

Setting up Social Enterprises

Social enterprises are businesses that trade in the market with a social purpose. A social enterprise is not defined by its legal status but by:

- Its nature.
- Its social aims and outcomes.
- The basis on which its social mission is embedded in its structure and governance.
- The participation of its shareholder groups in its governance and activities.
- The way it uses the profits generated by trading activities.

Reasons to form a social enterprise

From the public authority's perspective, outsourcing to a third party to provide public services has the major benefit of placing the obligations relating to delivery of services on a new independent provider. On the other hand, by outsourcing services to a third party, the authority loses direct control over those services and must therefore rely on the service contract with the new provider to be able to enforce the service standards it requires.

Establishing a social enterprise to deliver a public service can have the following benefits:

- **Independence.** The new social enterprise is a separate, independent entity from the authority and free to manage its own activities in the way it thinks most appropriate. Often a social enterprise's governance structure will be based on participation by its shareholders (employees, users, local community groups or social investors), which can empower and incentivise those involved.
- **Funding.** As an independent entity, a social enterprise's budget is its own and ring-fenced from the authority's. It has the freedom to generate various income streams, such as through grant funding, debt or equity finance. These could be in addition to income derived from providing services, such as under any ongoing contractual arrangements with the authority.

On the other hand, becoming independent from the authority has the following implications:

- **Income streams:** the social enterprise will have to fund itself, just like any other independent business. The social enterprise might also need to bid for authority contracts against its new competitors and in compliance with the public procurement regime with no guarantee of success. In an increasingly competitive market place, some organisations may not be successful in securing sufficient contracts to survive (for example, in the health sector, where many independent social enterprises are currently being established to deliver health and social care related services).
- **Responsibility:** those responsible for running the social enterprise (for example, the board of directors of a company) will have responsibility for managing its activities and its funds and other assets, for instance, ensuring the wellbeing of its staff and dealing with associated

matters, such as salaries and pension provision. These responsibilities, which were previously borne by the authority, can be onerous. For more information in the local government context.

- **Liability:** depending on the legal form and the particular circumstances, those responsible for running the social enterprise may be held personally liable for losses to third parties caused by its activities. The risk of personal liability can be reduced in a number of ways: principally, through choosing an incorporated vehicle and taking out appropriate indemnity insurance in respect of potential liabilities.

Setting up a social enterprise: key factors

Before setting up a social enterprise, the following factors need to be carefully considered, which may affect the choice of legal form:

- **Social mission.** A legal form will often be chosen specifically to protect the social mission by having intrinsic safeguards built into the constitution
- . However, the legal form must still allow the social enterprise the freedom to take advantage of any business opportunities that arise.
- **Managing risk.** Business risks can be minimised by using an appropriate legal form. One way of limiting the potential risks to individual directors is to use an incorporated legal form for the social enterprise.
- **Accessing finance.** Although some types of funding can be obtained irrespective of the legal form, other types are only available to certain legal forms
- **Tax.** A wide variety of tax liabilities can be avoided or reduced by adopting charitable status.
- **Power structure.** The basis of most legal forms is a two-tier power structure whereby a small group of individuals are responsible for the day-to-day running of the organisation (called the board of directors, board of management, management committee or board of trustees), but are accountable to a wider group of individuals (often called the members or the shareholders).

Stakeholders

The structures adopted by most social enterprises essentially divide into three types:

- **Oligarchy.** The individuals who make up the board are the same people as the members. This is a straightforward structure for new and relatively small enterprises.
- **Representative oligarchy.** This is used by organisations that want to have members who are organisations instead of individuals (for example, the members may include the local authority, which has the right to appoint an individual to serve on the board).
- **Membership.** Here, the membership group is wider than the individuals on the board and elects the board. This structure is often used by organisations which define themselves as "co-operatives"

Social enterprises often involve their stakeholders to a greater extent than many private businesses. Some common examples of stakeholders in social enterprises are: employees; members of the organisation; investor/grant makers/lenders; customers/service users and families; the local community; local voluntary organisations; and the public authority.

Stakeholder involvement can often be a great source of strength in business. However, to ensure the business runs effectively, it is worth giving careful thought to exactly how people can become involved. There are many ways of doing this. At one end of the scale, stakeholders can have rights written into the organisation's constitution including, for example, the right to attend and vote at annual meetings and to elect the management committee. At the other end, stakeholders could be appointed onto advisory groups, whose advice assists but does not bind the management committee's decisions.

Social enterprises: possible legal forms

Social enterprises can take one of a number of different legal forms. The main ones are:

- Unincorporated association.
- Incorporated organisation:
 - Limited company;
 - Community Interest Company (CIC);
 - Industrial and Provident Society (IPS);
 - Limited Liability Partnership (LLP); and
 - if the social enterprise is also a charity, ***Charitable Incorporated Organisation*** (CIO)

Key characteristics of the various legal forms available are set out below.

Unincorporated associations

Unincorporated associations are groups that come together for a particular purpose, for example, to run a sports club. The central features of most unincorporated associations are:

- A constitution that sets out the rules governing their relationship and a broad membership which elects the management committee.
- Personal liability for the members of the management committee. This is because unincorporated associations do not have a legal identity in their own right; the members of the management committee therefore enter into obligations (such as contracts) on behalf of the organisation and they are responsible for its debts and other liabilities. A member of the management committee may risk their personal assets if the assets of the business are not sufficient to cover all the debts and liabilities. This means that this form may not be appropriate if the organisation is likely to have significant liabilities, such as those arising

from undertaking major activities, employing staff or acquiring property. Two common approaches to guard against such risk are to take out appropriate insurance for the benefit of the management committee members in respect of such potential liabilities and/or to incorporate.

The main advantages of being unincorporated are the relatively "light touch" regulation (for example, no requirement to send and file annual returns or accounts with **Companies House**) and some tax advantages (for example, sole traders and partners pay their tax in arrears rather than up front).

Incorporated organisations (including CICs)

If the social enterprise is incorporated, the organisation itself is a legal entity liable for its own obligations. This limits the personal liability of individual management committee members, shareholders or members, which is not the case for unincorporated organisations. Incorporation has the following benefits:

- As a separate legal entity in its own right, the social enterprise can enter into contracts, employ staff, lease property and will have the burden of those obligations and liabilities.
- "Limited liability". Incorporation limits the personal liability of the individuals involved (although it does not remove it altogether). This is particularly important if the social enterprise intends to employ staff, take on significant property interests or undertake major contractual obligations.
- Incorporation provides an established form of structure for stakeholder membership.
- With limited liability comes regulation disclosure requirements, which can increase public confidence in the organisation.
- Recognition by financial institutions. Many banks and other financial institutions will insist on incorporation before providing loan finance. Equity finance is only available to certain types of incorporated organisations.

Limited companies

There are two types of company: companies limited by shares (CLSs) and companies limited by guarantee (CLGs).

CLSs have a "share capital", which is a nominal figure used to represent the total net assets of the company. Shares are issued to shareholders, who become the owners of the company. The shareholders' potential liability is limited to the amount of their investment.

By contrast, CLGs do not have a share capital and the members (equivalent to the shareholders in a CLS) give a nominal guarantee to cover the company's liability, normally limited to £1. By not having a share capital, as CLGs do not have the inbuilt "for-profit" framework which CLSs do allowing investors in the company to receive a return on their investment, the CLG brand has been traditionally associated with charities, trade associations and not-for-profit companies..

CLSs are divided into private companies and public limited companies; the latter are subject to particularly stringent accounting standards. Many public limited companies offer their shares to the public by being listed on the stock market.

As both are companies, many of the features of CLSs and CLGs are the same or similar. The impact of the different legal forms is most clearly felt when considering the financing options, some of which require a share structure and are therefore unavailable to some organisations

Some key characteristics of companies are:

- **Power structure:** companies have a two-tier power structure consisting of a small group of individuals responsible for the day-to-day running of the organisation (the board of directors), which is accountable to the members (in a CLG) or the shareholders (in a CLS), who may or may not be the same people as the board. The members or shareholders have a number of fundamental powers: in particular, the power to dismiss the board and to change the constitution.
- **Constitution (Memorandum and Articles of Association):** the rules of the company are contained in the Articles, which set out the internal management structure and procedures, such as roles of members and directors, procedures for appointment and removal, conduct of meetings and so on. The Memorandum records the initial members on the company's establishment. Standard forms of Articles of Association may be used, although it is often advisable to check with a legal expert to ensure that the constitution is appropriate to the organisation.
- **Purposes:** the "objects" clause sets out the company's aims or purposes, which could be simply to carry on business as a "general commercial company" or, for a social enterprise or charity, will be narrower and focused on the particular objective. For a charitable social enterprise, the objects must be exclusively charitable.
- **Limited liability:** the directors benefit from the protections of limited liability due to the company form, except in exceptional circumstances (for example, where a director has acted fraudulently or continued to run the company when it is insolvent, known as "wrongful trading"). It is possible to take out appropriate directors' and officers' liability insurance to cover such potential liabilities, but not in the event of fraud or other bad faith.
- **Accountability:** companies are required by law to make public certain information, such as an annual return and financial accounts, which need to be filed with the Registrar of Companies, the regulator of companies established in the UK. Details of changes of directors and the company secretary, constitutional amendments and other disclosable matters also need to be filed.
- **Registration:** this is a straightforward process, requiring the completion of standard administrative forms and payment of a fee.

Community Interest Companies (CICs)

A CIC is a form of company which has been available since 2005, developed in order to address the lack of a legal vehicle for non-charitable social enterprises. Fundamentally, CICs are normal companies – they can be established either as CLGs or as CLSs. However, CICs have some particular features to safeguard the social mission, namely:

- A CIC has to carry out activities which fulfil a "community purpose". This purpose will be defined on applying to set up the CIC, for example, the promotion of healthcare for the inhabitants of a particular area.
- A CIC also has a lock on its assets. This prevents profits from being distributed to its members or shareholders other than in certain limited circumstances (for example, a CIC which is a CLS provides the flexibility for shareholders to receive limited dividends).

The CIC form allows for a lock on the company's assets while allowing the board of directors to be paid; for this reason, it is an increasingly popular vehicle for social enterprises where the social entrepreneur establishing the organisation wishes to remain in control and receive a salary from it. CICs cannot be charities.

CICs are regulated by the CIC Regulator, which is intended to be "light-touch". A CIC is required to file a community interest report each year, which will include details of how it has pursued the community interest and involved stakeholders.

CICs can be registered with Companies House in the same ways as normal companies, with the completion of an additional form setting out the community interest and how it will be pursued.

Industrial and Provident Societies (IPs)

This legal structure tends to be used where it is appropriate to give a wide membership an equal stake in the organisation and an equal say in management and other affairs, for example, by co-operatives and credit unions.

IPs are societies, not companies. They can take two forms: community benefit societies (CBSs) and co-operative societies (co-ops). The difference between the two is in the stakeholder groups that the society is set up to benefit: a co-op is set up to benefit its members, whereas a CBS is set up to benefit the community more widely (whether people are members or not).

The regulator of IPs is the **Financial Conduct Authority (FCA)**, which has a significant regulatory function. For example, IPs need to file an annual return and audited accounts (if over the statutory threshold).

For their constitution, IPs adopt a set of model rules registered by one of the recognised sponsoring bodies or a bespoke set with the FCA. In co-ops, it is mandatory for voting to be on a one member, one vote basis. In CBSs, it is standard for this to be the case (although not necessarily). Any member can own up to £20,000 of the share capital in an IPS, though in a charitable CBS the members usually only hold a nominal amount. The constitution may allow for the IPS to issue "withdrawable shares", which can be bought back or "redeemed" from members. This can provide a straightforward and cheap way to raise equity finance from its members, as withdrawable share capital is exempt from

certain regulations applicable to conventional share issues (such as the publication of an appropriately drafted prospectus for potential investors).

Unlike companies, IPSs have the ability to merge through resolutions of their members into an existing or new society or company (known as a "Transfer of Engagements"). This is a cheap and convenient process for corporate change.

Currently, all charitable CBSs are *exempt charities*. This means that they are recognised as charities by *HM Revenue & Customs* (HMRC) for tax purposes but are not currently required to register with the Charity Commission, nor are they directly regulated by it.

Limited Liability Partnerships (LLPs)

The LLP legal form retains the organisational flexibility of a traditional "partnership" and is taxed as a partnership, but members have the benefit of limited liability. In particular, the LLP has the advantage of being tax "transparent", which means that the members are taxed directly in their capacity as the individual or corporate body in accordance with their tax status. It has a single-tier structure (the LLP "members" are the equivalent of directors of a company).

The rights and duties of members have to be given by agreement between them (and the LLP). These are usually set out in a master written agreement (the "LLP Agreement"). However, in the absence of an LLP agreement, there are default provisions under the *Limited Liability Partnerships Act 2000* (as amended). The LLP Agreement does not have to be filed with Companies House.

Many LLPs are used by two or more individual or corporate bodies to carry on a lawful business with a view to profit; however, social enterprises can adapt the LLP form to their needs, in particular, by having protections for the social mission set out in the LLP Agreement.

An LLP can be straightforwardly incorporated by filing an application form together with a registration fee to the Registrar of Companies.

Members are liable in the winding up of an LLP up to the amount they have agreed (which can be nothing). Certain "designated members" have the same rights and duties as any other member but have extra responsibilities, such as signing the accounts on behalf of the members and delivering documents to the Registrar of Companies.

The price of limited liability is disclosure; accounts must be prepared in accordance with the relevant accounting rules and filed at Companies House. They must disclose the highest paid member's profits and the annual return must be completed. In addition, as for limited companies, there is certain information which must appear on the LLP's correspondence, such as the full name of the LLP, the place of registration, registered number, and so on.

Social enterprises as charities (including CIOs)

Key features of charities

Many social enterprises are also charities; the key feature of a charitable social enterprise is that it is established with exclusively charitable objects, such as the advancement of education or the relief of poverty. Being a charity is a status; it is possible to establish a charity using a variety of legal forms,

including a **charitable trust**, an unincorporated association, a CLG, an IPS and a CIO. The most common legal form increasingly is the CLG.

A large number of charities are not required, or are not able, to register with the Charity Commission and it is not necessary for an organisation to be registered in order to be a charity.

Other key features of charities are:

- Governance: the management committee of a charity (its **charity trustees**) are responsible for the charity's administration and management, and are normally unpaid.
- Asset lock: a charity's assets must always be used to further the charity's purposes, and any profits or surpluses generated cannot be paid out to the trustees or members but have to be reinvested in the charity.
- Constitution: regardless of the legal form, the constitution will contain:
 - a statement of its exclusively charitable objects;
 - a list of the powers the trustees have in furthering the charity's objects;
 - a list of any benefits trustees are authorised to receive from the charity; and
 - a "not-for-profit distribution clause", requiring that all residual assets on dissolution are applied for charitable purposes (and not distributed to private interests).
- Public/private benefit: as public benefit organisations, charities have to be careful about not giving disproportionate levels of private benefit to any particular group or person.
- Tax relief: charities benefit from a number of tax advantages.
- Gift Aid: gifts to charities by companies and organisations which pay Corporation Tax are tax deductible as charges on income. Donations by individuals attract Gift Aid relief, which means that, provided the individual is a UK taxpayer, the charity can recover the amount of basic rate tax that the donor had paid on the amount of gift.
- Regulation: most charities in England and Wales are regulated by the Charity Commission. The Charity Commission is often viewed as a relatively "heavy" regulator and exercises considerable scrutiny over charities, particularly those turning over more than £250,000 per annum. Charities with an annual income of more than £10,000 have to file annual reports, accounts and an annual return. For further information about the Charity Commission's regulatory powers.
- Trading: as an overarching principle of charity law, charities can only trade in the fulfilment of their primary purpose, that is, what the charity is set up to do. If the charity wishes to undertake further trading activities in order to raise money but which will not fulfil the charity's primary purpose, unless the trading is minimal (that is, within the permitted statutory threshold, currently 25% of a charity's total incoming resources, subject to a minimum allowance of £5,000 and overall cap of £50,000) and does not expose the charity to significant risk, the charity will have to set up a separate, for-profit trading company

owned by the charity to undertake the activities. This arrangement is approved by the Charity Commission and HMRC. The rules around trading by charities or through their trading companies are complex and legal advice should be sought to ensure the trustees comply with the various rules and regulations.

To register as a charity, the social enterprise must apply to the Charity Commission . The main part of this process involves completion of a detailed application to establish that its activities in promoting its charitable objects will provide sufficient benefit to the public (without producing more than incidental private benefit): the "public benefit test". Depending on the activities of the social enterprise, correspondence with the Commission can be lengthy and incur significant legal fees, with no guarantee of success. Organisations with exclusively charitable objects and an income of more than £5,000 are required to register with the Commission.

Charitable incorporated organisations (CIOs)

A new legal form , the charitable incorporated organisation (CIO), has been designed specifically and exclusively for charities.

The CIO combines the benefits of being a corporate body, with a separate legal identity and limited liability for its charity trustees and members, while being regulated solely by the Charity Commission and, unlike CLGs, not by Companies House as well.

Implementation of the CIO is being phased; the Charity Commission began registering CIOs in January 2013.

Funding: finance and tax implications

There are a range of sources of finance available to social enterprises, aside from the organisation generating its own surpluses to reinvest. Although some types of funding can be obtained by any legal form, other types are only available to certain legal forms.

The principle financing options are:

- Grants. Any legal form is able to accept a grant. However, charities tend to find funders more receptive due to the guarantee that all funds will be applied to its exclusively charitable purposes. CICs are likely to find more success than straightforward commercial enterprises because of their asset lock. Common sources of grants are charitable foundations, government and EU funds.
- Debt finance. This source of finance is available to any legal form, usually in the form of loans from banks or other specialist finance providers. However, it is preferable to use an incorporated legal form as the obligation to repay the loan is a substantial liability and many lenders will in any event insist on incorporation.
- Equity finance. This involves a company ceding part-ownership and selling shares in itself to a third party in exchange for capital. Not all legal forms will allow a company to receive equity investment. In particular, as it does not provide for a share structure, the CLG form does not allow for the possibility of equity finance (however, it may be possible to secure equity investment in a trading subsidiary wholly owned by the charity).

When choosing a legal form, it is important that appropriate professional advice is obtained as to the tax implications of adopting a particular model, particularly as the social enterprise is likely to be dependant on its surpluses.

A wide range of tax reliefs and exemptions are available to charities. For example, a charity can obtain Corporation Tax relief on profits provided that these are applied solely to the purposes of the charity and the trade is exercised in the course of carrying out the primary purpose of the charity. Charities may also benefit from Capital Gains Tax relief (on disposals of assets) and Stamp Duty Land Tax relief (on land transactions)

Charities can also obtain rate relief at a mandatory 80% from unified business rates plus potentially a further 20% at the local authority's discretion where they wholly or mainly occupies property for charitable purposes. Similarly, CICs and other organisations undertaking charitable activities may be successful in obtaining up to 100% discretionary rate relief from the authority if they can establish that they mainly or wholly occupy a property for charitable purposes, though this relief is entirely at the discretion of the authority.

Regardless of legal form (other than a number of specific exemptions, for example, for charities in relation to fundraising activities), the social enterprise will be subject to the usual rules on VAT. This is because VAT is a tax charged on most goods and services that VAT-registered businesses provide in the UK (and also on goods and some services imported from countries outside the European Union).

A business does not have to charge VAT unless it is registered for VAT. It will need to register for VAT if its annual turnover from providing goods or services counted as "taxable supplies" is over the "VAT threshold" (currently, £77,000).

The law surrounding tax, particularly VAT, is complex requiring careful analysis of the detail, and specialist advice should be sought when considering which legal form to adopt.