

A guide to legal structures

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1 Introduction to legal structures

Choosing the right legal form for your social business is very important and each form has advantages and disadvantages, depending on how you wish to run your business. For this reason, it is usually advisable to work out a clear business strategy before you choose a legal form for your organisation. Section 2 highlights some of the questions that you should consider.

A group of individuals wishing to set up some form of organisation will either become an *unincorporated organisation* or an *incorporated organisation*. Sections 3 and 4 of this guide will explain the difference between these business forms and will highlight the non-charitable legal form options available to you.

Section 5 will go on to consider charitable status and the unincorporated and incorporated legal form options for those organisations who feel charitable status is appropriate.

2 Form follows function

The best legal form for your enterprise will depend on several things. The key dependencies are:

- ▶ Exactly what you are going to do – your trade
- ▶ Who will own and control the enterprise – your governance
- ▶ How you will raise the money – finance
- ▶ What you will do with any surplus or profit – application of surplus
- ▶ What you will do with your assets if you wind up – dissolution and ownership

You should have determined much of the above during your planning phase. You should then be in a position to determine the most appropriate legal form to fit what you want to do. Do not choose your legal form and then design your enterprise to fit –

this is a common error at start-up. Be wary of advice that advises a legal form without a thorough look at exactly what sort of business you want to create.

3 Unincorporated organisations

An Unincorporated Organisation is an organisation that exists as a group of individuals or members who have jointly come together for a common purpose. Any unincorporated organisation should adopt a formal governing document irrespective of its scale and aims. The governing document will ensure anyone involved with the organisation is clear as to what it has been set up to do, who is eligible to become involved and how it organises itself and should cover:

- ▶ The name of the organisation
- ▶ Its objectives and powers
- ▶ Who can be a member
- ▶ How and when members meet
- ▶ How decisions are made
- ▶ What will happen to the assets of the organisation if it is wound up

Other issues may well be included but these are the main elements. The governing document of an unincorporated organisation is usually called its constitution. This organisation can undertake its activities as it sees fit but it will have the following characteristics:

- ▶ Acts as a group of individuals
- ▶ Not a recognised legal form that is separate from these individuals
- ▶ These individuals can collectively employ people, own property and sign contracts in the name of the organisation but in the eyes of the law they and the organisation are the same

- ▶ If the unincorporated association owns or takes a lease of property, holding trustees must be appointed who are normally separate from the managing committee of the organisation

Unincorporated organisations have been set up for a wide range of groups and businesses. For example, an after school club or a tenants and residents association will often remain unincorporated. Some co-operatives, such as fuel co-operatives, may decide to opt for an unincorporated legal form, in which case they will seek to enshrine the co-operatives principles into their constitution. Model constitutions are available for unincorporated organisations from most county voluntary councils (CVC's).

Unincorporated organisations do not benefit from Limited Liability. This means that ultimately individual members of the organisation have personal responsibility for its debts. Unincorporated organisations who take on financial risks such as purchasing or leasing land or buildings or employing staff may wish to consider setting up an incorporated organisation.

4 Incorporated organisations

An organisation may have its own reasons for considering incorporation. All members of an organisation should be clear as to why they should consider legal registration and what the implications of this are.

An incorporated organisation becomes a legal entity that exists separately from the membership and therefore continues to exist in spite of changes in membership.

It can take legal action in its own name, it can own property, enter into contracts, sue and be sued and it can open a bank account in its name.

It has limited liability. This is normally essential when a group has one or more of the following characteristics: a high turnover; employs staff; signs contracts; owns property; gives credit.

It becomes a legal form recognised by potential funders and supporters. In some instances grant funders, loan funders and banks may insist on incorporation.

By adopting a formal governing document clarity of business structure is obtained and by embedding co-operative principles the business can be identified in law as benefiting its members.

If a group remains unincorporated but has a drawn up constitution and a membership register, then all members can be liable for any debts incurred by the business. Once incorporated, the Directors of the company become the legal managers and, in the eyes of the law, have special duties and responsibilities.

If the organisation has decided to incorporate, it needs to consider whether it should incorporate as:

- ▶ A Limited Company;
- ▶ A Registered Society; or
- ▶ A Charitable Incorporated Organisation (CIO) (see Section 5)

Limited Companies

The limited company is the most popular form of incorporated structure that organisations can adopt. This is true of community based organisations, non-profit distributing organisations and the private sector. They are therefore widely recognised and understood by banks, public bodies and other businesses.

The concept of the limited company is a simple one. By registering as a limited company the organisation becomes a recognised legal entity that is separate from the members who have come together to form it. It can carry out all of the activities of an organisation such as employing people, receiving grants or owning assets - as an entity in its own right. It will always be a group of individuals (or organisations) acting collectively within an agreed

set of rules, formally known as Articles of Association.

Below, we look at four types of private limited company. Please note that there is also a fifth type of company - a Public Limited Company (PLC) - but it is very unlikely that a Social Business will adopt this form and is therefore not featured in this guide.

A Company Limited by Shares

A company limited by shares is often seen as the most appropriate structure for a profit distributing company that aims to provide a service or make products at a profit with a view to returning part or all of those profits to shareholders in the business. A company limited by shares will often raise start up capital by issuing shares in the business to its shareholders, however it has strict controls on its ability to raise money from the public. Members usually have an expectation of a return on their capital and their liability to the creditors of the company is limited to the capital originally invested, the nominal value of the shares and any premium paid in return for the issue of the shares by the company. There are certain rights, which may vary, attached to the shares, such as a right to company profit through dividends and pre-emption rights specifying who can buy shares from the owners.

A Company Limited by Guarantee

A company limited by guarantee does not have shares (share capital) and therefore cannot raise start-up capital in the same way. Those involved become members and pledge to pay a fixed sum, usually £1, towards the outstanding debts of the company if it is dissolved or wound up. Members' liability is limited to this fixed sum. It is often seen as the most appropriate company structure for a non-profit distributing company set up for the benefit of a defined community. Its objectives often have a social focus rather than purely financial. However, like any company it should always act properly and aim to make a profit to fulfil its social aims. It is likely to have specific rules setting out how any

surplus should be used which might include, for example, reinvestment into the business or to support activity within the community in which it operates. It often benefits from access to grants not always available to companies limited by shares.

A company limited by guarantee could potentially apply for charitable status. See section 5 for further details.

Community Interest Company Limited by Guarantee or Limited by Shares

The Community Interest Company or CIC is a type of company, designed specifically for businesses who want to use their profits and assets for the public good. CICs are easy to set up, with all the flexibility and certainty of the company form, but with some special features to ensure they are working for the benefit of the community. CICs report to an independent regulator on how they are delivering for the community and how they are involving their stakeholders in their activities.

A new CIC will need to convince the regulator that it has been set up to benefit a community and must pass a community interest test. CICs also have to produce annual community interest reports. A CIC can be limited by either guarantee or by shares; CICs that are limited by shares usually have the provision to pay a dividend to shareholders subject to conditions imposed by the Regulator. Because of this, some public funding bodies may not fund a CIC limited by shares.

*A CIC will **not** be able to apply for charitable status.*

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

www.bis.gov.uk/cicregulator

Share Company or Guarantee Company?

A share company is seen as a profit making enterprise. This is because it effectively borrows money from its members, referred to as

“shareholders”, to invest in the business with a view to generating profits for its members. A shareholder will not normally purchase shares if he/she cannot expect a greater financial return on their investment than they would get in the building society or bank. The share company is owned by the shareholders who will appoint the board of directors as shown in the Company’s articles of association. Income for the business can be generated from the issuing of shares.

The guarantee company is often seen as a non-profit distributing company. It cannot issue shares because it cannot provide a return to potential shareholders. Guarantee companies will normally provide a service for the benefit of a defined community (geographic or community of interest) and aim to make a profit to invest surpluses back into the business, or make social/charitable donations. They cannot pay dividends to directors, employees or members and company assets are usually held in ‘Common’ in which case means they must be transferred to similar organisations if the company is wound up. There are no shares and therefore no shareholders. As there is no means of attracting working capital from shares, guarantee companies often seek funding from grants or access to loan finance to pay for capital and revenue costs. Guarantee companies will stipulate these characteristics in their Articles of Association.

Registered Societies

Registered Societies formally referred to as Industrial and Provident Societies, operate in the same way as companies. Most Housing Associations are Registered Societies and the retail co-operative movement is based on the legal form of a Registered Society. Whilst they are perhaps not as widely recognised as companies they have a number of advantages over the company structure.

There are two types of Registered Societies:

Co-operative Society:

A co-operative society is an appropriate structure for a democratic profit distributing organisation that aims to provide a service or make a product at a profit with a view to returning part or all of those profits to the members of the co-operative.

Its greatest advantage over a company limited by shares is that it does not have the strict controls over its ability to raise money from the public or a specified group of people to help set it up and run it. Its members can be paid a limited return on capital.

The current maximum (withdrawable) shareholding in a Registered Society is £100,000 of share capital. However, other Registered Societies are allowed to invest without limit in the shares of another Registered Society.

Community Benefit Society:

A community benefit society can also issue shares to its members in the same manner as a co-operative society. Many of them may only issue one share per individual which is simply for membership purposes. A community benefit society must demonstrate why it should not be formed as a company as part of the registration process. One reason is that it is very simple for a society to issue shares which usually retain the value of £1 and do not go up in value (par shares). Another reason is that democratic principles are enshrined in this legal form.

A community benefit society has the advantage over a company limited by guarantee in that it is not only recognised as a not-for-profit distributing organisation which can receive grants and has a social rather than a financial focus, but it can also issue multiple withdrawable shares to its community members for social investment purposes as another way of raising capital. Like any company it should always act properly and aim to become a profitable business which will allow for re-investment in the business, payment of limited interest on share capital and the withdrawal of shares by members

subject to specific conditions.

Societies are registered with the Financial Conduct Authority (FCA) in London and are subject to the Co-operative and Community Benefit Societies Act 2014.

A Community Benefit Society could potentially apply to the Inland Revenue for Exempt Charity Status. See section 5 for further information.

<https://www.fca.org.uk/firms/registered-societies-introduction>

5 Charities and trading arms

Charities

To be a charity in England and Wales, an organisation must have an exclusively charitable purpose **and** benefit the public.

Be aware that not everything that benefits the community or that is a good cause is charitable. The Charities Act 2011 defines a charitable purpose, explicitly, as one that falls within 13 descriptions of purposes:

- ▶ The prevention or relief of poverty
- ▶ The advancement of education
- ▶ The advancement of religion
- ▶ The advancement of health or the saving of lives
- ▶ The advancement of citizenship or community development
- ▶ The advancement of the arts, culture, heritage or science
- ▶ The advancement of amateur sport
- ▶ The advancement of human rights, conflict resolution or reconciliation or the promotion of religious or racial harmony or equality and diversity

- ▶ The advancement of environmental protection or improvement
- ▶ The relief of those in need, by reason of youth, age, ill-health, disability, financial hardship or other disadvantage
- ▶ The advancement of animal welfare
- ▶ The promotion of the efficiency of the armed forces of the Crown, or of the efficiency of the police, fire and rescue services or ambulance services
- ▶ Any other charitable purpose

Above all, the purpose of the charity must be for public benefit. It must be of actual benefit and it must benefit the public as a whole or a sufficient section of the public.

There are several advantages to charitable status including; non-domestic rate relief, corporation tax relief, gift aid on donations and the possibility to attract grant funding that may not be available to non-charitable organisations.

A charity can be established in one of four ways:

- ▶ *A charitable trust* - usually set up to manage property and other assets, it is a non-trading and **unincorporated** charity. The governing document is referred to as a Trust Deed.
- ▶ *An **unincorporated** charitable association* - a structure chosen by a group wishing to set up a charity but do not feel that the charity's scale or nature of operations warrant incorporation e.g. it may not employ staff or have significant contractual obligations. The governing document is referred to as a constitution.
- ▶ *A charitable company limited by guarantee* – **incorporated** as a limited liability company and subsequently obtains charitable status. The governing document is referred to as the Articles of Association.

- A charitable **incorporated** organisation – a relatively new legal form introduced in 2013 that gives the Trustees limited liability and charitable status without the need to form a company. The Governing document is referred to as a Constitution.

Of these structures, only the charitable company and the charitable incorporated organisation provide limited liability for the trustees. All the forms above are regulated by the Charity Commission and corresponding governing documents can be found on their website: <https://www.gov.uk/government/publications/setting-up-a-charity-model-governing-documents>

Charitable Company

A charitable company will enjoy the advantages of the charity but also the advantage of the company limited by guarantee - the members will have limited liability normally not exceeding £1. The company will have exclusively charitable objects which will be highlighted in its Articles of Association, will have satisfied the Charity Commission that it has been set up to benefit the public and will need to have a turnover of £5,000 or more. The Charity Commission recommend that a minimum of three director/trustees sit on the board.

The Articles of Association of the charitable company must stipulate common ownership (i.e. assets do not belong to the members), non distribution of profits to members and employees are not normally allowed to sit on the board.

The Charitable Company is regulated by both Companies House and the Charity Commission and has to file annual accounts and keep organisational information updated with both Regulators. Although this option may entail greater administration, the company structure is a well recognised legal form, supported by an established legal framework and has some features that the Charitable Incorporated Organisation does not such as a Public Register of Charges which allows funders and lenders to register a public charge over the

organisation's assets. The current view is that the charitable company is a more suitable incorporated structure for medium to large-scale charities.

Charitable Incorporated Organisation (CIO)

A CIO has been designed to give trustees the benefit of limited liability and a single Regulator, the Charity Commission. It is a relatively new legal form that is generally considered to be more appropriate for small to medium scale charities that are unlikely to need to charge their assets to creditors. It may take longer to set up a CIO but the organisation will automatically be charitable as soon as it has been set up. There is no minimum turnover requirement before you can apply to become a CIO.

There are two models to choose from, the "Foundation Model" and the "Association Model".

The foundation model is for charities whose only voting members will be the charity trustees. The association model is for charities that will have a wider membership, including voting members other than the charity trustees.

Charitable Community Benefit Societies

Community Benefit Societies, who have exclusively charitable objects cannot become registered as charities with the Charity Commission but may apply to HMRC for Exempt Charity Status for tax purposes. If successful, they will be granted the same tax advantages as those charities registered with the Charity Commission. A Principal Regulator has not yet been appointed for Societies with Exempt Charity Status. However, the Charity Commission issued a statement in 2012 acknowledging that charitable community benefit societies may issue community shares and pay members interest on share capital, subject to a number of conditions set out by the Commission.

Charities and Trading

Trading by charitable organisations is allowed within certain specified limitations.

There are two types of trading which are specifically sanctioned by legislation.

- ▶ Trade undertaken in the course of carrying out a primary purpose
- ▶ Trade carried out by the beneficiaries of the charity itself

In both situations all income generated is ploughed back into the business to carry out the main objectives of the charity.

Further detailed information can be found on: <https://www.gov.uk/government/publications/trustees-trading-and-tax-how-charities-may-lawfully-trade-cc35/trustees-trading-and-tax-how-charities-may-lawfully-trade>

Trading Arms

Charities who want the freedom to trade and reduce the risk to the parent charity will often consider setting up a trading arm/trading subsidiary. Basically this is a company that is owned and controlled by one or more charities which is usually set up to take on risks on behalf of and generate income for the parent charities. Trading subsidiaries must be used for non-primary purpose trades involving significant risk.

A trading subsidiary can be set up using a company limited by shares where the parent charities are the shareholders or a company limited by guarantee where the parent charities are the members. It is also possible for a charity to be the sole shareholder or member within a trading subsidiary.

Trading subsidiaries are usually funded by share capital or loans from the parent however, for charitable subsidiaries the parent charity's trustees must be able to justify financial support for a trading subsidiary as an appropriate investment of the charity's resources. The Charity Commission suggests that it is good practice to also seek investment funding from other sources. A parent charity must not make donations to the trading

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

Proper administrative arrangements must be made between the trading subsidiary and the charity ensuring they are entirely separate. Good governance suggests that the majority of directors of the trading subsidiary should not also be trustees of the charity

The trading subsidiary like any company is liable for corporation tax however; this liability can be reduced by gifting profits to the parent charity. This is usually done through Gift Aid. Accountancy advice should always be taken.

6 Co-operative principles

A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through jointly owned and democratically controlled enterprise.

Voluntary and Open Membership

Co-operatives are voluntary organisations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination. Categories of membership can be defined and equal representation from different categories can be guaranteed through the constitution of the organisation.

Democratic Control

Co-operatives are democratic organisations controlled by their members who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership and it is through

the legally required annual general meeting where the members elect them. Most co-operatives have equal voting rights (one member, one vote) and most decisions are made by majority vote unless a 75% majority is specified in law.

Member Economic Participation

Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative. Members usually receive a limited compensation of any of the capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes; developing their co-operative by providing for reserves, benefiting members in proportion to their transactions with the co-operative or through a suitable trust scheme, and supporting other activities approved by the membership that may be social and /or charitable.

Autonomy and Independence

Co-operatives are autonomous, self help organisations controlled by their members. If they enter into agreements with other organisations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy.

Education, Training and Information

Co-operatives provide education and training for their members, elected representatives, managers and employees so they can contribute effectively to the development of their co-operative. They inform the general public about the nature and benefits of co-operatives.

Co-operating With Other Co-operatives

Co-operatives serve their members most effectively and strengthen the co-operative movement by

working together through local, regional, national and international structures.

Concern for Community

Co-operatives work for the sustainable development of their communities through environmentally and socially responsible policies approved by their members.

7 Further information

Don't forget, if you need specific advice or guidance on your legal structure, please do not hesitate to contact us on sbwenquiries@wales.coop

Or visit the online toolkit <http://businesswales.gov.wales/socialbusinesswales/>

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