

BIS | Department for Business
Innovation & Skills

**A GUIDE TO LEGAL FORMS FOR
SOCIAL ENTERPRISE**

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A Guide to Legal Forms for Social Enterprise

Definition of a Social Enterprise

The term “Social Enterprise” describes the purpose of a business, not its legal form. It is defined (by Government) as “a business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners”.

Setting up a social enterprise

At the simplest level, a social enterprise can be a sole trader who has decided to donate the majority of the profit he or she makes to a good cause. Social enterprises may however take a variety of legal forms and the process for establishing one will depend on which legal form is chosen. Commonly used legal forms include Limited company, Community Interest Company (CIC), and Industrial and Provident Society. However some social enterprises may also take on an unincorporated legal form such as an unincorporated association or a trust (or a combination of the two).

This emphasises an important distinction between setting up a business (social enterprise or otherwise) – which simply involves the decision to trade in goods and services – and establishing a company (or other incorporated entity) which involves being subject to registration and other legal requirements.

Unincorporated forms

If a social enterprise remains unincorporated, as a sole trader or partnership, its profits will be taxed as income of the individuals involved. They would normally be treated as self-employed and be required to use self-assessment to calculate the income tax and national insurance contributions applicable to any profits taken out of the business. Unincorporated associations may be similarly treated for tax purposes, although many are liable for corporation tax on their income and must register with HM Revenue and Customs (HMRC) for this purpose.

All businesses (whether incorporated or not) are required to register with HMRC for VAT if their VAT taxable turnover exceeds £70,000 per annum, and for PAYE and employer national insurance contributions if and when they decide to take on employees. Similarly certain other legal requirements apply to all businesses – for instance those governing business names, record keeping (for tax purposes as relevant), and consumer protection legislation.

Incorporated forms

As with any business, there are some key advantages for social enterprises in choosing an incorporated legal form: such forms have a separate legal personality and limited liability for investors. Incorporation is advisable, and often necessary, where businesses are taking

on significant contractual obligations or raising external capital. A brief overview of the processes for establishing the main incorporated forms, and their applicability for use by social enterprises is set out below.

Limited companies:

The most common incorporated form for business is the private company - limited either “by shares”, or alternatively “by guarantee”. The limited company is subject to stricter regulatory requirements than unincorporated forms: greater accountability and transparency to shareholders and to the public is the price to pay for the benefit of limited liability.

In order to establish a limited company the business must register with Companies House, and with HMRC for corporation tax. This “incorporation” process is relatively straightforward. Those intending to incorporate the company must submit a form to Companies House with the proposed company’s details which include, the company’s proposed name, registered office address, company officers, and whether it will be private or public, as well as a statement of capital and initial shareholdings or statement of guarantee. Alongside this they must submit a Memorandum of Association, for which Companies House provide a proforma on their website. They must also indicate if the company is adopting the model Articles of Association provided, or an amended version of these articles, or bespoke articles of their own (although note that the model articles apply by default if no indication is given).

Once a company has been incorporated, Companies House will inform HMRC that a new company has been incorporated, which triggers HMRC to send an information pack to the Registered Office Address of the company. The company is then required to file a paper form to register for corporation tax (if it has taxable income or profits).

The limited company form offers flexibility for various types of business, including social enterprises. It is quite possible for example for the members of a company to include provisions in its articles of association which define its social purpose. It is important to note that it will always be possible for these provisions to be overturned or amended by a special resolution of the company’s members. Note that this may not be an issue if, for instance, the social enterprise company is a wholly owned trading subsidiary of a charity, or if shares are given to other benefitting from the social enterprise.

Community Interest Companies (CICs):

A Community Interest Company (CIC) is a form of company specifically created for the social enterprise sector. The CIC form has been growing in popularity since its establishment in 2004, and there are now over 5,500 registered CICs. CIC’s are required by law to have provisions in their articles of association to enshrine their social purpose, specifically an ‘asset lock’, which restricts the transfer of assets out of the CIC, ultimately to ensure that they continue to be used for the benefit of the community; and a cap on the maximum dividend and interest payments it can make. CIC structure provides a clear signal to investors that the enterprise operates for the benefit of the community, and that this social purpose is protected by proportionate regulation. A CIC may convert into a charity, or into a Community Benefit Society (see below), or it may voluntarily dissolve – but once established it may not convert into a standard limited company.

The process for setting up a CIC is relatively simple. It is essentially the same as that for a limited company except those wishing to register a CIC must also submit a second form comprising a community interest statement, providing evidence that the CIC will meet the community interest test defined in law. This statement is passed by Companies House, which manages the Registration process, to the CIC Regulator prior to registration for review and decision. The CIC Regulator also provides a series of model articles of association for prospective CICs to adopt “off the shelf” to ensure that the process is as straightforward as possible.

Industrial and Provident Societies (IPSs):

There are two kinds of Industrial and Provident Society (IPS) – Co-operative Societies (which may be social enterprises) and Community Benefit Societies or ‘BenComms’ whose purpose must primarily be “for the benefit of the community”. IPSs must register with the Financial Services Authority rather than Companies House. This process consists of a short paper-based form to which the society must attach two copies of its proposed rules.

Limited Liability Partnerships (LLPs):

A Limited Liability Partnership (LLP) has a separate legal personality similar to a company. Unlike a standard partnership, members of the LLP enjoy limited liability as the name suggests, but the partnership is essentially transparent for tax purposes: non-corporate partners register for self assessment and pay income tax on their share of the profits, while profits shared by corporate partners will be liable to pay corporation tax on this income.

Although not originally designed for the purpose, the LLP form provides a flexible model for social enterprises, particularly where they seek to work in partnership with other organisations or investors, or adopt a mutual model for ownership and control. LLPs have much more freedom than companies to arrange their affairs as they wish – for example in the way decisions are made, and the way in which profits are distributed to members. Thus in order to be a social enterprise an LLP need only decide that, rather than each member taking an equal share of the profits, a majority proportion of the profits will be dedicated to a social purpose.

Two considerations are especially important in drawing up the membership agreement of an LLP social enterprise. First, partners’ salaries are normally treated as profit in the LLPs accounts, whereas in a company they would be treated as operating costs. This can be misleading for investors and others, particularly when the business is starting out and profits after salary costs are limited, because in strict accounting terms a majority of the profits may not be reinvested or distributed for a social purpose. It is therefore crucial that the membership agreement makes the underlying social purpose and the terms of partners’ remuneration extremely clear. Second, as with a company, it is difficult to completely lock the social purpose into the LLP’s membership agreement. Ultimately if all partners resolved to amend the membership agreement they have the ability to do so. However it is of course possible to give partnership status in the LLP to those individuals or organisations benefitting from the social enterprise.

LLPs are straightforward to set up and register: Companies House provide a simple registration form. There is no requirement to submit an LLP’s full membership agreement to Companies House, and the ongoing requirements to file document with Companies House are less onerous than for a limited company.

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Any enquiries regarding this publication should be sent to:

Department for Business, Innovation and Skills
1 Victoria Street
London SW1H 0ET
Tel: 020 7215 5000

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