdf

Any UK business is likely to be eligible for B Corp certification as long as it can prove that it competes in a competitive marketplace, generates the majority of its revenue from trading and is neither a charity, nor majority owned by the state. For full certification, the business must have been operating for over 12 months, however, any start-ups structured as for-profit businesses can earn temporary 'Certification Pending' designation.

B Corps have to pay an annual certification fee which ranges from £250 to upwards of £50,000 depending on the turnover of the business. The full certification rates, which are subject to change, are available at http://bcorporation.uk/become-a-b-corp/how-to-become-a-b-corp/make-it-official-uk.

For more information on the launch of the B Corp certification in the UK, visit: http://bcorporation.uk/

27. The Companies Act 2006 s172 makes the interests of the members a paramount consideration, above those of other stakeholders.

CASE STUDY

Elvis & Kresse is a socially minded, specialty design house that reclaims waste materials that were otherwise destined for landfill and transforms them into premium-value consumer goods. It was founded by Kresse Wesling, an UnLtd Award Winner, with her partner James (aka Elvis) Henrit. Elvis & Kresse is a CLS and, as of 2015, it is also a certified B Corp.

The CLS was initially established to save London's decommissioned fire hoses. The now-decommissioned fire hoses become too damaged to use for fire-fighting purposes after approximately 30 years of usage. Elvis & Kresse rescues the decommissioned hoses, scrubs away the decades of soot and grease, and re-engineers the industrial material using quality craftsmanship and classic, timeless design.

Given their business backgrounds, a CLS was the legal structure that Kresse and James were most familiar and comfortable with. The CLS was founded in 2005 through their private efforts and finances.

"CLS is the easiest structure to establish and has known rules," says Kresse. Although she was aware of other options, including the then newly-introduced introduced CIC structure, she did not feel that, as a self-funded business, they were appropriate.

To further lock in their social mission, Elvis & Kresse decided to apply for certification as one of the founding UK B Corps in 2015. Since becoming a certified B Corp, Elvis & Kresse has actively traded with other B Corps and this has increased sales. Therefore, becoming a B Corp and being able to trade in the B Corp community has proved to be a commercial advantage of B Corp certification.

COMMUNITY INTEREST COMPANY

REUTERS/ PAUL HACKETT

COMMUNITY INTEREST COMPANY

AT A GLANCE

SUMMARY

A community interest company is a limited liability company, designed for social ventures that want to use their profits and assets for the public good

ADVANTAGES

- ✓ Clear social purpose identity makes it evident that the venture has a social element which could be useful in attracting impact investors and assessing eligibility for grant funding
- ✓ Protection of assets - asset lock means the community interest company's assets and profits must be retained within the community interest company or transferred to another organisation with an asset lock (normally another community interest company or a charity)
- ✓ Benefit of the community rather than private gain. On a winding up the community interest company'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
- ✓ Separate legal entity therefore liability of shareholders for the debts of the company are limited to the amount paid for shares
- ✓ The social mission is embedded in the constitution of the venture
- ✓ Business investors in community interest companies are eligible for Social Investment Tax Relief ('SITR') for both debt and equity funding

AT A GLANCE, CONTINUED

DISADVANTAGES

- As it is still a relatively new structure, some investors may be unfamiliar with community interest companies
- 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 community interest company Regulations,[27] which includes submitting an annual report to the community interest company Regulator, who has wide powers to regulate community interest companies
- Reporting obligations mean financial information may be publicly available

27. Details of the CIC regulatory regime are set out in CAICE 2004 (as amended) and in the Community Interest Company Regulations 2005 (the Regulations) as amended by the Community Interest Company (Amendment) Regulations 2009 (2009 Regulations), the Community Interest Company (Amendment) Regulations 2012 (SI 2012/2335)(2012 Regulations) and the Community Interest Company (Amendment) Regulations 2014 (SI 2014/2483)(2014 Regulations).

CASE STUDY

GOODWILL SOLUTIONS CIC

Goodwill Solutions CIC ("Goodwill Solutions") was founded in January 2008 by UnLtd Award Winner, Mike Britton, and offers bespoke logistics and warehousing solutions. The business has rapidly grown acquiring over 100,000 sq. ft. of storage space and a large network of clients across the UK and EU. It has an annual turnover of over £3 million.

The business aims to help the local community by running projects (such as the Back to Work programme), training ex-offenders, the homeless and disadvantaged youths for employment in the logistics sector. They also supply low cost, high quality furniture to local people and charities.

Having originally formed as a CLS, Goodwill Solutions became a community interest company in 2009. Mike says that he was keen for Goodwill Solutions community interest company to convert from a CLS to a community interest company in order to ensure that the assets of Goodwill Solutions would always be for the benefit of the social mission rather than private gain. The community interest company model was an ideal structure for this purpose, because a fundamental element of a community interest company is that its assets are 'locked', meaning that its assets must be retained within the community interest company rather than distributed to its members. Note that a CLS can also achieve an asset lock, but the asset lock of a CLS is contractual in nature and must be included in the articles of association of the CLS (please refer to page 55 of the Guide).

COMMUNITY INTEREST COMPANY

a. OVERVIEW

A community interest company ('CIC') is a limited liability company designed for social ventures that want to use their profits and assets for the public good. The difference between a CIC and a CLG or CLS is the specific requirement that all profits are to be made available for the community it is formed to serve.

It is important to note that a CIC cannot be a charity nor a political party, political campaigning organisation or subsidiary of a political party or political campaigning organisation. Charitable entities that convert to CICs will lose their charitable status. A charity, however, may have a subsidiary that is organised as a CIC. A CIC is a more flexible body than a charity.

b. FEATURES OF A CIC

- Not-for-profit limited company (usually limited by guarantee, although it can be limited by shares);
- A CIC can be a newly incorporated company, or it can be converted from an existing company;
- A CIC is subject to the Companies Act and the other usual company governance rules;
- CICs are regulated by the CIC Regulator;[28]
- Profits after payment of capped dividends and interest must be reinvested for community benefit;
- A CIC is flexible as it can take a number of different corporate structures so long as all its activities contribute to providing benefit to the community;
- A CIC must deliver a community benefit and pass the 'community interest test' (see below); and
- A CIC is subject to an 'asset lock' (see below).

28. The Regulator is appointed by the Secretary of State (section 27, CAICE 2004) and her powers and duties are set out in CAICE 2004 and the Regulations. The Regulator is to regulate using a "light touch", create an awareness of CICs generally and to provide guidance and assistance on matters relating to CICs.

c. COMMUNITY INTEREST

To become a CIC, a company must pass, and continue to satisfy, the 'community interest test'. To satisfy the community interest test, a company must show that a reasonable person would consider that its activities are being carried on for the benefit of the community or a section of the community. A section of the community is defined as any group of individuals who share a common characteristic which distinguishes them from other members of the community and a reasonable person might consider that they constitute a section of the community. This does not prevent the CIC from paying its employees, or paying dividends to its shareholders (subject to the limitations described below), but there must also be a wider community benefit to the activities of the CIC.

d. ASSET LOCK

A fundamental element of a CIC is that its assets are 'locked'. This means that assets must be retained within the CIC, and are not to benefit the CICs members, directors, employees or other persons. A CIC may only transfer assets at their market value, unless it is transferring them to another asset locked body or for the benefit of the community it was set up to serve. Assets of a CIC must also be transferred to another asset locked body on winding up, which ensures that the assets remain for the benefit of the community. CICs may also adopt a more stringent asset lock.

A CIC may pay a dividend to its shareholders (who are not asset-locked bodies), unless its articles of association provide otherwise. However, such dividends are subject to a maximum aggregate dividend cap (currently 35% of 'distributable profits'). This is to protect the principle that the CIC's assets benefit the community, by ensuring dividends are not disproportionate to the amount invested by the investor or the profit generated by the CIC. Dividends must be approved by either ordinary or special resolution of the shareholders[29].

There is also a cap on the amount of interest that a CIC may pay on loans or debentures it issues. The cap seeks to strike a balance between allowing CICs to access investment whilst ensuring that the assets of the CIC continue to be protected for the benefit of the community. The cap is currently limited to 20% of the average amount of the CIC's debt or sums outstanding under a debenture issued by it during the 12 month period immediately preceding the date on which the interest on that debt or debenture becomes due.

29. Ordinary resolutions require the consent of at least 50% of the shareholders entitled to vote, and special resolutions require the consent of at least 75%.

e. ESTABLISHMENT COSTS AND DOCUMENTATION

Establishing a new CIC

Establishment of a CIC is similar to that of a limited company. New organisations can register by filing form IN01 and the 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). Companies House will then forward the form CIC36 to the CIC Regulator.

The CIC Regulator has produced various model memoranda and articles of association that may be used. These can be found at:

https://www.gov.uk/government/publications/community-interest-companies-constitutions

For other useful materials by the CIC regulator and more information on setting up and running CICs, visit https://www.gov.uk/government/organisations/office-of-the-regulator-of-community-interest-companies.

Converting an existing company to a CIC

An existing company can convert to a CIC by satisfying the CIC Regulator that it meets the CIC requirements. In doing so, it must pass a special resolution amending 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[30]. Copies of these documents must be filed with the Regulator, together with a filing fee 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: https://www.gov.uk/government/publications/community-interest-companies-business-activities/cic-business-activities-forms-and-step-by-step-guidelines#form-a-community-interest-company-cic. For the model articles of a CIC, visit https://www.gov.uk/government/publications/community-interest-companies-constitutions.

Any subsequent change to the articles of association of a CIC will need the approval of the CIC Regulator.

30. Section 33, CAICE 2004.

f. CORPORATE STRUCTURE

CICs can be public or private companies limited by shares or guarantee, and are incorporated under the Companies Act.

g. LIABILITIES

Members

As a CIC is a limited liability company, its members benefit from limited liability. If the CIC is set up as a company limited by guarantee, refer to Section 2.4 for a description of the limited liability of its members. If the CIC is set up as a company limited by shares, refer to Section 2.5 for a description of the limited liability of its shareholders.

Directors

The position of the directors of a CIC is the same as that of a company limited by guarantee or company limited by shares. Refer to Section 2.4 or 2.5 for a description of the liability of directors.

h. TAX TREATMENT

Entity

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.

Shareholder

The Social Investment Tax Relief (SITR) scheme applies to investments made on or after 6 April 2014 and before 6 April 2019 and provides investors with income tax relief and an exemption from capital gains tax when investing in social ventures. Investments may comprise of either debt or equity, provided certain conditions are met. The investor may claim income tax relief of 30%, up to an annual investment limit of £1,000,000 (across various social ventures), provided that the investment is held for 3 years. For example, if the individual invested £100,000 into a qualifying social venture, his or her income tax liability would be reduced by £30,000 (30% of £100,000) for that tax year. The investor would also be entitled to an exemption from capital gains tax on any gains made when disposing of the investment, so long as he or she has owned the investment for the requisite 3 years. Additionally, any losses suffered by the investor upon the disposal of shares (but not debt) can be offset against the investor's income or capital gains, the net effect of which is to limit the investment exposure of the investor.

For a social venture to qualify for SITR, it must be one of more of the following: (i) a community interest company; (ii) a community benefit society; (iii) a charity (including a charitable trust); or (iv) an accredited social impact contractor. Additionally, there are a number of legislative criteria to be met for qualification under the SITR scheme. These include that the social venture must: (i) be unquoted at the time of investment; (ii) have under 500 full-time employees at the time of investment; (iii) have gross assets of less than £15 million immediately prior to investment (and no more than £16 million immediately after the investment); (iv) utilise the money raised via the investment for the purposes of the social venture's chosen trade within 28 months of the date of the investment; and (v) 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) or a member of a partnership. The maximum that a social venture may raise over any three year period is €344,827[31].

Please note that the particular circumstances of the social venture, as well as the circumstances of the individual investor, must be considered in detail so as to determine whether the social venture, the individual and the shares qualify for SITR. There is also an approval process to be undertaken with HMRC. You should speak to your tax adviser if you think your social venture might qualify for the SITR scheme.

i. ONGOING GOVERNANCE AND REGULATORY OBLIGATIONS

CICs are regulated by the CIC Regulator. The CIC must file a community interest report, known as the CIC34, which is submitted to the CIC Regulator's office on an annual basis along with a fee. The Community Interest Report must contain:

- a fair and accurate description of the CIC's activities that have benefited the community;
- details of the consultations with persons affected by the CIC's activities (if any);
- details of the directors' remuneration (unless full details are provided in the annual accounts of the CIC);
- the value (or a fair estimate of the value) of any assets transferred for less than full consideration;

31. This limit could be raised substantially in the near future, subject to EU approval.

- details of dividends declared on shares and compliance with the capping rules set by the Regulations; and
- information on any performance-related interest paid on loans or debentures.

It also has obligations to file accounts and a confirmation statement in the same way as other companies.

The CIC Regulator, an independent public official, has the power to advise, guide, investigate and enforce. CAICE 2004 provides the Regulator with a wide range of enforcement powers[32].

j. FINANCE AND FUNDRAISING

Grants may be available depending on the CIC's expected activities and the impact of its work. Grants are usually targeted at specific projects and one off capital purchases.

CICs can raise finance through the issuing shares to private investors. However, unlike shares in an ordinary private company limited by shares, shares in a CIC will be limited by the 'asset lock', and restrictions on the payment of dividends, which may make returning value on the shares more difficult. This may be unattractive to some potential private investors who are seeking a purely commercial return, but will be a familiar structure for those who are seeking a modest return on their investment but also recognise and support the social purpose of the CIC.

CICs are able to raise capital using all of the main methods of crowdfunding (i.e. donation-based, rewards-based, equity-based and loan-based crowdfunding). Although, for the reasons mentioned above, equity-based crowdfunding might prove more difficult to attain.

Shares in a CIC can also be structured in a way which enables shareholders to attract EIS relief. For more information, please see section 2.5(g)

A CIC may also obtain loan finance, subject to the interest caps referred to above.

32. Sections 41 – 48, CAICE 2004

CHARITABLE INCORPORATED ORGANISATIONS

REUTERS/ HERWIG PRAMMER

CHARITABLE INCORPORATED ORGANISATIONS

AT A GLANCE

SUMMARY

A charitable incorporated organisation is a form of charity which has its own separate legal personality.

ADVANTAGES

- ✓ Single registration with the Charity Commission.
- ✓ Charitable incorporated organisations benefit from a separate legal personality just like a company. It can therefore contract and hold property in its own name and the personal liability of its members and trustees is limited[32]
- ✓ Limited details of charitable incorporated organisations will be placed on the register of charities and its register of members and trustees must be open to public inspection
- ✓ Charitable incorporated organisations benefit from tax advantages. Their income is chargeable to Corporation Tax; however they benefit from an extensive list of tax exemptions under the Corporation Tax Act 2010

32. Section 205(2) and (3) Charities Act 2011

AT A GLANCE, CONTINUED

DISADVANTAGES

- Not suitable where the social venture does not have purely charitable purposes
- The charitable incorporated organisation is a relatively new concept that has not been tried and tested, particularly in the areas of insolvency and restructuring. This may cause lenders to approach charitable incorporated organisations with caution, giving rise to problems raising debt finance
- It can take up to 40 days to become registered with the Charity Commission
- The lack of a publicly available charges register, like that available through Companies House, may make it difficult to obtain loan financing from commercial lenders

CASE STUDY

NEW NOTE ORCHESTRA

New Note Orchestra ('New Note'), established by Molly Mathieson, uses music to support people in recovery from alcohol and substance misuse. Their aim is to help rebuild lives. They offer a structured musical programme, creating a supportive community to help participants stay clean and sober.

By taking part, musicians increase their confidence, self-esteem, gain skills and make new friends. They cater for beginners through to professional players. They encourage everyone to compose music as a group in a very supportive environment.

New Note registered as a charitable incorporated organisation in April 2015. Molly decided to set it up as a charitable incorporated organisation for three main reasons. Firstly, New Note has a clear charitable purpose and relies on a mixture of revenue from performances as well as grants and donations. Molly wanted to be a registered charity as she felt New Note would never make enough money just doing performances, and would always be partly relying on grants and donations. Secondly, she did not personally feel comfortable with having shareholders or making a profit through the work of New Note. Lastly, Molly felt that a charitable incorporated organisation (compared with, for example, a CLG that is registered as a charity) would have a much more accessible registration process, given that they are only accountable to the Charity Commission. If she had chosen the legal structure of a CLG which is registered as a charity, New Note would be required to observe the ongoing governance and regulatory obligations of both Companies House and the Charity Commission.

CHARITABLE INCORPORATED ORGANISATION

a. OVERVIEW

Charitable incorporated organisations ('CIOs') are a corporate structure designed specifically for charities.

The CIO structure is designed to provide charities with the benefits of being a separate legal entity, such as the ability to own property, enter into contracts in its own name and limited liability for trustees and members, whilst simultaneously avoiding the regulatory and administrative requirements imposed by Companies House in respect of CLGs which are charities. The main advantage of the CIOs, is that they are only regulated by the Charity Commission, and will not also be registered with Companies House (meaning no duplication of administration requirements, such as the annual report) or subject to regulation by the provisions of the Companies Act.

The benefits of the incorporated status of the CIO means that this structure appeals to medium to large-sized charities which employ staff and enter into contracts because, like a company, a CIO has a separate legal status and limited liability.

The CIO has been available for only a few years and the Charity Commission has published model constitutions on its website for those considering switching to a CIO. So far, this new corporate structure has proved popular and the Charity Commission recently announced that nearly half of applications to form new charities are opting for the CIO model.

b. ESTABLISHMENT COSTS AND DOCUMENTATION

New charities

New charities wishing to become CIOs will first have to register as a charity with the Charity Commission.[33] This can be a rather lengthy process and for full guidance please see the Charity Commissions guidance on setting up charities, available at:

https://www.gov.uk/topic/running-charity/setting-up

The new charity must also decide on its constitution. This can be based on either the 'Foundation' or 'Association' templates published by the Charity Commission. The Charity Commission's model constitutions are available at: https://www.gov.uk/government/publications/setting-up-a-charity-model-governing-documents. Trustees of the charity will also need to be appointed. They can be the same people as the members of the

33. To register as a charitable company (without share capital), visit https://www.gov.uk/government/publications/setting-up-a-charity-model-governing-documents

company, in which case the 'Foundation' template is the most appropriate. If the trustees are to be different from the members, which is often the case in larger more complex charities, the 'Association' model is more suitable.

For full guidance on how to register a charity, including CIOs, visit http://www.gov.uk/guidance/how-to-register-your-charity-cc21b#how-to-apply-to-register-your-charity.

Converting from existing charitable incorporated company
At present, to convert from a charitable incorporated company into a CIO, there is no direct statutory conversion process, which means that conversion can only take place by registering a new CIO, transferring assets to it and then either: closing the original charitable company, or keeping the original charitable company as a 'shell'.

The Cabinet Office is consulting on introducing a new direct conversion process for charitable incorporated companies, which would allow a charity to keep its existing name, bank accounts and charity number.

For more information and updates on this consultation, please see the following link:

https://www.gov.uk/government/consultations/converting-to-a-charitable-incorporated-organisation.

Converting from an existing unincorporated association
Unincorporated associations and trusts do not have an incorporated structure that can be registered as a CIO. There is also no statutory conversion process for converting a trust or unincorporated association to a CIO.

Therefore, a new CIO will need to be formed, and then the old unincorporated charity must be dissolved and all assets will have to be transferred to the new CIO. Section 40 of the Charities Act 2006 allows this transfer to take place with just two thirds of trustee's approval if the charity is small, owns no designated land and has a gross income in its last financial year of less than £10,000. However this also depends on the constitution of the unincorporated association, which may require unanimous consent for such transfers.

This conversion process involves the creation of a new legal entity and so the charity will have to inform all creditors, banks, third parties with which it deals and relevant government departments of the change. The charity number will also be different to that used by the old charity. The charity will therefore have to amend all materials with their charity number on them as well as the website.

c. LIABILITIES

A CIO is a separate legal entity from its trustees and members. The member's liability to contribute to the CIO's assets on a winding up is specified in the CIO's constitution (the constitution may provide that members have no liability, or provide for a nominal liability such as £1). This is of course subject to any criminal liability that may be placed on trustees and members who act negligently, improperly, or do not fulfil their obligations under statute.

d. ONGOING GOVERNANCE AND REGULATORY OBLIGATIONS

CIOs benefit from the less onerous charity accounting regime in Part 8 of the Charities Act 2011 rather than the reporting and accounting requirements of the Companies Act.

CIOs are regulated only by the Charity Commission and therefore have to submit a confirmation statement to them as opposed to Companies House.

Full guidance on the accounting and audit requirements of CIOs and charities more generally is available at:

https://www.gov.uk/government/publications/charity-reporting-and-accounting-the-essentials-march-2015-cc15c/charity-reporting-and-accounting-the-essentials-march-2015.

e. CORPORATE STRUCTURE

A CIO will need a constitution made up of a memorandum and articles of association. As already mentioned above, the Charity Commission has published two model constitutions on its website which can be modified by the specific CIO depending on their desired governance structure.

One such model constitution is the 'Foundation' format which is aimed at CIOs where the members and trustees are to be the same. The 'Association' format is however aimed at CIOs where the trustees and members may be different. These model constitutions are useful as the regulations governing CIOs set out extensive requirements as to what the constitution of a CIO must contain.

Charitable companies converting to a CIO should therefore consider adopting modified versions of the model constitutions published by the Charity Commission to ensure that they meet the relevant requirements.

f. FINANCE AND FUNDRAISING

A point of concern for commercial lenders to at CIO may be that, unlike a company where Companies House maintains a register of charges against that company and its assets, there is no equivalent register of charges maintained by the Charity Commission for CIOs.

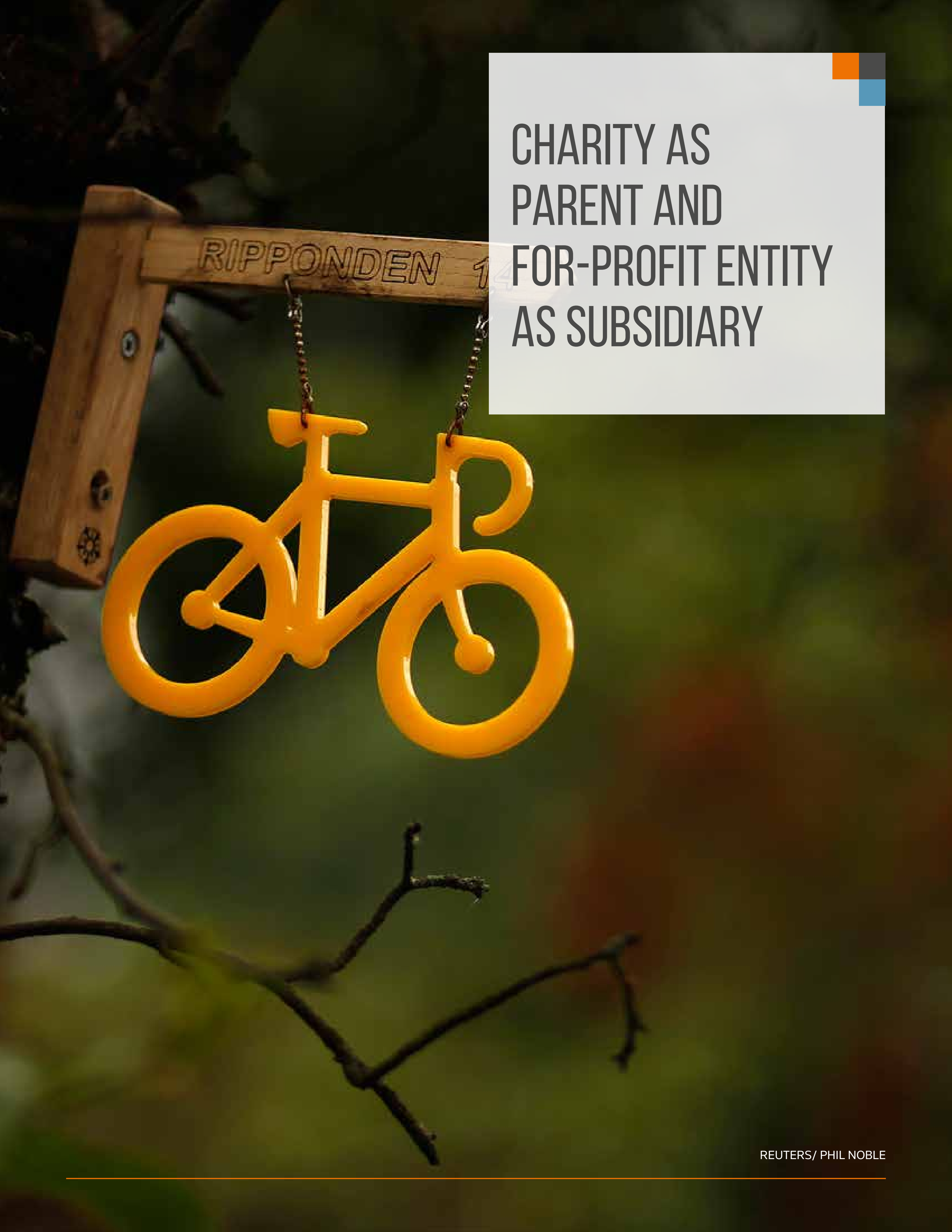
g. TAX TREATMENT

CIOs are treated the same as charitable CLGs for the purposes of tax. Please see section 2.4, 'Tax treatment' for more details.

HYBRIDS

REUTERS/ TOBY MELVILLE

CHARITY AS PARENT AND FOR-PROFIT ENTITY AS SUBSIDIARY



REUTERS/ PHIL NOBLE

CHARITY AS PARENT AND FOR-PROFIT ENTITY AS SUBSIDIARY

AT A GLANCE

SUMMARY

Charity establishes a commercial trading arm in order to generate profits which can be distributed to the charity.

ADVANTAGES

- ✓ Associated Gift Aid tax benefits of giving 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
- ✓ Trading subsidiary benefits from the goodwill that status as being the commercial arm of a charity brings

DISADVANTAGES

- ☒ Increased compliance costs, separate accounts and reporting obligations for trading subsidiaries
- ☒ Separate administration costs and procedures for each entity
- ☒ Difficulty in raising finance, as charity may be restricted in the investment it may make in the trading subsidiary, and structure may not be attractive to outside investors

a. OVERVIEW

Charities typically structure their trading activities through a separate trading subsidiary in order to:

- carry out non-primary purpose trading on a larger scale than a charity would be allowed to;
- 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 inherent risks of carrying on a trading activity;
- set up a separate central administrative unit for accounting and/or management purposes; and
- reduce the tax liability arising on profits made from the trading activities.

Typically the trading subsidiary will be established as a private company limited by shares, with any profits generated through the trading activities of that Subsidiary company distributed to the charitable parent by way of dividend.

b. ESTABLISHMENT COSTS

Charitable parent ('Parent company')

If the Parent company does not already exist, then the first step is to establish the charitable parent. The Parent company could, by way of example, be established as a CIO (see section 2.7 for further information) or as a CLG (see section 2.4 for further information).

If the Parent company is established as a CLG, then it must also separately register as a charity by using the online application service of the Charity Commission[32]. The online application can be found at: https://apps.charitycommission.gov.uk/officeforms/RegistrationLanding.ofml.

The completed application form will need to be accompanied by:

- a signed trustee declaration form for each trustee;
- a copy of the governing document i.e. the memorandum and articles of association; and
- evidence of income.[33]

32. https://www.gov.uk/guidance/how-to-set-up-a-charity-cc21a

33. Note that the Charity Commission will require evidence of a minimum funding of £5,000 to register a charity. Please see https://www.gov.uk/topic/running-charity/setting-up.

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 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.

Please see the Charity Commission's guidance on setting up charities for further information on charitable objects and registering as a charity in England and Wales, which is available at: https://www.gov.uk/topic/running-charity/setting-up

We have assumed that the CLG is the chosen structure for the Parent company in this section.

Subsidiary company

Assuming the trading Subsidiary company is to be established as a private company limited by shares ('CLS'), then refer to section 2.5(b) '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.

We have assumed that the CLS is the chosen structure for the Subsidiary company in this section.

c. LIABILITIES

The liability associated with this legal structure depends on the type of entity chosen for the charitable Parent company and the Subsidiary company. For information on the liability of members and directors/trustees of a Parent company that is incorporated as a CLG or CIO, please see section 2.4(c) 'Liabilities' and section 2.7(c) 'Liabilities', respectively. For information on the liability of members and directors of a Subsidiary company that is incorporated as a private company limited by shares, please see section 2.5(c) 'Liabilities'.

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;
- an exemption on profits from property that is used for charitable purposes; 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, the Subsidiary company enters into a Gift Aid arrangement with the Parent company under which it agrees 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 taxable distribution of profit but as a qualifying donation under the company Gift Aid rules and therefore it is effectively deducted from its income. The Subsidiary company may therefore eliminate its taxable 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.

Wholly owned subsidiaries of charities may 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.

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 (as of the date of publication this was £83,000) 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 https://www.gov.uk/vat-charities.

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; or

ii. if it is a fundraising event that is occurring on behalf of the Parent company but undertaken by the Subsidiary company.

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.

Please see section 2.4(g) 'Ongoing governance and regulatory obligations' in the section relating to CLGs for information.

As a charity, the Parent company will also be required to comply with the requirements of the Charity Commission including filing confirmation statements and accounts with the Charity Commission. For further information on these requirements, please see the Charity Commission's guidance, available at:

https://www.gov.uk/government/publications/charity-reporting-and-accounting-the-essentials-cc15b .

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 2.5(g) 'Ongoing governance and regulatory obligations' in the section relating to private companies limited by shares for further information.

f. CORPORATE STRUCTURE

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

Consideration will need to be given to who the directors/trustees of the Parent company should be, and who the directors of the trading Subsidiary company should be. These are sometimes the same people, however care must be taken to ensure that conflicts of interest do not arise, that the charitable assets of the Parent company are not used for non-charitable purposes, and that the directors/trustees of the Parent company and the Subsidiary company have the appropriate skills.

g. FINANCE AND FUNDRAISING

Parent company

The biggest source of finance for a charity will be gifts and donations that it receives from the general public (which includes donation-based crowdfunding). 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 trading Subsidiary companies of a charity fund their business through a mixture of share capital, loan capital, and retention of profits.

Share and loan capital is normally, though not always, provided by the Parent company. In providing this capital the Parent company must first assess whether it is a suitable investment of its assets – the interests of the Parent company are paramount. In some situations, outside investment may be sought as an alternative or combined/matched with investment by the Parent company.

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

NON-PROFIT SUBSIDIARY OF FOR-PROFIT ENTITY

REUTERS/ KIERAN DOHERTY

NON-PROFIT SUBSIDIARY OF FOR-PROFIT ENTITY

AT A GLANCE

SUMMARY

For-profit enterprise establishes a non-profit subsidiary with a particular social or charitable purpose

ADVANTAGES

- ✓ Large companies can utilise some of their profits to further a social aim or demonstrate their corporate social responsibility
- ✓ Method for large companies to make donations to and support other social ventures/charities
- ✓ PR benefit/increasing interest of corporates in social venture or contribution to the communities that support them
- ✓ There are potential tax benefits

DISADVANTAGES

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

NON-PROFIT SUBSIDIARY OF FOR-PROFIT ENTITY

a. 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 would typically be either a public or private company limited by shares. It may be an existing company, or it may need to be established at the same time as the non-profit subsidiary is established. For the purposes of this section, we have assumed that the for-profit parent company is a private company limited by shares.

Non-profit subsidiary

A private CLG or CIO are likely to be the most typical forms of entity used for the non-profit subsidiary. 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

If it does not already exist, the for-profit parent company will be incorporated in the same way as any other private company limited by shares. Please see section 2.5(b) 'Establishment costs and documentation' in the section relating to private companies limited by shares for further information.

Non-profit subsidiary

Assuming the non-profit subsidiary is to be incorporated as a CLG, then see section 2.4(b) 'Establishment costs and documentation' for further information relating to the procedure and costs of incorporation. Where it is also to be registered as a charity, then please see section 3.1(b) 'Establishment costs' in the section relating to a charity as a parent and a for-profit entity as subsidiary hybrid.

c. LIABILITIES

The liability associated with this legal structure depends on the type of entity chosen for the for-profit parent and the non-profit subsidiary. For information on the liability of members and directors of a for-profit company that is incorporated as a private company limited by shares, please see section 2.5(c) 'Liabilities'. For information on the liability of members and directors/trustees of a non-profit subsidiary that is incorporated as a CLG, please see section 2.4(c) 'Liabilities'.

d. TAX TREATMENT

Corporation Tax

For-profit parent company

The for-profit parent company will be liable to corporation tax as usual. For a very high level overview, please see section 2.5(e) 'Tax treatment' in the section relating 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 3.1(d) 'Tax treatment' in the section relating to a charity as parent and a for-profit entity as subsidiary hybrid for further information on the relevant exemptions.

VAT

For-profit parent company

The for-profit parent company will be subject to the VAT rules in the normal way. Please see section 2.5(e) 'Tax treatment' in the section relation to private companies limited by shares.

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 (as of the date of publication this was £83,000) 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 https://www.gov.uk/vat-charities.

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. Please see section 2.5(g) '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. Please see section 2.4(g) '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 confirmation statements and accounts with the Charity Commission. For further information on these requirements, please see the Charity Commission's guidance, available at:

https://www.gov.uk/government/publications/charity-reporting-and-accounting-the-essentials-cc15b.

f. CORPORATE STRUCTURE

Where the non-profit subsidiary is intended to be the non-profit arm or foundation of a for-profit enterprise, the for-profit parent company will typically be the sole member of the non-profit subsidiary. There may however be variations on this, such as where the shareholders are a mixture of for-profit organisations (e.g. banks) and an independent sponsor which ensures that the venture continues on its 'social mission'.

Consideration will need to be given to the directors/trustees of the non-profit arm, and to the independence of the board of the non-profit organisation from the for-profit organisation.

g. FINANCE AND FUNDRAISING

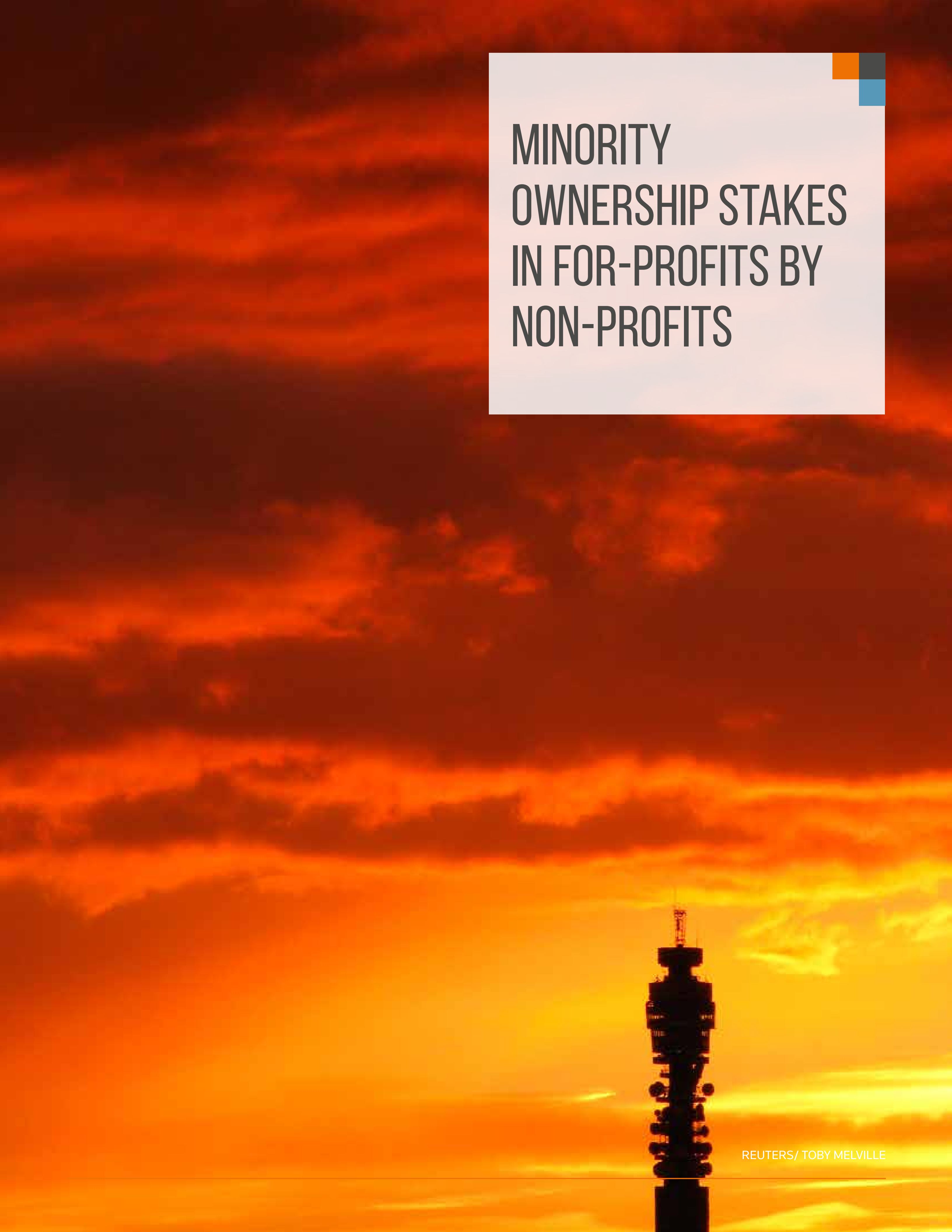
For-profit parent company

In some cases, an existing for-profit enterprise will establish a non-profit subsidiary to further a particular social or charitable aim. In cases where a social venture is from its inception being structured as a for-profit parent company with a non-profit subsidiary, then one of the main advantages of having a for-profit parent is the ability to raise capital from external investors. A private company limited by shares is the typical legal form for this structure. Please see section 2.5(i) 'Finance and fundraising' in the section relating to private companies limited by shares for further information.

Non-profit subsidiary

In this structure, the main source of income for the non-profit subsidiary is likely to be any revenue that it generates from its activities, any contributions/charitable donations from its for-profit parent, and any charitable donations that it receives from the general public (which includes donation-based and rewards-based crowdfunding). It may be the case that the non-profit subsidiary is expected to become self-sufficient after a period of time. Charities and other non-profit organisations can also benefit from grants, such as government and EU grants.

MINORITY OWNERSHIP STAKES IN FOR-PROFITS BY NON-PROFITS



REUTERS/ TOBY MELVILLE

MINORITY OWNERSHIP STAKES IN FOR-PROFITS BY NON-PROFITS

AT A GLANCE

SUMMARY

Charity or other non-profit organisation makes a minority investment in a for-profit business, usually where that business has similar objectives to the charity or non-profit

ADVANTAGES

- ✓ Charitable/non-profit entities invest in other businesses which have similar objectives to the charity/non-profit's objectives, with any returns from that investment used to further the charity/non-profit's objectives
- ✓ As it is a minority investment, the charity/non-profit does not need to have the skills for that business "in-house", and can agree with the relevant business how actively involved it is in the management of that investment
- ✓ Ability to generate income/returns from another source

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
- ☒ Tax disadvantages for companies only partly owned by a charity compared with for-profit entities which are wholly owned subsidiaries of a charity

MINORITY OWNERSHIP STAKES IN FOR-PROFITS BY NON-PROFITS

a. OVERVIEW

Another way for charitable and other non-profit organisations to further their charitable or social purpose, whilst taking into account funding constraints on the charity/non-profit, is to make a minority investment in a for-profit entity. The for-profit entity typically has similar social objectives to the charitable or non-profit organization. This is the case with the Carbon Trust, which invests in the carbon-space. Any returns from these investments will also typically be used to further the charity or non-profit organisation's wider charitable or social purpose.

b. ESTABLISHMENT COSTS

If it does not already exist, then the charitable or non-profit entity will typically be established as a private CLG, a community interest company ('CIC') or a CIO. For the purposes of this section, we have assumed that the non-profit entity is a CLG and has registered as a charity. See section 2.4(b) 'Establishment costs and documentation' for further information relating to the procedure and costs of incorporation. Where it is also to be registered as a charity, then please see section 3.1(b) 'Establishment costs' in the section relating to a charity as a parent and a for-profit entity as subsidiary hybrid.

We have assumed that the for-profit entity into which the charitable or other non-profit organisation makes an investment is a private company limited by shares.

c. LIABILITIES

The liability associated with the charitable or other non-profit organisation depends on the type of legal entity chosen. For information on the liability of members and directors/ trustees of a non-profit subsidiary that is incorporated as a CLG, please see section 2.4(c) 'Liabilities'.

Where the charity or other non-profit organisation makes an investment in a private company limited by shares, the charity or other non-profit will benefit from limited liability, as detailed in section 2.5(c) 'Liabilities'. The liabilities of the directors of the private company limited by shares (which may include directors appointed by the charity or other non-profit organisation) are also described in section 2.5(c) 'Liabilities'.

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

As a CLG, the non-profit entity must comply with all governance obligations relating to private companies in addition to those requirements applicable to charities. Please see section 2.4(g) '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 confirmation statements and accounts with the Charity Commission. For further information on these requirements, please see the Charity Commission's guidance, available at:

https://www.gov.uk/government/publications/charity-reporting-and-accounting-the-essentials-cc15b.

f. CORPORATE STRUCTURE

Non-profit entities which invest minority stakes in for-profit companies usually have an investment portfolio managed by an external investment manager. The directors/trustees, or an investment committee of the directors/trustees, will agree an investment policy for the company in order to generate returns, while effectively managing risk and ensuring the furtherance of the charitable or social objectives of the organisation.

One advantage of appointing an external investment manager to manage investments is that it requires fewer resources and skills 'in-house' at the non-profit entity, compared with establishing a for-profit subsidiary of the non-profit entity.

The rights associated with the minority stake investment will be subject to negotiation between the parties, but the non-profit entity will typically have much less control over the management of the investee company, compared with the non-profit entity establishing a for-profit subsidiary company.

g. FINANCE AND FUNDRAISING

As a for-profit enterprise, established as a private company limited by shares, the investee company's structure is conducive to external investment. It can facilitate different types of equity investment (including the minority investment by the charity/non-profit as well as other forms of investment such as equity-based crowdfunding), and is generally suitable for loan and debt financing (including loan-based crowdfunding).

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.

'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.

'FCA' means the Financial Conduct Authority who is responsible for regulating cooperative and community benefit societies.

'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.

'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 uses 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.

‘PRA’ means the Prudential Regulation Authority which regulates the conduct of specific firms such as banks and investment firms

‘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.fca.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 FCA, acting as the competent authority under Part VI of FSMA. In this role, the FCA 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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