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Voluntary organisations & social enterprises:

Finding the right legal structure for trading

Charities and Trading

Charities come in many shapes, sizes and structures but all of them have a number of features in common:

- Charities enjoy a variety of tax breaks, including being exempt from paying corporation tax, some VAT relief, Stamp Duty Land Tax (SDLT) relief, a minimum of 80% relief on business rates and the ability to take advantage of Gift Aid.

- With the badge of credibility that is attached to being a charity, many find that they can access funding that would not be available to non-charities.

- Charities can be structured to limit their members' and trustees' liability by becoming a company limited by guarantee, an Industrial & Provident Society, or (when it becomes available) a charitable incorporated organisation.

Whilst there are some restrictions including:

- the need for exclusively charitable purposes and solely working within those purposes,

- being subject to the active involvement of the Charity Commission in reviewing whether the organisation provides sufficient "public benefit" and

- the requirement for your governing body to be comprised of volunteers not paid employees,

Charities are not as restricted on their ability to trade as you might first think. By trading we mean generating an income from selling goods or providing services.

The recommended structure for a charity is a company limited by guarantee. This provides the limited liability that is not available for a trust or unincorporated association and allows the governing body to enter into contracts in the name of the charitable company, rather than the names of individual trustees.

A charity with an annual income of £5,000 or more must register with the Charity Commission.

Primary Purpose Trading

- Charities are established with certain aims in mind, for example advancing education. These aims are called their objects or purposes.
- Charities are permitted to carry out an unlimited amount of trade if that trading directly achieves their primary purpose.
- For example, if a charity is established with the primary purpose of advancing education and charges fees for providing education, it would be carrying out primary purpose trading because the direct aim of providing the service is to advance the education of the people attending.
- Any proceeds from primary purpose trading must then be reinvested for the charity's purposes to be exempt from taxation.

Ancillary or Additional Trading

- Charities can also carry out trading that is ancillary to or additional to their primary purpose trading.
- Although this type of trading does not have to directly achieve the charity's primary purpose, it is permitted so long as it is closely associated with those primary purposes.
- For example, a museum could run a café for the use of its visitors.
- As with primary purpose trading, any profits from ancillary or additional trading are exempt from tax provided that they are reinvested for the charity's purposes.

Trading by Beneficiaries

- The people that a charity is established to help are known as its beneficiaries.
- If a charity established to support disabled people were to open a café that was staffed mainly by its beneficiaries (i.e. disabled people), this would be classed as trading carried out by beneficiaries.
- It would be possible to involve some non-beneficiaries, perhaps as managers should this be necessary.
- Profits from trading by beneficiaries can be exempt from tax and must be used only for the charity's purposes.
- A charity would need to consider employment law issues such as national minimum wage if it employed beneficiaries.

Small trading profits exemption

- If none of the three types of trading above apply to any of the trading a charity does, it can use the small trading profits exemption.

- This exemption allows 25% of the total charity income to be derived from non primary purpose trading up to a maximum of £50,000.

- For example, non-primary purpose trading could include selling Christmas cards to raise funds.

- These figures relate to turnover rather than to profits and again all trading profits must be used for the charity's purposes.

Trading Subsidiaries

- If a charity carries out a large amount of trading it may need to establish another structure such as a trading subsidiary in order to protect its tax exempt status.

- Even where some of the above exemptions apply, some charities use a trading subsidiary as a way of managing the risks associated with trading, such as making losses.

- Subsidiaries are usually private companies limited by shares. They are usually wholly owned by the parent charity.

- Any profits made by the trading subsidiary can be donated to the parent charity by way of Gift Aid, which will avoid any tax liability.

- The charity will need to check it has power to invest in a subsidiary. The charity trustees need to examine the business case carefully before committing any funds to the subsidiary.

- A trading subsidiary should have a robust business plan and progress against the plan should be monitored carefully by the charity.

- Loans by the charity should be on commercial terms and set out in a legal agreement. Loans should if possible be secured against assets. Any other support by the charity for example provision of staff time should be properly costed and charged for. There should be an arms' length relationship between charity and subsidiary.

- The board of the subsidiary should include someone other than trustees or employees of the charity. Conflicts of interest need to be properly managed.

- The charity should not continue to support a subsidiary that is failing.

- Charities need to get appropriate legal, tax and VAT advice. For example does VAT need to be charged between charity and subsidiary; how does involvement of a subsidiary in a charity shop affect business rates relief; if you have a shop, can you benefit from gift aid on donated goods?

Social Enterprises and Trading

For some people the restrictions imposed on a charity are not suitable for their business idea. It is worth bearing in mind however that a move away from a charitable structure also involves forfeiting the tax breaks, and it is often possible for a charity to be run as a social enterprise to a large extent.

- There is no legal definition of social enterprise, but a social enterprise is commonly understood to be a business with primarily social objectives whose surpluses are principally reinvested for those objectives in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners.

- There is no one set structure for a social enterprise however many are established as companies. Some of the most common structures are companies limited by guarantee and companies limited by shares. There is also a structure that suits many social enterprises called a Community Interest Company (CIC).

- Whilst a social enterprise could have a very informal structure such as a partnership, this type of structure will not provide any limitation of liability for the governing body.

Companies

A company is a membership organisation in which the company members generally elect directors as the governing body. It is used not only by businesses but also by not-for-profit organisations and charities. Benefits include:

- A flexible structure that can be adapted for any size or type of organisation

- Quick to set up and instantly recognisable as a structure

- The liability of members is limited to the value of their share or guarantee

- There are no limitations on the levels or types of trading that a company can do if it is not a charitable company, provided that it is within its stated purposes (or 'objects') which can be drafted very widely

The drawbacks of a company include:

- Requirements to comply with company law and to file documents with Companies House. Failure to comply with company law could result in substantial fines and/or the company being struck off the register

- The public can require access to certain information including the register of directors and register of members.

- The people running the organisation at a board level must become company directors.

Company limited by Guarantee

A guarantee company has no shares. Instead each member promises to contribute a sum (usually £1) if the company becomes insolvent and is wound up. A member's personal liability is limited to the amount they promise to contribute.

Company limited by Shares

A share company has members (or shareholders) who each purchase at least one share in the company. Such companies can invite people to invest in them through buying shares, but they cannot raise money by selling shares on the stock exchange.

Community Interest Company

- A CIC can be a guarantee company or a share company. Its governing document requires it to comply with a community interest test showing that its objects are for a community interest purpose and all of its activities are going to be carried on for the benefit of the community and certain other requirements.
- CICs must comply with company law and with laws that are applicable only to CICs.
- It is seen by some as a 'half way house' between the restrictions of a charity and an unrestricted commercial company.
- Features include a lock on the assets which prevent them from being distributed for less than market value unless they are distributed for the community benefit, and a cap on dividends which prevents windfall profits being paid to member or directors.

Benefits include:

- The community interest test allows broader purposes than the public benefit requirements for a charitable organisation.
- Directors can be paid reasonable remuneration if the governing document allows.

Drawbacks

- It has none of the tax advantages or rates reliefs of a charity but is still limited in the way it can use its assets and the dividends it can pay members and directors.
- It is not a particularly well known structure within business or with the public

Joint Ventures

- Sometimes joining up with another organisation to either develop a new idea or carry out certain services can be a way of sharing the costs and risks of a new venture.
- It is usually best to set up a limited liability company to carry out the joint venture to provide a barrier to the risks associated with the project.

- Often a joint venture company has a board that consists of people from both organisations to ensure that both organisations have an equal say in the direction of the joint venture.

- This is a good way for not-for-profit bodies to link up with commercial bodies whilst protecting the original organisation from reputational risk should the project be unsuccessful.

- If you are a charity, any risks to your reputation or assets from such a joint venture should be carefully considered and monitored.

This article provides general information only. Charities should take professional advice if they are considering setting up trading activities.

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