

Social Enterprise - From a Tax Perspective

What is a social enterprise?

A social enterprise is a business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or community, rather than being driven by the need to maximize profit for shareholders and owners.

Social enterprises account for 5% of all businesses with employees; there are 62,000 social enterprises in the UK. They contribute £8.4bn per annum to the UK economy, which equates to almost 1% of annual GDP.

Business structures

Choice of legal form can have a significant bearing upon many aspects of an enterprise's activity. Taxation status, governance and management and external regulation and scrutiny vary significantly between the different legal forms that may be adopted by businesses. The most common legal forms for a social enterprise are Partnership, Limited Liability Partnership, Company Limited by Guarantee or Shares or Industrial and Provident Society. In addition to choice of legal form, many social enterprises also register a specific community oriented status which provides assurance to those with whom they deal but may also add further regulatory requirements.

Although social enterprise is at heart a very different proposition from charity, many charities have developed social enterprise as part of their work and a number of social enterprises

have adopted charitable status to take advantage of tax concessions (see below). Limited companies which operate social enterprises can additionally register as Community Interest Companies - a form especially designed for social enterprise which requires companies to restrict distributions of profit and capital and take on an "asset lock" guaranteeing that the assets will be used for community benefit in perpetuity.

Incorporation (taking on company, IPS, LLP or similar status)

The following points apply to limited companies but also apply to each of the other forms of incorporated entity. The pros and cons of incorporation - except for those that relate to taxation specifically - are generally the same for entities which are charities as for those which are not. Changes introduced in the Companies Act 2006 simplifies the administration of private companies - for example the requirement to hold an AGM, the ability for meetings to be held remotely, and provisions to allow electronic communication with members.

Benefits of incorporation include:

- Separate legal entity, allowing the company to enter into contracts, employ staff and lease property
- Liabilities and obligations rest with the company, not the shareholders/ members
- Clear ownership structure and governance

- Recognition by financial institutions and therefore easier to raise finance

Benefits of being unincorporated include:

- Greater freedom of operation, not regulated by Companies House (if a company or LLP), or the Financial Services Authority (if an IPS)
- Partners pay their tax in arrears in January and July rather than up front via PAYE
- Reduced rate of NI contributions for owners who are treated as self-employed
- Partnership losses may be set against tax paid in previous years

Limited Liability Partnership (LLP)

Introduced in the UK in 2001, under the Limited Liability Partnerships Act 2000, the LLP is a legal form which aims to offer the best of both of the two main forms of organisation for small businesses which have a number of owner/ workers. It has the flexibility of a partnership constitution combined with the separate legal personality and limited liability of a company.

Key features of an LLP:

- A corporate body, meaning that it is a separate legal identity.
- Financial exposure of members limited to their investment in LLP
- Profits are liable to income tax (for individual members) or corporation tax (for corporate members).

- Partners benefit from the reduced rate of NI and later payment of tax mentioned within the incorporation section above.
- Members of the LLP are charged to capital gains and inheritance tax in the same way as partners in a traditional partnership.

Industrial and Provident Societies (IPS)

The Industrial and Provident Society considerably predates the relatively modern description of "social enterprise", however many would argue that in this form is to be found the most simple and well tested structure which is ideal for the operation of a social enterprise. There are two types of society established under IPS legislation:

1. Community Benefit Society
 - Set up to trade for the benefit of the community
 - Must demonstrate that the benefits will not be returned to its own members
2. Co-operative Society
 - Set up to conduct business through member participation for mutual benefit

No individual is permitted to hold more than £20,000 of capital in either type of society. Voting rights are allocated one per member, irrespective of shareholding. Currently an IPS with charitable objects does not have to register with the Charity Commission (i.e. it is an exempt charity). In a co-operative society, employees can be involved in governance.

Charity

Many, if not most, social enterprises are also charities. Although there is at times an ambivalence toward association with philanthropic charity among social

entrepreneurs, it should be remembered that some of the oldest trading businesses providing public benefit are charities - charitable hospitals, schools and many other fee charging care providing institutions were the only source of many social goods before the advent of the welfare state - although ironically that status may be under challenge for many of these following the implementation of the Charities Act 2006. The Charities Act 2006 brings exempted charities ultimately within the regulatory supervision of the Charities Commission. However, the exempted charities' existing regulator will continue to be the principal regulator but the Charities Commission will be able to investigate if the principal regulator makes such a request.

Benefits of charitable status include:

- Profits of any trade are free of tax if the profits are used for the purposes of the charity and the trade follows the primary purpose or is undertaken by beneficiaries
- Chargeable gains made by a charity are tax free
- No tax on bank interest or rental income
- Relief from Stamp Duty Land Tax
- Reduced or waved business rates

Disadvantages include:

- Meeting the costs of the Charity Commission's regulations
- Governance of the charity by trustees who are unpaid, very limited employee involvement allowed
- Entrepreneur/ founder can not usually be both a trustee and earn income from the enterprise

Community Interest Company (CIC) (cannot be combined with charitable status)

The CIC is an additional "wrapper" added to a limited liability company specifically created for social enterprise. The first CICs were registered in July 2005 and there are now almost 3,000. CIC status establishes an "asset lock" which binds assets to the community purpose and caps the return to owners and directors which can be obtained through dividends, interest and salaries.

A recent survey of CIC's revealed that:

- 37% felt access to finance was the biggest issue facing company.
- Average turnover is £144,000.
- 90% are stand alone companies (7% trading subsidiaries of charities, 3% other).

CICs are used by some entrepreneurs as an alternative to a charity because:

- They want freedom of non-charitable form, but with clear assurance of not-for-profit status.
- In a charity, a founder of a social enterprise who wishes to be paid cannot be on the board and must give up strategic control to volunteer board, which is often unacceptable.
- CICs limited by shares can sell those shares and pay dividends (subject to a limit, the cap).
- CICs will be specifically identified with social enterprise, some entrepreneurs may feel that more suitable than charitable status.

The company will be liable to Corporation Tax on its profits and gains with no relief for general non trading expenditure, including expenditure for community purposes.

The Annual Report must explain how activities have benefited the community and how stakeholders are being involved.

Statutory lock on assets and profits

Caps on distribution of dividends interest payments and directors' salaries.

ATTRACTING INVESTORS

General Schemes for Investors

There are a number of incentive arrangements designed to attract investors to contribute capital to small and medium sized enterprises (SME's). Many of these are applicable to companies operating social enterprises in an identical way to any other company. When considering the benefits of these incentives to potential investors, it should be borne in mind that much of the benefit is derived from exemption from capital gains tax and that the CIC form by design prevents investors from achieving capital gains.

Enterprise Management Incentives (EMI)

- Options may be granted over shares to employees with a market value up to £120,000 in the current Finance Bill.
- Total EMI options to all employees cannot exceed £3m.
- Shares must be in an independent trading company, with gross assets of no more than £30m.
- No income tax or National Insurance when options are granted or exercised.
- Employees granted the options must spend at least 75% of their working time working as an employee for the company.
- A 250 employee limit is being

introduced

- Capital gains tax advantage, (taxed at 18% from 6 April 2008, but may qualify for a 10% tax rate under Entrepreneurial Relief).

For EIS and VCT schemes (see below for the definitions), the following conditions apply to the company in which an investment is made:

- None of the shares, stocks or debentures may be listed at the time of investment.
- Gross assets must not exceed £7m immediately before and £8m immediately after the issue of the shares.
- Number of employees at the time the shares are issued must be less than 50 (includes directors, part time employees will be pro-rated, students and apprentices will not be counted).
- Must either exist for the purpose of carrying on a trade or it must be the parent company a group whose business is essentially that of carrying on a trade.

Individuals can invest in both EIS and VCT schemes in any given tax year; the limits for each scheme are not reduced by the dual investment.

Enterprise Investment Scheme (EIS)

- Individuals who invest in a qualifying company can claim EIS relief (20% of investment) against income tax* Maximum investment in any tax year is £500,000
- Minimum investment in any one company is £500 in any one year
- At the time of investment, the shares in the investee company cannot be quoted
- Can also take advantage of capital gains tax deferral and relief

- Cannot be an employee of the company or otherwise connected (<30%)

Venture Capital Trust Scheme (VCT)

- Individuals who invest in VCTs can claim income tax relief at the rate of 30% of the amount invested
- Maximum investment in any tax year is £200,000
- Additionally, dividends received from the VCT will be exempt from income tax
- Exempt from CGT on disposal of the VCT shares
- Lower risk than EIS as the VCT invests in a range of companies
- Income tax relief will be clawed back if the shares are disposed within the first five years

Corporate Venturing Scheme (CVS)

- Relief (20%) for companies who invest in a qualifying company
- Investing company can not own more than 30% of the issuing company
- At least 20% of the shares of the issuing company must be held by individuals (not including directors and employees of the investing company)
- Subscription for shares must be wholly in cash, fully paid when the shares are issued
- There is no minimum amount and no absolute limit on the investment. However, in reality the upper limit will be determined by the gross asset limit of £8m following issue and the limit on the investing company of 30% ownership

Venture Capital loss relief (VC)

- Losses arising on disposal of shares

from an unquoted company will be allowable as a deduction against income tax or corporation tax

- No maximum relief, in practice will be limited by available profits
- Can be carried back against profits of prior year

Community Investment Tax Relief (CITR)

Intended to stimulate investment in enterprises serving disadvantaged communities, CITR is the tax relief most directly associated with social enterprise - although it is not available, as many of the reliefs described above would be, for direct investment into an enterprise. Investors instead gain relief through investing in intermediary organisations, known as Community Development Finance Institutions (CDFIs), who then invest in a qualifying enterprise (see below).

Relief is available to individuals or companies

Investment is by way of a loan, securities or share capital

There is no limit to the amount of investment on which a single investor may claim relief under the CITR scheme (there are limits on the amount of investment that can be raised by any single CDFI; £10m for a retail CDFI and £20m for a wholesale CDFI)

Tax relief is 5% of the value of the investment in the CDFI, per annum (starting in the year in which the investment was made), up to a cumulative total relief of 25% if the funds remain invested for the first 5 years.

Community Development Finance Institution (CDFI) qualification to manage CITR

Must invest 25% of investment fund in qualifying enterprise in year 1, 50% in year 2 and 75% in year 3.

A qualifying enterprise is:

- A small/medium enterprise.
- Unable to obtain finance from other sources.
- Located within a disadvantaged area or serves disadvantaged individuals.

Given that the average turnover for a CIC is £144,000 and 37% felt finding finance was an issue, CICs would seem appropriate investments for CITR.

A recent report shows:

- CDFIs are providing £331m in loans and investments.
- The average funding to social enterprises is £43,500.

Tax relief for the business

In very general terms, profits arising from a trade carried out in the course of business are taxable. Expenses relating to the trade are deducted from its income

to arrive at a profit figure with expenses incurred that do not relate to the trade "disallowed" i.e. not permitted to be deducted from profit. Certain 'charges' including donations to charity may be deducted from profit before applying tax. Expenditure on community purposes not related to the trade or on assets which do not attract tax relief may be 'disallowed' in tax computations.

Taxation of profits/surplus

The four scenarios illustrated in *Chart 1* show the different outcomes that may arise for direct tax purposes from operating a social enterprise in each of the following ways:

1. Any surplus realised by a charity, if relating to qualifying activities, will be exempt from tax.
2. The costs of meeting the social objectives may be manifested any additional costs of the trade, reducing taxable profit.
3. Profits in a non-charitable organisation donated to a charity under the Gift Aid regime to support social objectives will be deducted from taxable profits.
4. Trading income from a non-charitable business will normally be

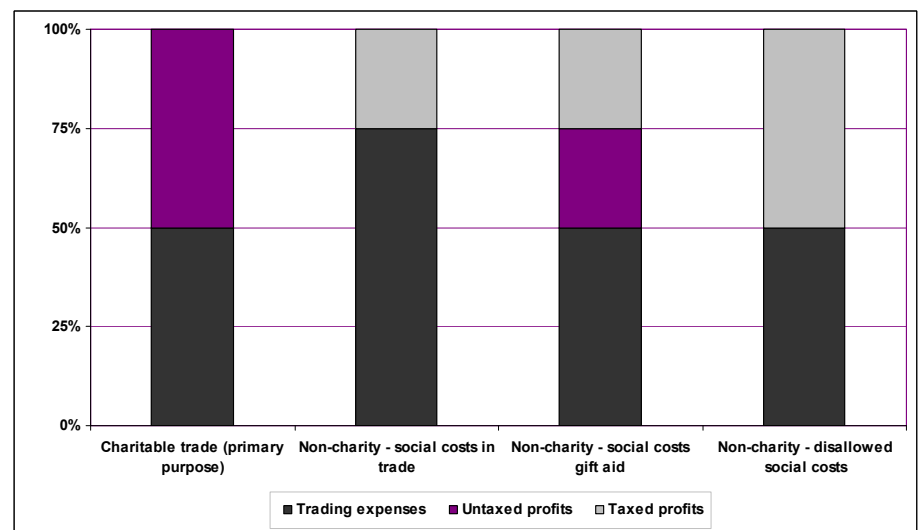


Chart 1

chargeable to income or corporation tax - if the part of profit spent on community or environmental purposes is unrelated to the trade, it may be disallowed.

In each case it is assumed that "normal" costs of the trade are equal to 75% of income and social cost/contribution 15% leaving 10% net surplus.

Mutuality

Where profits are derived from trade between members of an organisation, the profits are not chargeable to tax. Other income, such as bank interest, will be taxed.

Grants

Grants to charities, for the purposes of the charity are not chargeable to tax.

Grants to non-charitable entities:

- For revenue expenditure, where the business is carrying on a trade, will be treated as a trading receipt.
- For capital expenditure, they will not be treated as trading receipts. However, the grant reduces the qualifying capital expenditure for capital allowance purposes.

Businesses existing purely on grants with the aim of regeneration of business and employment would not be classed as trading. In this scenario the grants would not be taxable but we recommend this treatment is agreed with HM Revenue and Customs.

Non-trade income and expenditure

Income received, not relating to the trade of the business, could be

non taxable (if the income does not fall within the charge to tax under alternative tax schedules).

Similarly, non trade expenditure incurred by the business is unlikely to be allowed as a tax deduction.

Investment in capital assets, such as premises for the social enterprise, may not qualify for tax relief. If this is the case, then any decrease (or increase) in the value of the asset may be tax deductible (or chargeable) when the asset is disposed of.

Value Added Tax

Charities and social enterprises with business activities may be liable to VAT on those supplies.

Some activities can be exempt from VAT, which normally requires that the provider is non-profit-making, not necessarily a charity.

This can apply to:

- Education and vocational training
- Admission fees to performances or galleries/museums
- Sports services to individuals

In addition, welfare supplies by charities or state-regulated welfare bodies can also be exempt. This covers a wide range of welfare services including care of the elderly, disabled, children, and spiritual welfare.

Charities and certain not-for-profit bodies can exempt charges relating to qualifying fundraising events.

Exemption also applies to certain financial services and the supply of

insurance, as well as to many supplies of land. The finance exemption is narrowly drawn but includes the granting of credit, management of bank accounts, and some intermediary services.

The sale of goods is always taxable, but sale of donated goods by charities, or other bodies that will pay the profits to charity, qualify for zero-rating.

Other zero-rated items are books, some foodstuffs, and children's clothing.

Reliefs from VAT on costs are mostly restricted to charities, and these include relief from VAT on advertising, goods related to the collection of donations, works to facilitate disabled access to buildings, and in some cases, the construction of new buildings or alterations of existing listed buildings.

Zero-rating also applies to the construction of some new residential buildings, and alterations to listed residential buildings. The reduced rate of 5% can apply to conversion works and refurbishments of residential property.

Where VAT is incurred on expenditure, this is recoverable only to the extent that the cost relates to taxable supplies. This means that many charities and social enterprises are not able to recover all their VAT. In this case, developing and agreeing an appropriate and practical recovery method is very important

Buzzacott contacts for social enterprises

Edward Finch, Partner
finche@buzzacott.co.uk

Alastair McQuater, Tax Partner
mcquatera@buzzacott.co.uk

General enquiries
socialenterprise@buzzacott.co.uk