

**SOCIAL
ENTERPRISE
TOOLKIT**

MMO

**A Practical Guide for
Charities and Not-for-
Profits**

This toolkit has been developed to assist not-for-profit organisations to set up or transform into social enterprises. The toolkit reflects our experience and key legislation in the area, and has been developed into tables and diagrams for ease of use.

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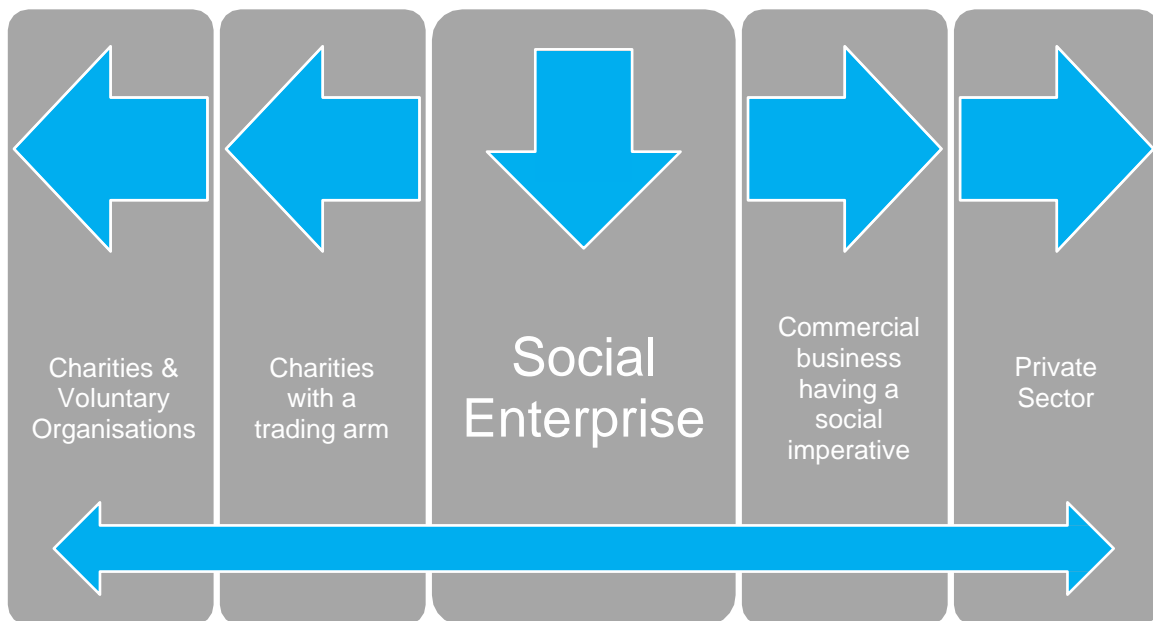
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1 Introduction

The social enterprise structure is a fast-growing phenomenon in Australia within the not-for-profit sector, and with good reason. Reductions in funding and donations have prompted many not-for-profit organisations to seek alternative ways of addressing inequality beyond the traditional charitable and not-for-profit efforts.

This toolkit will provide examples of ways an organisation can structure itself as a social enterprise to effectively respond to these shifts in the not-for-profit sector.

2 What is a Social Enterprise?



Australia has no set legal definition of a social enterprise, but generally it is defined as an organisation that:

- a. is driven by a public community cause, whether that be social, environmental cultural or economic;
- b. uses trade to fulfil its mission; and
- c. obtains most of its income from trade, rather than donations; and
- d. applies the majority of its profits towards its social mission.

3 Differences between Charities & Not-for-Profits and Social Enterprises

Features	Charities & Not-for-Profits	Social Enterprises
Origin	Charities begin with a non-profit charitable purpose. Not all not-for-profits are necessarily charities.	Social enterprises begin as a for-profit business that operates to achieve a social purpose.
Profit	Charities and not-for-profits must have a 'non profit' clause in their constitution.	Social enterprises generate a profit which is used to further the social cause, and pay dividends to shareholders.
Financing	Reliant on donors and grants. While NFPs can run commercial activities, they can only do so on the basis that any profits are to be used for the organisation's purposes enshrined in the constitution. Charities and NFPs tend to rely on debt.	A social enterprise uses commercial methods (sales and trade) to further a social cause, rather than grants and donations. Social enterprises tend to rely on equity.
Purpose	A charity's purpose is prescribed by legislation (<i>Charities Act 2013 (Cth)</i>), and must be endorsed by the Australian Charities and Not-for-Profits Commission.	Social Enterprise purposes are not restricted to those prescribed in legislation.
Tax Benefits	Tax concession and exemptions are provided to charities and NFPs according to legislative requirements (e.g. capital gains tax, fringe benefits tax, goods and services tax, income tax etc.). These tax benefits are based on the charity's or NFP's purpose and activities.	Tax concessions and exemptions generally do not apply to a social enterprise operating independently.

4 Choosing a Legal Structure

In Australia, a social enterprise may adopt almost any legal structure and choosing the right legal structure for a social enterprise can be difficult. The most popular legal structures for social enterprises are:

- Incorporated Associations
- Public Companies Limited by Guarantee
- Proprietary Limited Companies
- Indigenous Corporations

4.1 Incorporated Associations

An incorporated association has its own legal identity separate from its members, providing protection to members in legal transactions. However each State and Territory has its own Associations Incorporation Act so this legal structure is suited to small organisations operating in only one jurisdiction.

If an incorporated association eventually wishes to carry on activities in more than one jurisdiction, it is legally possible to convert into a public company limited by guarantee.

An incorporated association can:

- a. enter into and enforce contracts, including the ability to hold, acquire and deal with property;
- b. sue or be sued; and
- c. continue regardless of changes to membership.

The relevant incorporated associations legislation in each state and territory prohibits an association from providing monetary gain to its members.

Some jurisdictions will also restrict incorporated associations from conducting significant commercial activities.

While there are significant differences between an incorporated and unincorporated association, the key difference for members is that members will not be protected from personal liability if an association is unincorporated.

Pros	Cons
<p>A separate legal personality – able to sue/be sued, enter contracts, deal with property, and continue after membership changes.</p> <p>This also protects members from personal liability.</p>	<p>Not ideal for an organisation wishing to operate in multiple states presently or in the future.</p>
<p>No specific legal provisions on related party transactions.</p>	<p>If the association is wound up, its members have no claim to any of the organisation’s assets. Any remaining assets will be passed onto another charity with similar purposes.</p>
<p>The association’s governing document can be relatively flexible, although it must comply with the relevant state or territory’s legislation.</p>	<p>Restricted from engaging in significant commercial activity in some jurisdictions.</p>
<p>Generally simpler and more affordable to set up than a company structure.</p> <p>As a not-for-profit structure, may be eligible for some tax concessions.</p>	<p>Unable to provide monetary gain to its members.</p> <p>In some states, legislation requires a minimum of five members.</p>

4.2 Public Companies Limited by Guarantee

A public company limited by guarantee is an incorporated structure set up under the *Corporations Act 2001* (Cth) ('Corporations Act'). The members have limited liability and agree in writing to pay a nominal amount to the property of the company. If the company is wound up, the liability of the members is limited to the nominal amount that they have guaranteed. There is also a prohibition on the members sharing in any profits of the company.

Pros	Cons
<p>A separate legal personality – able to sue/be sued, enter contracts, deal with property, and continue after membership changes. This also protects members from personal liability.</p> <p>Not limited to any one state – ideal for organisations operating nationwide/larger not-for-profits.</p> <p>The company’s governing document (constitution) can be relatively flexible.</p>	<p>Members have no right to receive a share in any company profits.</p> <p>ASIC imposes strict requirements on how the company can be run, particularly on how it manages its financials.</p> <p>The administrative/legal burden may not be manageable for smaller organisations.</p> <p>Strict regulation on related party transactions.</p>
<p>Able to engage in commercial activities.</p>	
<p>Potential donors would have more confidence in the viability of the company, given the stricter requirements imposed by ASIC.</p>	
<p>Able to receive tax concessions if company is registered as a charity.</p> <p>Members only have to pay a fixed contribution to protect the company in the event it is wound up (usually a nominal amount).</p>	
<p>As a not-for-profit, may be eligible for some tax concessions.</p>	
<p>Only requires a minimum of one member.</p>	

4.3 Proprietary Limited Companies

A proprietary limited company is, generally, a for-profit company where shares between the owners limit the ownership. In the context of social enterprises, normally a proprietary limited company is a for-profit structure that can operate within a “hybrid structure”, where the Pty Ltd makes a profit and distributes surpluses to a not-for-profit or charity, or uses its surpluses to further its social mission.

While all companies are required to keep written financial records, if a company is a ‘small proprietary company’, it would generally not have to prepare formal financial reports each year and lodge them with ASIC.

Pros	Cons
Not limited to any one state – able to operate nationwide.	Since it is generally a for-profit structure, for- profits are unable to directly receive tax concessions, including DGR status that would be offered to not-for-profit structures.
Able to engage in commercial activities and distribute a pecuniary profit to its shareholders.	If not a ‘small proprietary company’, will have to maintain and lodge written financial records with ASIC.
If a ‘small proprietary company’ – not required to lodge annual financial reports to ASIC.	Strict regulation on related party transactions.
Suitable for hybrid structures.	
Only requires a minimum of one shareholder.	

4.4 Indigenous Corporations

An Indigenous corporation is an incorporated legal structure available for Aboriginal and Torres Strait Islander organisations only. An Indigenous corporation cannot distribute any dividends to members by law; therefore, it can be an ideal structure for a not-for-profit.

Indigenous corporations deal with a specialist regulator, the Office of the Registrar of Indigenous Corporations (ORIC), as opposed to dealing with ASIC.

Pros	Cons
<p>A separate legal personality – able to sue/be sued, enter contracts, deal with property, and continue after membership changes. This also protects members from personal liability.</p>	<p>An organisation must be eligible to be listed as an Indigenous corporation in order to use this structure.</p>
<p>Can take into account Aboriginal or Torres Strait Islander customs and traditions through its governing document.</p>	<p>The public is less familiar with this structure.</p>
<p>Unlike incorporated associations or companies, registration is free.</p>	<p>Generally requires at least five members.</p>
<p>ORIC provides specialist assistance, regulation and structure to Indigenous corporations.</p>	
<p>Able to operate nationwide.</p>	
<p>Smaller Indigenous corporations may be exempt from producing annual financial reports.</p>	
<p>Less strict regulation regarding related party transactions.</p>	

5 Traditional Structure Comparison

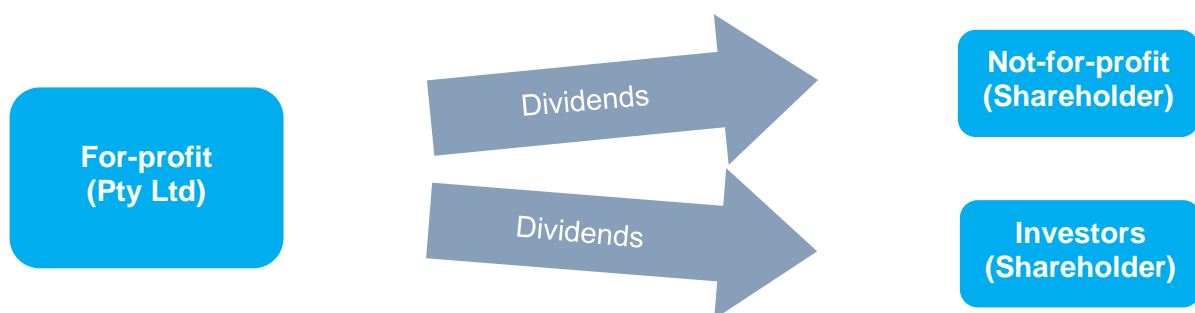
	Separate legal personality?	Can operate interstate?	Able to make profit for members/shareholders?	Tax concessions available?
Incorporated Associations	✓	✗	✗	Possibly
Companies Limited by Guarantee	✓	✓	✗	Possibly
Proprietary Limited Companies	✓	✓	✓	✗
Indigenous Corporations	✓	✓	✗	Possibly

6 Hybrid Structures

A social enterprise may either operate as a for-profit or not-for-profit; however many incorporate elements of both to achieve their mission.

Below are a few examples of ways in which a social enterprise might structure itself by combining for-profit and not-for-profit elements:

Example 1



This structure sets up the not-for-profit as a shareholder of the for-profit company alongside its private investors. The for-profit arm can seek investors to fundraise and operate businesses that provide an income. The for-profit is then able to distribute its surplus profits to shareholders, including the not-for-profit, through dividends.

Example 2

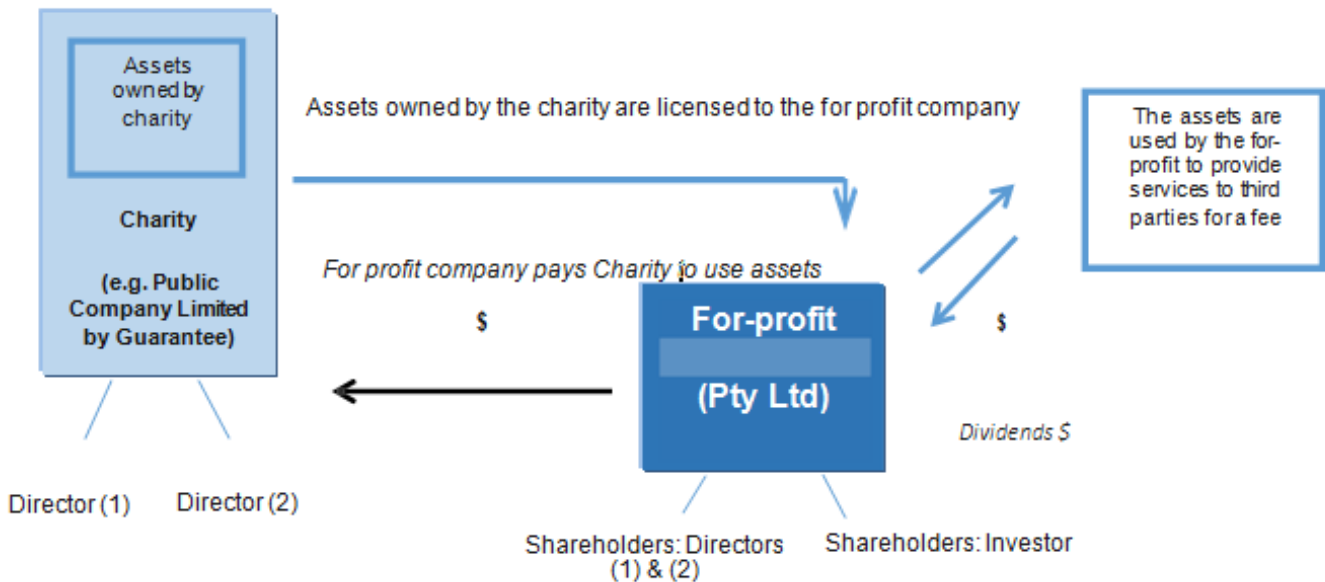


In the above structure example, a not-for-profit could use funds received from its charitable activities or donations to pay an 'arms length fee' to a for-profit, which could in turn seek investors to fundraise and generate income.

The not-for-profit would have a services agreement with the for-profit entity facilitating the above structure.

This structure essentially allows a proprietary limited company to carry out commercial activities in pursuit of the not-for-profit's social mission.

Example 3



In this structure we have two entities:

- a. A charity (for example a Public Company Limited by Guarantee that is a Health Promotion Charity (for instance); and a
- b. For-profit company (a Proprietary Limited company).

This structure example enables a charity to receive income by licensing its assets to a for-profit company for fees. The for-profit company can then use these assets to provide services to third parties for fees, allowing it to generate income for investors through dividends.

This whole structure is a social enterprise and a good example of a hybrid legal structure.

Again, if the company structure is used, the law on related party transactions will need to be considered.

7 Considerations

7.1 Related Party Transactions

Organisations looking to engage in any of the hybrid structure examples should be wary of requirements in the Corporations Act concerning related party transactions, presuming that the public company structure is used. Section 208 of the Corporations Act requires a public company to obtain approval from its members when proposing to give a financial benefit to a 'related party'.

The definitions of 'financial benefit' and 'related party' are widely drafted in the Corporations Act and need to be carefully considered by not-for-profits looking to engage in these hybrid structures involving for-profit companies.

If a company fails to obtain approval, and no exceptions listed in the Corporations Act apply, a director involved may be liable for civil penalties (and criminal penalties in certain circumstances).

Notably, section 210 of the Corporations Act creates an 'arm's length exception', allowing a public company to provide a financial benefit without member approval. In our case, this would allow Example 2 to operate without member approval being required.

7.2 Tax Considerations – Franking Credits

Franking credits can arise for shareholders in a company if that company has paid income tax on its taxable income and distributed its after-tax profits by way of franked dividends.

The following are examples of organisations that may be eligible for a refund of franking credits:

- Registered charities; and
- Income tax exempt deductible gift recipients ('DGRs').

To be eligible for a refund of franking credits, a charity must be a registered charity with the Australian Charities and Not-for-profits Commission and endorsed by the Australian Taxation Office as exempt from income tax, or endorsed as a DGR and exempt from income tax.

Charities within a hybrid legal structure should take advantage of franking credits.

Other organisations eligible for franking credits include:

- a. entities that are prescribed as exempt institutions and eligible for a refund under the regulations; and
- b. income tax exempt institutions that are eligible for a refund under a Commonwealth law other than the income tax law.

To be eligible for a refund of franking credits, an income tax exempt DGR listed by name must meet all the following requirements:

- a. have an ABN;
- b. satisfy the residency requirement; and
- c. be a DGR listed by name in the *Income Tax Assessment Act 1997* (Cth).

8 Your Legal Structure Checklist

When considering which legal structure might suit your not-for-profit needs, you may want to consider the following questions:

- Do our members need protection from potential personal liability?
- Does our organisation operate interstate, or expect to in the future?
- Would our organisation need to engage in commercial activities?
- Could our organisation handle the administrative and legal burdens associated with regular financial reporting?
- Is it important that our members receive pecuniary gain?
- Is our organisation eligible as an Indigenous corporation?
- Is it essential to our organisation to receive tax concessions?
- Could our organisation operate within one of the hybrid examples, notably:
 - *Would our not-for-profit benefit from being a shareholder of a for-profit company?*
 - *Are we in a position to establish not-for-profit and for-profit organisations that assist each other’s goals? If not, can and/or should we facilitate it?*
 - *Are we in a position to facilitate ‘arms length’ transactions between a not-for-profit and a for-profit?*
 - *Does our not-for-profit have assets that could be licensed to a for-profit (and in turn, leased to third parties to generate income)?*
 - *Could our not-for-profit and any for-profit have a ‘related party’ issue? And if so, should we seek member approval for any financial benefit?*

This toolkit is intended to provide only a limited analysis of the subject matter covered. It does not purport to be comprehensive, or to provide legal advice. Readers should satisfy themselves as to the correctness, relevance and applicability of any of its content, and should not act on any of it in respect of any specific problem or generally without first obtaining their own independent professional legal advice.

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