LEGAL STRUCTURES FOR SOCIAL ENTERPRISE
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Executive Summary

Social enterprises – organisations with dual social and business goals – can contribute to public good by bringing together entrepreneurial ingenuity and genuine concern to make our society a better place.

Increasing attention is being given to social enterprises in the media, at conferences and within communities. In these contexts, questions often arise about what legal structures are optimal to enable social enterprise development.

“Legal structures” are the various forms available in statute for organisations wishing to incorporate as legal entities. New Zealand has an array of legal structures including charitable trust boards, incorporated societies, limited liability companies, limited partnerships, industrial and provident societies, co-operative companies and Māori land trusts. None of these are tailor-made for social enterprises.

A Department of Internal Affairs survey indicated that most social enterprises are set up as charitable trust boards or incorporated societies. The sale of goods and services generates income for their social, cultural or environmental mission. Sometimes, as desire for trading income increases, the organisation establishes or purchases a business that operates at arm’s length and returns the profits to the not-for-profit parent.

Increasingly, the limited liability company structure is being adopted by new social enterprises. In the company’s constitution it can be made clear that profit maximisation is to be balanced by “social good” objectives.

Various factors must be weighed up when choosing a legal structure. For instance, the company form is a flexible option for organisations that may change their focus as they grow. Companies can also attract investment by paying dividends, and this facilitates expansion.

Charitable trust boards or incorporated societies, which have inherent prohibitions against private profit-making, more readily attract philanthropic donations than companies. They are also more likely than companies to qualify for charitable status, and thus benefit from tax exemptions.

Various other countries have set up legal structures specifically for social enterprises. Community Interest Companies in the United Kingdom are companies with special features to safeguard their social missions, such as an “asset lock” that limits profit distribution. In the United States, benefit corporations create public benefit but also return profit to shareholders. The clear branding provided by such structures helps policy makers and funders target assistance when seeking to foster social enterprise development.

In New Zealand, a new legal structure was not viewed as an immediate priority by most people interviewed during this report’s development. Social enterprises are managing to operate within current legal structures. Greater concern focuses on such matters as availability of specialised incubation, mentoring, and accelerator programmes, and difficulty accessing start-up and growth capital.

In coming months, further research on New Zealand social enterprises will become available. Government agencies, funding bodies, social enterprise networks and others are starting to discuss strategic options for social enterprise development. The aim of such collaborative work is to help foster social enterprises that can fully contribute to a productive economy and thriving communities.
The intent of this paper

Several overseas jurisdictions have enacted new legal structures to specifically serve and encourage the growth of social enterprises. While New Zealand social enterprises fit themselves into the existing array of legal structures such as charitable trust boards, incorporated societies and limited liability companies, these forms are not tailor-made to serve social enterprises’ needs.

This paper considers how well our current legal structures serve social enterprises, what overseas approaches have sought to achieve, and whether New Zealand would benefit from a new legal form. As little has been written in New Zealand about legal structures for social enterprise, we anticipate that this paper will contribute to discussion within government and social enterprise networks about:

- how well current legal structures serve the aspirations of social enterprises;
- whether a new legal structure, drawing on overseas examples, is desirable; and
- actions that might be needed to address issues related to social enterprises and their legal structures.

This paper provides a preliminary scoping rather than a definitive account. It does not seek to consider the specifics of particular industries (for instance, animal welfare or social services) or particular population groups (for instance, iwi enterprises). The aim is to determine whether more detailed research into social enterprise legal structures is warranted, and to consider this in the context of other desirable activity within and outside of government to support social enterprise development.

Background

What are social enterprises?

Most simply, a social enterprise can be described as an organisation that trades in order to support social, cultural or environmental goals. The Department of Internal Affairs has adopted a definition of social enterprise that has three main elements:

- a social, cultural, or environmental mission that achieves public or community benefit;
- a substantial portion of income derived from trade (50 per cent or more, or a demonstrable intention to reach this level); and
- reinvestment of the majority, or all, of profit/surplus in the fulfilment of the organisation’s mission.

A further defining point is that social enterprises are private entities that are self governing, not part of the State and have the independent authority to wind up their own operations.

For many charitable trust boards and incorporated societies (often referred to as “not-for-profit organisations” as they do not allow pecuniary gain\(^2\) for their members or officers), deriving income from the sale of goods and services is not new. Where such trading becomes the major source of income, the organisation may be described as a social enterprise.

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1 Based on a definition used by Social Traders in Australia.
2 Pecuniary gain = monetary profit.
Other social enterprises take the form of companies with “social good” ideals. To be considered a social enterprise, the social/environmental orientation needs to go beyond a small amount of “corporate social responsibility” activity; it needs to be an integral part of the organisation’s mission. These organisations are sometimes referred to as “social businesses”.

Definitional issues, such as the circumstances where organisations that primarily benefit members may be seen as serving a wider social good, or exactly what activities qualify as “trade”, are subject to debate in social enterprise networks. Such discussion is a healthy part of a growing movement that challenges traditional perceptions of boundaries between the state, the for-profit sector and the not-for-profit sector.

**What do we know about New Zealand social enterprises?**

A Department of Internal Affairs survey\(^3\) in 2012 found that 76 per cent of 421 respondents who were identified as social enterprises had been trading for 10 years or more. Respondents’ industry classifications were mainly education and training (43 per cent), social assistance (22 per cent), recreation and sport (17 per cent) and arts and heritage (15 per cent). In terms of legal entities, 52 per cent (of 218 responses) were charitable trust boards followed by incorporated societies at 37 per cent. Only seven per cent of organisations indicated they were limited liability companies.

The small numbers of limited liability companies may partially reflect that the survey had a stronger reach into registered charities’ networks than business networks. It is also possible, however, that the new breed of young social entrepreneurs who adopt company structures\(^4\) are not yet present in great numbers. Future trends will be interesting to assess.

**Fig 1: Legal status of social enterprise survey respondents**

<table>
<thead>
<tr>
<th>Legal status of organisations</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charitable Trust</td>
<td>52%</td>
</tr>
<tr>
<td>Incorporated Society</td>
<td>37%</td>
</tr>
<tr>
<td>Limited Liability Company</td>
<td>7%</td>
</tr>
<tr>
<td>Informal group</td>
<td>1.4%</td>
</tr>
<tr>
<td>Set-up under an Act of Parliament</td>
<td>0.5%</td>
</tr>
<tr>
<td>Co-operative</td>
<td>0.5%</td>
</tr>
<tr>
<td>Co-operative company</td>
<td>0.5%</td>
</tr>
<tr>
<td>Māori Land Trust</td>
<td>0.5%</td>
</tr>
<tr>
<td>Not sure</td>
<td>0.2%</td>
</tr>
<tr>
<td>Sole proprietor</td>
<td></td>
</tr>
<tr>
<td>Partnership</td>
<td></td>
</tr>
<tr>
<td>Publicly listed company</td>
<td></td>
</tr>
</tbody>
</table>

**Potential benefits of social enterprises**

In the face of global economic challenges, the need for innovative ways to build resilient local economies becomes more imperative. Social enterprises can contribute to the economy and provide employment opportunities, including jobs for otherwise marginalised people. Rather than relying on government funding, philanthropic grants and donations (like traditional not-

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\(^3\) Department of Internal Affairs (2013). *Mapping social enterprises in New Zealand: Results of a 2012 survey.*

\(^4\) Evident in social enterprise development hubs in Auckland (“The Kitchen”) and Wellington (“Enspiral”).
for-profit organisations), social enterprises generate income from trading and scale up by obtaining loans and attracting investment. This ability to obtain income from selling goods and services is valuable in a time where government resources are particularly constrained.

The messages associated with the Government’s Better Public Services programme include an emphasis on “best sourcing” services from outside government agencies and on co-production with external bodies to achieve “collective impact”. As well as responding to community-identified needs, social enterprises potentially have a strong role to play in supporting government objectives in diverse areas.

**Barriers to social enterprise development**

Social enterprises face a range of hurdles, which may vary as they move from the start-up phase, through expansion, to maturity. Those that set up as, or emerge from, a not-for-profit background face challenges in moving from the familiar territory of grants and donations towards a business model, and acquiring the necessary commercial acumen. Charitable trust boards and incorporated societies are prohibited by their legal structures from providing pecuniary gain to their members. Hence many not-for-profits, although interested in growth, are limited in their ability to raise capital because they cannot pay returns to investors.

Social enterprises that begin with a predominantly commercial orientation typically face high levels of risk in the early stages, as do many other businesses. The initiators may put in much “sweat equity” and struggle to raise capital – sometimes placing mortgages on their homes, or drawing on friends and family for support, in order to get their ideas off the ground. They often lack steady revenue streams, which makes it difficult to manage core costs such as salaries and to attract investment and guarantee loans.

Development of a social finance market is hampered by various factors, including potential investor uncertainty about social enterprise risk profiles (resulting in higher costs for due diligence processes) and desire for fast growth (which may not be easy to achieve).

Social enterprise owners/members frequently lack experience in developing business cases and managing the financial aspects of the business. Mainstream commercial entrepreneurs can access various business incubator and mentoring programmes, and can approach a range of angel investors and venture capital sources. There are few equivalent sources of support for social enterprises and few financial intermediaries specialising in managing the transfer of funds from investors to social enterprises.

**Government’s role**

Initiatives around social enterprise are taking place within communities, universities and (to some limited extent) central and local government. A national social enterprise network is developing, capacity building workshops are running in some main centres, several conferences a year focus on social enterprise, and research is increasingly being undertaken. On the one hand these activities suggest a social enterprise market that is developing naturally without government intervention. On the other hand, the market is not strong, and is not yet reaching its potential.

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5 Effort put into a start-up company by the founders in exchange for ownership shares of the company (Wikipedia)
6 Social finance is investment that generates social or environmental returns (such as reduced reoffending or waste reduction) and financial returns for investors.
7 Affluent individuals who provide capital for business start-ups (Wikipedia).
8 Two notable organisations are the Hikurangi Foundation, which incubates social enterprises that have sustainability goals, and Prometheus Finance, which loans to organisations that are of social or ecological benefit.
9 For instance, the Office of Ethnic Affairs has capability building initiatives aimed at ethnic social enterprises. Auckland Council has a working party looking at social enterprise development in that region.
Government has a role in creating an enabling environment and addressing any regulatory barriers that detract from the ability of social enterprises to reach their potential. Governments overseas vary in the extent of their interventions – with the United Kingdom particularly active in galvanising interested players around a vision and strategic direction, establishing a specific legal structure for social enterprise, undertaking research, and funding social enterprises via a strong network of intermediary bodies.

By studying the issues that impact on social enterprises we can consider how to address any developmental barriers, and who (government, social enterprise networks, financers, private trainers and so on) are best placed to address these issues. As legal structures are determined by statutes administered by central government, it is appropriate for government to consider whether the structures are adequate for social enterprises’ needs.

**Legal structures available to New Zealand social enterprises**

“Legal structures” are the various forms available in statute for organisations wishing to incorporate as legal entities. A legal structure enables an entity to operate independently of its owners, limits their personal liability, and gives ongoing life to the organisation if the founders cease their involvement.

**Starting up a social enterprise**

Establishing a social enterprise involves a range of considerations which impact on the choice of legal structure, including whether:

- this involves transforming an existing organisation, purchasing an existing business, or starting an entirely new venture;
- the goods or services provided will, in themselves, achieve social/environmental good (such as a recycling venture) or whether income from the trading activity will be passed on to social/environmental activities (such as an op-shop generating income for social services);
- additional income will be sourced from investors or grant funders, and whether tax exemption is desired; and
- a lot or just a few people are involved, whether they are paid or voluntary, and how decisions will be made (for instance, by staff, members, directors, trustees).

Conducting a feasibility study, developing a business plan (with a strategic eye to growth over time), and linking to sources of advice are important. A sense of purpose and preferred mode of operating are needed before consideration of the legal structure options below.

**Charitable trust boards**

The Charitable Trusts Act 1957 enables trusts and societies that have charitable purposes to incorporate as charitable trust boards. Charitable purposes include the relief of poverty, the advancement of education, the advancement of religion or other purposes beneficial to the public. They may be “trust-based”, which requires at least two trustees, or “society-based”

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10 Various planning guides are available, such as A Business Planning Guide to Developing a Social Enterprise. SENSOCOT, United Kingdom.

11 This is a separate matter to seeking recognition of charitable purposes under the Charities Act 2005 in order to get tax exemptions.
which requires at least five members. Limited liability is likely to exist, provided the decision-makers act prudently, legally, within their objects, and not for personal gain.

Charitable trust boards often sell goods and services and apply the profits to their charitable purposes. Where business activity becomes an important source of income, a charitable trust board may decide to operate its business through a separate trading arm, or purchase an existing business. That business then returns its profits to the not-for-profit arm. Charitable trust boards cannot distribute profit and any surplus assets upon winding-up must be passed on to other charities.

**Incorporated societies**

Under the Incorporated Societies Act 1908, incorporated societies operate for the non-financial benefit of their members and in the pursuit of activities outlined in their constitution or set of rules. Any surplus assets must be passed on to other not-for-profit organisations when winding-up. They must have a minimum of 15 members. Limited liability exists, provided the decision-makers act prudently, legally, within their objects, and not for personal gain.

Incorporated societies can be considered social enterprises where they focus their effort on benefiting society and have significant trading. Like charitable trusts, trading activities may be carried out by the incorporated society itself, or a separate trading arm may be established, to return profits to the social/environmental mission.

**Limited liability companies**

Companies are incorporated under the Companies Act 1993 and must have a minimum of one shareholder and one director. Shareholders own the company while the directors are responsible for governance, and may also be responsible for day-to-day management. Profits are typically distributed to shareholders through dividends.

A company has a legal identity that is separate from its owners. It may enter into contracts, borrow, lend and employ people. Shareholders are not personally liable for any contract, debt or other obligation the company makes or incurs beyond the value of their shareholding, unless they give personal guarantees. Directors are personally liable if they have breached their duties and obligations or have given personal guarantees.

Statutory duties owed by the directors to the company include the duty to:

- act in good faith and in what the director believes to be the best interests of the company;
- exercise powers for a proper purpose; and
- comply with the company’s constitution (if it has one).

Social enterprises using the company form can adopt a constitution that makes it clear that profit maximisation is to be balanced by “social good” objectives. The constitution can prohibit any change to a company’s objectives unless agreed to by a specified majority of shareholders. The shareholders of a social enterprise may also enter into a shareholders’ agreement that outlines social/environmental objectives and specifies how the shareholders intend to act.
**Limited partnerships**

Limited partnerships were introduced in 2008 with the aim of enabling foreign capital investment in new companies in New Zealand. A partnership under the Limited Partnerships Act 2008 requires:

- a general partner who manages the partnership’s affairs and is liable for all debts and liabilities; and
- limited partners who have limited liability and are prohibited from management activity, except in “safe harbours” defined in the Partnership Agreement.

Each partner must pay tax on their share of the partnerships’ income, even if none of the income has been distributed.

It is not apparent that any limited liability partnerships are operating as social enterprises. Potentially, this model could be adopted if a strong management structure and a relatively passive investment partner is wanted. It offers a flexible structure, as beyond the Partnership Agreement, the partners can arrange their own affairs. However, to limit the general partner’s liability, a separate company may need to be incorporated to act in the general partner role.

**Industrial and provident societies and co-operative companies**

“Co-operatives” and “mutuals” are businesses owned and democratically controlled by their members/shareholders, who may (depending on the nature of the co-operative) comprise employees, consumers, producers or retailers. In many countries, co-operatives are considered an important part of the social enterprise movement. Whether they are included within scope in New Zealand depends on whether the social enterprise definition extends to organisations that primary exist to benefit their members or shareholders.

Under the Co-operative Companies Act 1996, companies can incorporate to undertake “co-operative activity”. This activity includes supplying the shareholders of the company with goods or services, or processing/marketing goods or services provided by its shareholders. At least 60 per cent of its shareholders must be “transacting shareholders” who supply or purchase goods or services from the co-operative company. These companies are managed by directors elected by shareholders.

There are 289 societies registered under the Industrial and Provident Societies Act 1908, which fall into two categories (defined in the Statutes Amendment Act 1939):

- a "bona fide co-operative society" which undertakes business in order to make profits; or
- a society whose business is primarily focused on “improving the conditions of living or otherwise promoting the social well-being of members of the working classes; or otherwise for the benefit of the community”.

Typically these societies are managed by a board or committee that is elected by members. The latter category would seem amenable to social enterprise. However, according to Co-operative Business New Zealand, most organisations on the Industrial and Provident Society register (administered by the Companies Office) are dormant or defunct. Anything that is permitted within the framework of an industrial and provident society can also be done within the framework of a cooperative company.

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12 Other legal structures for co-operatives, not discussed in this paper, include friendly societies and credit unions.
Any new industrial and provident societies need to seek approval to be added to the Securities Act (Industrial & Provident Societies) Exemption Notice 2013. All cooperative companies are automatically exempted from certain provisions of the Securities Act under the Securities Act (Co-operative Companies) Exemption Notice 2013.

**Maori land trusts**

Five different trust forms are available under Te Ture Whenua Māori Act 1993/Māori Land Act 1993 – pūtea, whānau, ahu whenua, whenua tōpū and kai tiaki trusts. These structures are only available to owners of Māori land.

The Act aims to support the efficient administration of multiple-owned Māori land. It seeks to keep lands in the hands of owners, and to occupy, develop and use the land for whānau, hapū and future generations. Different purposes are prescribed for each form of trust. The trusts are created by the Māori Land Court and must be approved by the beneficiaries of the trusts. Their aims are mostly cultural (for example, preservation of sacred sites) and economic aims (such generating income from farming).

Whether any of these trusts fall within the social enterprise definition depends on whether organisations that exist to benefit members/shareholders are considered within scope. Existing beneficiaries might challenge any moves to refocus towards wider social good objectives if this impacted on the support provided to them as individuals.

In 2008, proposals for establishment of new legal entities by tribal groups or Māori associations were outlined in the Waka Umanga (Māori Corporations) Bill, but this did not proceed. In 2013, a Review Panel is considering how Te Ture Whenua Māori Act 1993 processes can be streamlined to remove barriers to Māori land utilisation while preserving Māori land ownership.

**Overseas approaches to legal structures for social enterprise**

**United Kingdom**

The United Kingdom has a range of legal structures that may be applicable to social enterprises. The common structures are:

- **industrial and provident societies**, which comprise “bona fide” co-operative societies (which may distribute profit to members) and societies for the benefit of the community (Bencoms – which do not distribute profit to members and obtain charitable status);
- **companies limited by guarantee**, which are the preferred structure for many not-for-profit organisations. The word “limited” can be dispensed with if the company has objects that promote ‘commerce, art, science, education, religion, charity or any other profession’ and there is no profit distribution to members;
- **companies limited by shares**, which is a tailor-made structure for equity-financed organisations that distribute profits to shareholders. Not-for-profit organisations wishing to pursue social enterprise often set up these companies as associated structures, in order to leverage equity capital; and

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• **limited liability partnerships**, which can be used by social enterprises to work in partnerships with other organisations or investors. The partnership can decide to dedicate the majority of profits to a social purpose.

In 2004, the United Kingdom (except Northern Ireland) established a legal entity specifically for social enterprises – the **community interest company (CIC)**. CICs may be established as companies limited by guarantee or companies limited by shares, but they have additional features to safeguard their social mission. To become a CIC, a company has to satisfy a community interest test which is considered to be broader than the public benefit test that is applied in charities law. An annual community interest report must be placed on the public register of companies. Unlike registered charities, CICs can pay their directors.

CICs have an “asset lock” – that is, in general, a CIC’s assets (profits and surpluses) cannot be returned to members unless they are themselves asset locked bodies. When a CIC is wound up, residual assets must go to another organisation that similarly restricts distribution. However, CICs that are limited by shares can distribute dividends to shareholders. Unlike traditional companies, the entire CIC membership must vote to declare dividend issuance. The maximum limit on returns payable to equity shareholders is 20 per cent of the paid-up value of a share. A CIC is prohibited from declaring a dividend total per year that exceeds 35 per cent of its distributable profits. The dividend cap strikes a balance between encouraging investment in CICs and the principle that profits of a CIC should be devoted to community benefit. CICs do not receive tax exemptions.

**United States**

In the United States, several legal structures aimed at social enterprises vie for state-level recognition. The structures most widely enacted are **low-profit limited liability companies (L3C)** and **benefit corporations**.

L3Cs are companies that have a charitable purpose, with profit making as a secondary purpose. The L3C was designed to attract “program related investments” (equity or debt) from charitable foundations.

Benefit corporations have a dual purpose – to create “general public benefit” and to create profit for shareholders. Unlike limited liability companies, benefit corporations are shielded from lawsuits by shareholders if the corporation does not maximise shareholder profit. Even in liquidity situations, directors do not have to take the highest offer if this impacts on their non-financial interests. Unlike L3C, benefit corporations must have their social and environmental performance assessed by independent third-party standard-setters, and an annual benefit report must be published.

Neither L3Cs nor benefit corporations can get federal or state taxation benefits (except for benefit corporations in the City of Philadelphia), and investors cannot get tax deductions. Unlike CICs (United Kingdom), both benefit corporations and L3Cs can offer investors unlimited midstream and residual returns.

**Canada**

*The community contribution company (CCC)* is a new legal structure that will be available from August 2013. Its introduction aims to encourage private investment in British Columbia’s social enterprise sector. Unlike not-for-profit organisations, CCCs will be able to accept equity investment money, issue shares and distribute dividends (up to 40 per cent of annual
profits), leaving the bulk of profits to be used for the company's designated community purposes. Each CCC will be required to publish an annual "community contribution report" providing details of their social spending, community activities and dividend payments. On dissolution, an "asset lock" will require a minimum of 60 per cent of assets to be distributed to charitable organisations or other asset-locked entities.

**Australia**

A Social Enterprise Alliance has set up a working group on legal models to analyse and document use of available legal structures and consider whether a specific legal structure for social enterprise is desirable. The group is expected to produce a report in mid 2013.

**Pros, cons and issues related to legal structures**

Various factors discussed below could be considered “desirable” features for a social enterprise legal entity. These factors are based on:

- the characteristics of social enterprise legal structures in other countries; and
- features mentioned by around a dozen New Zealand social enterprise exponents interviewed in the course of developing this paper.

No one legal structure could contain all these characteristics; there are trade-offs between them. In particular, under current systems, tax exemptions and payment of return to investors cannot co-exist.

These potentially desirable features are compared to the existing legal structures in New Zealand – particularly the commonly used structures of incorporated societies, charitable trusts and limited liability companies – in order to get a sense of the adequacy for social enterprises of the current arrangements.

**Clear branding**

The public, funders and investors have certain expectations and assumptions about organisations according to their structure. Social enterprises are becoming better known but there is no one structure that clearly denotes a mixed social-commercial organisation.

The limited liability company is a well recognised and accepted legal form for conducting business. It is not, however, immediately associated with social and/or environmental goals, even though “corporate social responsibility” activities (such as sponsorship of community organisations or employee volunteering) are becoming more widespread. Social enterprises set up as companies require marketing strategies to promote their mixed purpose and convince customers that the profit motive is not the leading goal.

Conversely, charitable trusts and incorporated societies are generally understood to community-minded and are known to avoid pecuniary profit to individuals, but they may not be perceived to be as business savvy as limited liability companies.

Overseas legal structures like community interest companies and benefit corporations provide recognisable brands that denote organisations focused on both social and business objectives. The availability of such brands increases the profile of social enterprise and makes it easier for policy makers and funders to target assistance if they want to support social enterprise development.
**Easy to establish and change**

Choice of legal entity may be affected by perceptions about which structures are easiest to establish and reshape as the organisation grows.

The limited liability company form can be relatively straightforward to establish as it requires only one director and one shareholder (who can be the same person) to incorporate. If it is a small business it may require less dialogue to get underway than where a larger group of people are involved. However, developing a suitable constitution for a social enterprise using the company structure may require more time and discussion than would be the case for a classic for-profit business.

Establishing an incorporated society or a co-operative is likely to involve a significant number of people. For some, the time spent planning and visioning within such a group is seen as valuable in building joint commitment and setting a clear path.

Incorporated societies and charitable trusts are the most likely to pursue the status of a registered charitable entity. Any change in the charity’s purposes requires re-appraisal by the regulator to ensure it remains charitable. In contrast, a non-charitable company can change its direction without needing to obtain a regulator’s approval. This flexibility is important for start-up social enterprises as they regularly re-orientate their activities as they develop and refine their business models.

If an established incorporated society or charitable trust wishes to increase its income from trading, it may be pragmatic to establish a separate business arm or purchase an existing firm. The commercial arm can then concentrate on its trading activities and employ staff with the requisite business skills. However, a small start-up organisation is unlikely to choose from the outset to set up both a main body and associated company, given the time and resources required to achieve this.

A tailor-made legal structure for social enterprises could ease the establishment of these hybrid bodies. Nothing, however, circumvents the need for careful planning and consideration of all the models on offer, with a view to creating a structure that will serve the organisation immediately and into the future. In the United Kingdom, where more than 6,000 CICs have been registered, many social enterprises continue to choose other legal structures.

**Profit can be applied to the social/environmental mission**

Social enterprises set up as limited liability companies may face credibility issues with customers or funders who are unsure that social motives are really at the heart of the organisation. Special structures for social enterprise in other countries make clear that, while the organisation might seem like a company in many respects, there is also a strong focus on protecting its social or environmental goals. In the United Kingdom, this goes as far as placing restrictions on the extent to which CICs can distribute profit for private gain, so that most profit goes into the social mission. In the United States, the benefit corporation and L3C do not restrict private profit, but simply make it possible for profits to be put into social or environmental goals without directors being sued by shareholders seeking greater returns.

In New Zealand, the Companies Act 1993 does not impose a specific duty to maximise profit for shareholders. Directors must act in the “best interests” of the company. The duties imposed on the company’s directors must be interpreted in the context of the constitution and shareholders’ agreement (if there is one) and these can identify both profit and social or
environmental goals. Ministry of Business, Innovation and Employment has advised that it is not aware of any case law where directors have been sued for not maximising private profits. In terms of a company safeguarding a social mission in perpetuity, this may not be possible for a New Zealand company to the same extent as a British CIC (with its “asset lock”). The company’s constitution could, however, require a specified majority of shareholders to agree any change to the company’s objectives.

**Eligibility for tax exemptions**

For some social enterprises, tax is an important consideration when choosing a legal entity. With a few exceptions, to obtain exemptions from paying income tax, organisations need to be registered as charities. Most registered charities are incorporated societies and charitable trusts. Companies can also register if they have charitable purposes (as defined in the Charities Act 2005) and no profits are distributed to non-charitable shareholders or individuals.

Further, not-for-profit organisations with charitable, benevolent, philanthropic or cultural purposes can apply for donee status from the Inland Revenue Department. Where approved, this enables individuals and companies that donate to these organisations to claim a 33 per cent rebate on their income tax.

For other social enterprises, the attraction of tax exemption is outweighed by the constraints of having to meet the definition of charitable purpose and not being able to attract investors by paying a return.

The overseas structures designed for social enterprises are modifications of the company structure (hence the word “company or “corporation” in their titles) and, like companies, they do not generally attract tax exemptions. They may benefit instead from government or philanthropic funding programmes that specifically focus on their legal structure.

**Ability to attract investment**

A significant limitation on the ability of charitable trusts or incorporated societies to grow in scale is the inability to return dividends to shareholders. These organisations are typically reliant on donations, grants, sponsorship and government contracts, with some occasional forays into loans. Banks and other investors struggle to understand risk profiles and creditworthiness, so transaction costs of due diligence are higher. Company-form social enterprises may also find that investors are unsure of what to make of their hybrid nature. However, a company is better placed than a not-for-profit organisation to attract investment if it has an attractive business case.

The overseas social enterprise legal entities have been developed with an aim of attracting investment. Where the degree of allowable return is restricted, this investment may be less forthcoming. Data on this is not available, but some literature suggests that the American benefit corporation is the superior model because the L3C’s “low-profit” moniker makes it difficult to attract market-rate investments.

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14 Sport and recreational organisations, and a few other bodies, may qualify for limited tax exemptions without being registered as charities.
**Ability to attract grants**

One objective of setting up CICs in the United Kingdom was to encourage philanthropic grants for social enterprises. Currently in New Zealand, most grant funders focus exclusively on not-for-profit organisations, so company-form social enterprises have less ability to attract such gifts. For instance, with regard to the Lottery Grants Board, the Gambling Act 2003 states:

> “the profits of New Zealand lotteries must be distributed … for community purposes only … A distribution will not be treated as being for community purposes if it involves private pecuniary profit or gain for an individual or body, except to the extent that the profit or gain arises as a mere incident of the principle purpose or purposes of the distribution.”

An increase in the number of social enterprises could see innovative philanthropic funders considering the circumstances in which such organisations might be eligible. As it stands, the not-for-profit legal entities have the advantage over companies if grants are to be sought.

**Reporting and compliance costs**

Requirements and costs associated with different legal structures may be a consideration when establishing a social enterprise. For example:

- incorporated societies must provide annual financial statements to the Registrar of Incorporated Societies and advise any rule changes (initial application is $102.22; filing an annual financial statement is free);
- charitable trust boards must advise the Registrar of Incorporated Societies of any rule changes, but do not need to provide annual financial statements (initial application is free; advising changes is free);
- limited liability companies must prepare annual reports for shareholders (including financial statements) and file annual returns with the Companies Office confirming contact and shareholding details (name reservation application is $10.22; company incorporation application is $150; amalgamations are $306.67; annual returns are $45);
- limited partnerships must file annual returns with the Companies Office confirming contact details and names of the partners (initial application is $270; annual levies are $20);
- the Registrar for industrial and provident societies requires annual returns (initial application is free; filing annual financial statement is free); and
- co-operative companies have the same reporting as other companies (name reservation application is $10.22; company incorporation application is $150; annual returns are $45).

Registered charities (whatever their legal structure) must provide annual returns and financial statements to the Department of Internal Affairs. No fee applies for charities with gross annual income less than $10,000. If over $10,000, the online fee is $51.11 and filing on paper is $77.67.

Additional annual filing fees ($255.55) apply to entities that develop, register and sell securities (such as shares and bonds). Entities offering securities to the public must comply with financial markets legislation including the Securities Act 1978, the Securities Markets Act 1988 and the Financial Reporting Act 1993.
A Financial Reporting Bill currently before Parliament provides for financial reporting by for-profit and not-for-profit entities to be consistent with standards currently under development by the External Reporting Board (XRB) and allows for the XRB to potentially develop non-financial reporting standards.

Most overseas legal structures for social enterprises require “community benefit” annual reports to be filed and publicly available. This may increase funder and public confidence that the company is socially focused as well as commercial. If New Zealand considered introducing a special legal structure for social enterprises, transparent reporting of dual social and commercial objectives could be considered.

**Limited liability**

All the legal structures under consideration offer limits on the liability of individuals involved in the organisation. For the Limited Partnership model, a separate company may need to be incorporated to act as the general partner, in order to limit their liability. This means an additional layer of governance and associated costs, and could make the structure less transparent to any community investors.

**Some key distinctions at a glance**

Some of the most important distinctions between traditional not-for-profit and for-profit organisations, which fledgling social enterprises need to consider, are summarised below.

<table>
<thead>
<tr>
<th>Charitable trusts/incorporated societies</th>
<th>Limited liability company</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Branding</strong></td>
<td></td>
</tr>
<tr>
<td>These organisations are clearly recognised as being focused on social purposes.</td>
<td>Companies are clearly recognised as being business focused.</td>
</tr>
<tr>
<td><strong>Tax</strong></td>
<td></td>
</tr>
<tr>
<td>Charitable status (with associated tax exemptions) can be applied for, if the organisation has charitable purposes and public benefit. They may also be eligible for donee status.</td>
<td>As some profit distribution is usually part of the aim of a company, charitable status (with associated tax exemptions) is not usually sought.</td>
</tr>
<tr>
<td><strong>Grants/ donations</strong></td>
<td></td>
</tr>
<tr>
<td>Philanthropic grants and public donations are usually targeted at these types of organisations.</td>
<td>Philanthropic grants are seldom granted to organisations that allow private profit.</td>
</tr>
<tr>
<td><strong>Investment</strong></td>
<td></td>
</tr>
<tr>
<td>Difficulty is often experienced in gaining affordable loans. Dividends cannot be paid to investors.</td>
<td>Companies are more likely to attract investment because can pay dividends.</td>
</tr>
<tr>
<td><strong>Social purpose</strong></td>
<td></td>
</tr>
<tr>
<td>Social purpose is clearly entrenched in the organisation’s objectives.</td>
<td>A social purpose is uncommon but can be specified in the constitution.</td>
</tr>
</tbody>
</table>
What's best for New Zealand?

Conclusions about the case for a new legal entity

Some limited, but not overwhelming, interest in creating a new legal structure was indicated by those interviewed during preparation of this report. The main point in favour was the ability to grow the market through a strong brand that would provide a sign-post to investors with social interests. Overseas features such as capped dividends and payment of directors were mentioned favourably. Some interviewees who preferred company structures could see no advantage in a new legal structure, unless tax exemptions were part of the picture (and without the regulatory requirements associated with tax-exempt charities).

Overall, there was a sense that motivated people could make the current legal structures fit their purposes. Each legal entity has pros and cons, and different personalities are drawn to different models. Entrepreneurs do not necessarily find it easy to gain advice on how to adapt legal models to meet their needs and lawyers with specialist knowledge of social enterprise appear to be almost non-existent.

The dominant message was that development of a stronger social enterprise market does not hinge on legal structure, and that there are more immediate priorities. A specific legal structure could be considered once other barriers to a flourishing social enterprise market have been addressed.

Other challenges

The greatest challenges for social enterprises raised during interviews were around meeting capital needs and early stage capability building. Most schemes to provide incubation and mentoring, accelerator programmes, and venture capital for commercial businesses were not seen as accessible for, or tailored to, the needs of social enterprises. Social procurement was a concept mentioned favourably.

The desired vision from people interviewed was of a mature social investment community supporting capable, investment-ready social enterprises. The current social enterprise scene was seen as exciting and growing, but also ad hoc and under-developed.

Next steps regarding legal structures

While a new legal structure for social enterprises may not be immediately necessary, more advice could be provided on the applicability of existing legal structures. It is hoped that release of this paper will help build knowledge and stimulate discussion.

Advice to community groups on how to establish and manage not-for-profit entities is provided by Department of Internal Affairs. The Department’s toolkit could be extended to provide more information on trading activities. This is being investigated. Other sources of advice, such as through Business Mentors New Zealand, could be considered.

Information applicable to social enterprises could be incorporated in online legal resources, such as the online Community Law Manual provided by Community Law Centres o Aotearoa. This could include a table summarising the benefits and challenges for social enterprises of the various legal structures.

15 This involves giving consideration to social outcomes when seeking tenders for commercial contracts.
Further, to maintain and improve data on the legal structures used by social enterprises, and other factors such as revenue, expenditure and primary beneficiaries, the 2012 social enterprise could be repeated in due course.

**Potential next steps for developing a strategic approach**

The social enterprise movement could potentially play a stronger role in social innovation, economic development and community-based responses to local needs. To support its growth, areas of development to consider include:

- **capability building**: whether existing capacity-building funds and developmental support programmes can be expanded/adapted to increase support for social enterprise development; and
- **supply of capital**: whether potential investors/funders have information needs around social enterprise, whether more financial intermediaries are needed, and what other options could increase seed funding and capital for growth.

Several initiatives are underway that will assist with understanding social enterprise needs and developing strategic approaches at national and regional levels. Analyses of social enterprise needs will be provided by two key pieces of research:

- Ian Axford Fellow, Mary-Jo Kaplan, will report in August 2013 on her investigations of social enterprise needs in New Zealand, with a particular focus on youth; and
- Di Jennings of the Community Economic Development Trust will complete research into success factors and barriers for New Zealand social enterprises by September 2013.

Collaborative discussions are beginning to focus on strategic options for building the social enterprise market and on appropriate roles for government, investors/funders, social enterprise networks and others. Pursuit of a co-ordinated, multi-sector approach could assist New Zealand social enterprises to more fully meet their potential to contribute to social, environmental and economic goals.