

Structures at the Seam: The Architecture of Charities' Commercial Activities  
Comparative Panel: A View of Other Landscapes  
The UK: New Opportunities for Commercial Activity\*

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The legal structures at present used by charities include trusts, unincorporated associations and companies, the latter occasionally limited by shares but more usually limited by guarantee. Charities with certain specific objects can use the structure of an industrial and provident (community benefit) society or a friendly society. In addition, a charity may be a corporation established by statute,<sup>1</sup> Church Measure<sup>2</sup> or Royal Charter.<sup>3</sup> The process of forming a charity has been rendered unnecessarily complex by the need for the promoters to consider the variety of structures available and then to select, and possibly adapt, the one that is most suitable to their particular objective.<sup>4</sup> When it comes to undertaking commercial activities, the range of legal vehicles in England and Wales which charities and other social traders may use has increased in recent years.

This paper will start with a brief description of the company limited by guarantee – hitherto the most appropriate structure for a charity conducting its own commercial activities. It will then describe the most common way in which charities have traditionally

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<sup>1</sup> See, e.g., National Trust Acts 1907 to 1971.

<sup>2</sup> For example, Church Commissioners Measure 1947 (10 & 11 Geo 6 No.2).

<sup>3</sup> Only 161 charities received a Royal Charter between 1518 and 2002. Strategy Unit, *Private Action, Public Benefit: Charitable Incorporated Organisation*, London: Strategy Unit, Cabinet Office, September 2002.

<sup>4</sup> See, e.g., Charity Commission, *Registering as a Charity*, CC21, London: TSO, October 2007 and Charity Commission, *Choosing and Preparing a Governing Document*, CC22, London: TSO, September 2007.

engaged in any significant trading – through a separate trading company. It will then turn to a new legal structure, created specifically for charities – the charitable incorporated organisation. Finally, it will examine yet another new structure, this time non-charitable, which charities may want to utilise when carrying out commercial activities – the community interest company.

## COMPANY LIMITED BY GUARANTEE

A company is appropriate where an organisation needs corporate status because it is expected to control substantial assets or to employ a large number of staff. Alternatively, a corporate structure will be suitable if the charity is expected to engage in charitable purposes which involve risks of a commercial nature (for example, continuing business transactions) and which may lead to large potential financial liabilities. Charities may be incorporated under the Companies Act 2006<sup>5</sup> as companies limited by guarantee without a share capital. A company, with a separate legal entity distinct from its members and directors, can:

- (a) Own property in its own right;
- (b) Have a perpetual succession so that property does not have to be transferred on change of trustees;
- (c) Start and defend legal proceedings in its own name;
- (d) Employ staff; and,
- (e) Make contracts in its own name.

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<sup>5</sup> The Companies Act 2006 received Royal Assent on 8 November 2006. The Act will effectively restate almost all of the provisions of the Companies Act 1985, together with the company law provisions of the Companies Act 1989 and the Companies (Audit, Investigations and Community Enterprise) Act 2004. The Act also codifies certain aspects of the case law. All parts of the Act will come into force by October 2009, but there has been early commencement of some of the provisions. See now Companies Act 1985, s.3

Traditionally,<sup>6</sup> the principal objects of the company and the regulations that govern administrative matters are set out in its memorandum and articles respectively.<sup>7</sup> Under reforms to company law, these documents will be replaced with a single document - the articles of association.<sup>8</sup> The provisions of an existing company's memorandum, including its objects, the amount of any guarantee and its prohibition on trustee benefits, will be deemed to be provisions of its articles, which will be its main constitutional document. Existing companies will not be required to amend their constitution to reflect this change.

In the company limited by guarantee, the liability of the members for the debts of the company is limited by reference to the nominal sum (up to £10) that they have agreed in the memorandum of association of the company to contribute to the company for the payments of its debts on it being wound up.<sup>9</sup>

Incorporation does not absolve trustees (who are called directors in an incorporated charity) from all personal liability. They may still be personally liable as company directors:

- (a) For breach of fiduciary duties;<sup>10</sup>
- (b) For breach of statutory duties under the Companies Act 2006;<sup>11</sup>
- (c) Under the Insolvency Act 1986;<sup>12</sup>
- (d) For breach of trust under charity law; and,

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<sup>6</sup> Under current law, a company is required to state its objects in its memorandum and its directors are required to ensure that the company only acts within its objects. Under Companies Act 2006, s.31, there will be no such requirement. A company's objects will be unrestricted unless specifically restricted in the Articles. Companies that are charities will still need to restrict their objects (under charity law). Charitable companies will still be required to seek the consent of the Charity Commission before amending the objects clause.

<sup>7</sup> For charities, see, e.g., Charity Commission, *Charitable Companies: Model Memorandum and Articles of Association*, GD1, London: TSO, July 2008.

<sup>8</sup> The memorandum of association will be relegated to a simple form to be filed on incorporation.

<sup>9</sup> See, e.g., Charity Commission, *Charitable Companies: Model Memorandum and Articles of Association*, GD1, London: TSO, July 2008, clause 7 of the Memorandum.

<sup>10</sup> These have now been codified in Companies Act 2006, Part 10, Chapter 2.

<sup>11</sup> See in general, Companies Act 2006, Part 10.

<sup>12</sup> Insolvency Act 1986, s.213 - fraudulent trading and s.214 – wrongful trading. Fraudulent trading is when a person acts dishonestly with the intent to defraud creditors. Wrongful trading is where the director knew or ought to have known that there was no reasonable prospect of the company avoiding insolvency.

(e) Under criminal law.

The company limited by guarantee has traditionally been viewed as the form which is best suited to charities' needs. However this form is not restricted to charities. The company limited by guarantee is subject to the general regulatory framework for limited companies, such as the requirement to file accounts. The common law governing companies also applies to it. This leads to a number of problems, both legal and practical.

Practical difficulties arise because charitable companies are answerable to two regulators - the Charity Commission and the Registrar of Companies. They face dual registration, reporting and regulatory requirements. This means completing two annual returns, which have some, but not much, overlap in the information they seek. It also means preparing both an annual report under charity legislation<sup>13</sup> and a directors' report under company legislation.<sup>14</sup> In addition, directors of charitable companies must submit accounts to both regulators.<sup>15</sup> This increases the administrative burdens and expense of those running charitable companies.

From a legal point of view, this dual source of rules can cause difficulties when trying to establish the precise nature of the powers and duties of a charitable company and its directors. For example, the standard of care to be exercised by the directors of a charitable company remains to be settled.<sup>16</sup> There is legal uncertainty as to exactly how the fiduciary duties imposed on directors by company law overlap with the duties imposed by charity law on trustees and, where there is a conflict, which duty will prevail. For example, the company directors' duty of care is to act in the best interests of the company<sup>17</sup> and for the benefit of its members. The duty of care imposed on charity

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<sup>13</sup> Charities Act 1993 (CA 1993), s.45.

<sup>14</sup> CA 1993, Part VI and Companies Act 2006, Part 15.

<sup>15</sup> Ibid.

<sup>16</sup> See now, Trustee Act 2000, s.1 and Companies Act 2006, s.174 concerning the duty to exercise reasonable care etc. for trustees and directors, respectively.

<sup>17</sup> Under Companies Act 2006, s.172, there will be a statutory duty upon directors to promote the success of the company. However, where a company's purposes consist of or include purposes other than

trustees is to act in the best interests of the charity, with an emphasis on both the current and future *beneficiaries*, who may well not be the same as the members.

Secondly, the Companies Act is designed primarily to meet the practicalities of the commercial sector rather than the different ethos of the not-for-profit sector. For example, the corporate governance regime, with the underlying assumption that members have a financial interest in the company, is not applicable for charities. This means that there is no explicit duty on members to act in the best interests of the company, as it is assumed that their financial interests and those of the company will be one and the same.

The answer to any question in relation to charitable companies requires a balancing of two competing strands - the provisions of company law designed for a profit-making entity undertaking commercial risk (with financially involved shareholders) and charity law designed to support a non-profit-making entity carrying out largely public objects (and with financially independent members). Warburton notes that the courts have shown a tendency to give priority to charity law rather than company law when dealing with a charitable company limited by guarantee.<sup>18</sup> She cites two examples: In *Liverpool and District Hospital for Diseases of the Heart v AG*,<sup>19</sup> Slade J held that a charitable company is in a position analogous to that of a trustee in relation to its corporate assets<sup>20</sup> and that surplus assets can be applied *cy-près*.<sup>21</sup> Similarly, legal proceedings involving a charitable company fall within the definition of ‘charity proceedings’<sup>22</sup> and consequently, anybody bringing such proceedings must first obtain the authorisation of either the Charity Commission or the court.<sup>23</sup>

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the benefit of its members (e.g., charitable purposes), all references to promoting the success of the company will refer to the achievement of those purposes, rather than the benefit of the members. This makes it clear that a charitable company will be able to promote the success of the company through its objects without being required to benefit the members.

<sup>18</sup> J Warburton, ‘Charity Members: Duties and Responsibilities’ [2006] *Conv* 330 at 348.

<sup>19</sup> [1981] Ch 193.

<sup>20</sup> *Ibid*, at 209.

<sup>21</sup> *Ibid*, at 213 and see *Re Dominion Students’ Hall Trust* [1947] Ch 183.

<sup>22</sup> CA 1993, s.33(2).

<sup>23</sup> See *Etheridge v Gingerbread Ltd* [2002] All ER (D) 264.

## THE TRADITIONAL OPTION FOR TRADING – A SEPARATE TRADING SUBSIDIARY

Charities have two problems with trading themselves. One is fundamental and relates to charitable status. The other is fundamental and relates to taxation.

### 1. Charitable Status and Trading

Trading itself is not a charitable purpose. Charity law only allows charities to trade if it is either: primary purpose trading (such as a religious charity selling bibles, a charitable school charging pupils, or a charitable clinic charging patients or selling medicines); ancillary trading (such as the sale of food and drink in a restaurant or bar by a theatre charity to members of an audience); or, non-primary purpose trading that does not involve significant risk to the resources of the charity.<sup>24</sup>

### 2. Taxation and Trading

Without a specific entitlement to an exemption, a charity's profits from trading are taxable. Section 524 of Income Tax Act 2007 (ITA 2007)<sup>25</sup> sets out the exemption for trading profits of charitable trusts.<sup>26</sup> The exemption applies only if the trade is a charitable trade. This is defined in section 525. Apart from the effect of the statutory

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<sup>24</sup> Charity Commission, *Trustees, Trading and Tax*, CC35, London: TSO, April 2007, paras.C6-8.

<sup>25</sup> The ITA 2007 is the fourth Act produced by the Tax Law Rewrite project. The aim of the project is to re-write direct tax legislation in clearer, simpler language. The ITA 2007 was preceded by: the Capital Allowances Act 2001; the Income Tax (Earnings and Pensions) Act 2003, which rewrote Schedule E; and, the Income Tax (Trading and Other Income) Act 2005, which rewrote Schedules A, D and F for income tax. The project will also include a rewrite of corporation tax. The ITA rewrites most of the remaining income tax provisions in the Income and Corporation Taxes Act 1988 (ICTA 1988). Both ITEPA 2003 and ITTOIA 2005 feed into the core provisions rewritten in ITA 2007 and together they complete the project's work on the rewrite of the income tax legislation. In the main, ITA 2007 does not change the effect of the law but it does correct some minor anomalies and incorporates a number of extra-statutory concessions and accepted practices into the legislation. The Act has no direct application to corporation tax, but where provisions previously applied to both income tax and corporation tax (e.g., in ICTA 1988) those previous provisions have been amended so that they now apply to corporation tax only.

<sup>26</sup> It is based on ICTA 1988, s.505(1)(e), which still applies to corporation tax. Exemptions for small-scale trades are dealt with separately in ITA 2007, s.526.

exemptions when a trade is carried on by a charity, tax is chargeable on the profits of the trade notwithstanding that the profits are, and can only be, applied to the purposes of the charity.<sup>27</sup>

### *Trade*

‘Trade’ in this context includes any venture in the nature of trade.<sup>28</sup> Activities which fall within the meaning of the word ‘trade’ and which have been carried on by charities include: running a restaurant open to outsiders,<sup>29</sup> bookselling,<sup>30</sup> carrying on a public school,<sup>31</sup> promoting a music festival to which the public were on payment admitted,<sup>32</sup> running an agricultural show<sup>33</sup> and arranging regular public dances.<sup>34</sup> However, Her Majesty’s Revenue & Customs (HMRC) takes the view that the realisation of donated goods is not a trade.<sup>35</sup> Income derived from letting out or licensing the occupation of land would appear not to be income of a trade and income from such a source would qualify for exemption under section 531 of ITA 2007.

The mere acknowledgement by a charity of a sponsor’s contributions will not amount to a trade for income tax purposes. But if the references to the sponsor amount to advertisements, payments by the sponsor will be treated as trading income. The circumstances in which HMRC will regard a reference to a sponsor as an advertisement are discussed in the HMRC detailed guidance notes for charities.<sup>36</sup>

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<sup>27</sup> *St Andrew’s Hospital, Northampton v Shearsmith* (1887) 19 QBD 624; *Psalms and Hymns Trustees v Whitwell* (1890) 3 TC 7; *Davis v Superioress Mater Misericordiae Hospital Dublin* [1933] IR 480.

<sup>28</sup> ITA 2007, s.989.

<sup>29</sup> *Grove v Young Men’s Christian Association* (1903) 88 LT 696

<sup>30</sup> *Religious Tract and Book Society of Scotland v Forbes* (1896) 3 TC 415; *Psalms and Hymns Trustees v Whitwell* (1890) 3 TC 7.

<sup>31</sup> *Brighton College v Marriott* [1926] AC 192.

<sup>32</sup> *IRC v Glasgow Musical Festival Association* (1926) 11 TC 154.

<sup>33</sup> *Royal Agricultural Society of England v Wilson* (1924) 9 TC 62.

<sup>34</sup> *British Legion Peterhead Branch, Remembrance and Welcome Home Fund v IRC* (1953) 35 TC 509.

<sup>35</sup> HMRC, *Detailed Guidance Notes for Charities*, Annex IV, Trading and Business Activities, para.23. See also Charity Commission, *Trustees, Trading and Tax*, CC35, London: TSO, April 2007, para.C3.

<sup>36</sup> HMRC, *Detailed Guidance Notes for Charities*, Annex IV, Trading and Business Activities, paras.28–34.

### *Exemption for Charitable Trade*

There are two categories of trading income generated by charities which rank for statutory exemption from income tax due to falling within the definition of a ‘charitable trade.’ First is the case where the trade is exercised in the course of the actual carrying out of a primary purpose of a charity and the trading profits are applied to the charitable purpose in question.<sup>37</sup> The exemption extends to trades which are not primary purpose activities but which are ancillary to the carrying out of a primary purpose so that they can be said to be exercised in the course of the carrying out of a primary purpose.<sup>38</sup> The second case is where the work in connection with the trade is carried out mainly by beneficiaries of the charity and the profits are applied to the charitable purposes of the charity.<sup>39</sup> This often applies where the work carried out by the beneficiaries has a therapeutic, remedial or educational value. An example of the latter would be the manufacture and sale of items by disabled people who are beneficiaries of a disability charity.

Where a charity carries out mixed trading (some that is a charitable trade, eligible for tax relief, and some that is not) the two elements are to be treated as separate trades under section 525 of ITA 2007. This allows relief to be fully given for the charitable trade element. This might apply to a shop in an art gallery which sells a range of goods, some of which are related to a primary purpose of the charity (for example, direct reproductions of exhibits and catalogues) and some of which are not (for example, promotional pens, mugs, tea towels etc.).

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<sup>37</sup> ITA 2007, s.525(1)(a). This is based on ICTA 1988, ss.505(1) and (1B) which still apply to corporation tax. See *Dean Leigh Temperance Canteen v IRC* (1958) 38 TC 315.

<sup>38</sup> See HMRC, *Detailed Guidance Notes for Charities*, Annex IV, Trading and Business Activities, para.13, which gives examples.

<sup>39</sup> ITA 2007, s.525(1)(b). This is based on ICTA 1988, ss.505(1) and (1B) which still apply to corporation tax. See *Brighton Convent of the Blessed Sacrament v IRC* (1933) 18 TC 76.

### *Small-Scale Trades*

Section 526 of ITA 2007 provides an exemption for trading income, adjustment income and post-cessation receipts in circumstances where the amount of income which can be exempted is small, and provided that the income is applied to the purposes of the charitable trust.<sup>40</sup> The exemption provided by this section applies only if the income is not otherwise exempt.<sup>41</sup> The original legislation restricted the exemption to income from trades carried on wholly or partly in the UK. This restriction has been dropped. The exemption applies so long as the charitable trust's trading incoming resources<sup>42</sup> and miscellaneous incoming resources<sup>43</sup> for the tax year do not exceed the requisite limit for the tax year, or the trustees had a reasonable expectation that it would not do so, at the start of the tax year. The requisite limit is 25% of the charitable trust's total incoming resources for the tax year, and must be between £5,000 and £50,000.<sup>44</sup>

### *Exemption For Profits From Fund-Raising Events*

Section 529 of ITA 2007 gives statutory effect to a pre-existing Extra-Statutory Concession<sup>45</sup> as it applies to charitable trusts. The profits from fund-raising must arise from a 'VAT exempt event'<sup>46</sup> and must be applied to the purposes of the charitable trust. Schedule 9 to the Value Added Tax Act 1994 provides an exemption from VAT for the supply by a charity of goods and services in connection with an event that is organised primarily to raise money for itself or other charities. The Schedule defines 'event' and

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<sup>40</sup> It is based on Finance Act 2000, s.46, which still applies to corporation tax.

<sup>41</sup> So profits from primary purpose trading (including related adjustment income and post-cessation receipts) are exempt under ITA 2007, s.524, whereas profits from a non-primary purpose trading activity (including related adjustment income and post-cessation receipts) may be exempt under this section.

<sup>42</sup> Defined in ITA 2007, s.528(2). The original legislation stated that the charity's 'gross income' must not exceed the requisite limit.

<sup>43</sup> Defined in *ibid*, s.528(4).

<sup>44</sup> *Ibid*, s.528(6).

<sup>45</sup> Extra-Statutory Concession C4.

<sup>46</sup> Under Group 12 of Schedule 9 to the Value Added Tax Act 1994.

places certain limits on the number<sup>47</sup> of events that a charity can hold in the same location in any given year.

### 3. Separate Trading Subsidiaries<sup>48</sup>

The fact that trading profits might be exempt from tax if the trading is carried on by the charity itself does not necessarily mean that it is appropriate for the charity to carry on the trading. The Charity Commission has set out a newly formulated test for non-primary purpose trading activities which involve a ‘significant risk’ and which the Commission requires to be routed through a trading subsidiary.<sup>49</sup>

For this reason, *inter alia*, normally, a charity will trade through a wholly owned non-charitable trading subsidiary which pays back its taxable profits to the charity as a corporate Gift Aid donation.<sup>50</sup> Gift Aid payments reduce the trading subsidiary’s taxable income by the amount of the payment. It is often possible, therefore, by making such payments, to eliminate the trading subsidiary’s entire potential corporation tax liability. Gift Aid donations made to UK charities by companies are paid gross and the company deducts the sum paid when calculating its profits for corporation tax.<sup>51</sup> For the receiving charity there is a charge to income or corporation tax on such gifts, but there is also exemption which will apply if the charity uses the gift for charitable purposes.<sup>52</sup> A trading subsidiary can make Gift Aid payments to its parent charity at any time from the start of the relevant accounting period until nine months from the end of that period. Deferring payments may assist cash flow in the trading subsidiary.

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<sup>47</sup> Up to 15 events of the same kind at the same location in any financial year, and any number of events of the same type, where the gross takings do not exceed £1,000, fall within the exemption.

<sup>48</sup> See HMRC, *Detailed Guidance Notes for Charities*, Annex IV, Trading and Business Activities, paras.56-65 and Charity Commission, *Trustees, Trading and Tax*, CC35, London: TSO, April 2007, paras.D1-23. For an earlier appreciation, see Hill and de Souza ‘Charities and Trading’ (1989) *Trust Law & Practice* 98–103, which provides a very full practical guide to the legal pitfalls.

<sup>49</sup> Charity Commission, *Trustees, Trading and Tax*, CC35, London: TSO, April 2007, para.C8.

<sup>50</sup> Previously, the non-charitable trading subsidiary would covenant all its net trading profits to the charity.

<sup>51</sup> ICTA 1988, ss.338, 338A and 339.

<sup>52</sup> ITA 2007, s.522. This is based on ICTA 1988, s.505(1) and Finance Act 1990, s.25(10) which still apply to corporation tax.

The funding of a trading subsidiary will usually come from its parent charity, by way of share capital and / or loan capital.<sup>53</sup> However, this must be justifiable as an appropriate investment (not a gift) of the charity's assets. The making of investments in companies which are owned wholly or substantially by the charity is within the scope of the general power of investment.<sup>54</sup> And, in the case of many corporate charities, there is an express power to set up a subsidiary. Nevertheless, the normal rules as to investment duties of charity trustees apply.<sup>55</sup>

It is important to ensure that any investment by a parent charity in a trading subsidiary is not treated as 'non-charitable expenditure', as defined in ITA 2007.<sup>56</sup> If it is so treated, then tax liabilities may arise. Similarly, the 'substantial donor' provisions can have the effect of treating a charity's investment in a business as non-charitable expenditure, where that business has made substantial donations to the charity. However, a trading subsidiary cannot be a 'substantial donor' in relation to its own parent charity, regardless of the size of the payments which it makes, or has made, to the parent charity.<sup>57</sup>

A trading subsidiary (so long as it is controlled by charities) is outside the scope of Part II of the Charities Act 1992, which deals with the regulation of certain types of fund-raising, namely that carried out by 'professional fund-raisers' and what are called 'commercial participators'. Connected companies are excluded from the definition of professional fund-raisers and commercial participators because the definition is disappplied to such companies.<sup>58</sup> However, the need for good practice in fund-raising by connected

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<sup>53</sup> See Charity Commission, *Trustees, Trading and Tax*, CC35, London: TSO, April 2007, paras.D6-D12.

<sup>54</sup> See Trustee Act 2000, s.3.

<sup>55</sup> See, e.g., *ibid*, ss.4-5.

<sup>56</sup> ITA 2007, ss.539-548. 'Approved charitable investments' and 'approved charitable loans' are defined in *ibid*, s.558 and s.561 respectively. See further, HMRC, *Detailed Guidance Notes for Charities*, Annex III, Qualifying Investments and Loans.

<sup>57</sup> *Ibid*, s.555.

<sup>58</sup> Charities Act 1992, s.58(2)(a) and s.58(1)(b). A company is 'connected with' a charitable institution if the institution or the institution and one or more other charitable institutions, taken together, is or are

companies is just as strong as it is for those subject to the controls in the Act, including the need to have full regard to professional codes and other recommended practice. Although some regard has to be made for the different circumstances where a connected company undertakes direct fund-raising, as far as is applicable, the Office of the Third Sector<sup>59</sup> and (in relation to charities) the Charity Commission strongly recommend, as a matter of good practice, that these bodies follow the same requirements, for example in terms of agreement between the charity and connected companies,<sup>60</sup> as for others who are subject to the requirements of the Act.<sup>61</sup> Similarly, appropriate statements<sup>62</sup> should be made where any representation is made by a trading subsidiary to the effect that charitable contributions are to be given or applied for the benefit of one or more charities. The Office of the Third Sector suggests that compliance with such arrangements may be straightforward in many cases.<sup>63</sup> For example, in a shop run by a trading subsidiary it may be possible to make the appropriate statement by a notice displayed prominently by the cash register saying that all profits are Gift Aided<sup>64</sup> to the parent charity.<sup>65</sup>

The Charity Commission has observed that a confusion of aims and finances sometimes results in charity funds being applied for the non-charitable purposes of the company or being put at risk in other ways. Where a charity has established a separate non-charitable trading company, it should not be seen merely as a paper exercise. The trading company

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entitled (whether directly or through one or more nominees) to exercise, or control the exercise of, the whole of the voting power at any general meeting of the company: *ibid*, s.58(5).

<sup>59</sup> As part of the Cabinet Office, the Office of the Third Sector (OTS) leads work across government to support the environment for a thriving third sector (voluntary and community groups, social enterprises, charities, cooperatives and mutuals), enabling the sector to campaign for change, deliver public services, promote social enterprise and strengthen communities. The OTS was created at the centre of government in May 2006 in recognition of the increasingly important role the third sector plays in both society and the economy. The Minister for the Third Sector is now Kevin Brennan, MP for Cardiff West, following the Cabinet reshuffle in October 2008.

<sup>60</sup> In line with Charities Act 1992, s.59.

<sup>61</sup> Office of the Third Sector, *Draft Guidance on Professional Fund-Raising and Commercial Participation*, London: Office of the Third Sector, Cabinet Office, February 2008, para.19.

<sup>62</sup> In line with Charities Act 1992, s.60.

<sup>63</sup> Office of the Third Sector, *Draft Guidance on Professional Fund-Raising and Commercial Participation*, London: Office of the Third Sector, Cabinet Office, February 2008, Annex B, Example 5.

<sup>64</sup> The guidance talks about the profits being ‘covenanted’ but this is no longer correct. See above.

<sup>65</sup> Office of the Third Sector, *Draft Guidance on Professional Fund-Raising and Commercial Participation*, London: Office of the Third Sector, Cabinet Office, February 2008, Annex B, Example 5.

is a separate entity and it is essential that its funds and those of the charity are kept separate and are separately accounted for; that loans by the charity to the trading company are generally on a secured basis; and, that the charity does not subsidise the trading company in any way.<sup>66</sup> Whilst there is no objection in principle to the consolidation of bank accounts in order to obtain better terms of business from the bank, financial structures of the parent charity and the trading subsidiary must nevertheless be kept separate.<sup>67</sup> To strengthen the distinction between a charity and its non-charitable trading company, it is, the Commission recommends, advisable also to distinguish the names of the two organisations from each other to prevent confusion, both as to activities and as to which of the organisations a potential donor is supporting.<sup>68</sup> Thus it is important that any charity with, or proposing to set up, a trading company takes proper advice on the legal, accounting and tax implications. If in doubt, the trustees are recommended to ask the Charity Commission and HMRC for necessary information and advice.

This paper will now focus on the introduction of two new entities into the legal landscape: the Charitable Incorporated Organisation and the Community Interest Company.

## CHARITABLE INCORPORATED ORGANISATION

The necessity of having to adopt and adapt existing legal structures in order to set up charities is not only no longer acceptable, but is also proving an unnecessary restraint on the development of charitable activity. Charities now require a legal structure which is both flexible enough to permit innovative action and also one which will provide sufficient protection for those involved. In many cases, charities find the traditional legal structures sadly lacking. They are not designed to cope with the potential liabilities and necessary control mechanisms.

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<sup>66</sup> [1993] Ch Com Rep 22, para.87.

<sup>67</sup> Charity Commission leaflet 'Charities and Trading' CC35, April 2007, para.D20.

<sup>68</sup> Ibid, para.D23.

Once the relevant provisions of the Charities Act 2006 are implemented, the first purpose-built legal structure for charities, the charitable incorporated organisation (CIO), will be introduced. This form will provide a new type of corporate entity for those charities that do not want to become charitable companies. Those charities that opt for this new legal format will only need to be regulated by the Charity Commission (unlike charitable companies which must also be registered at Companies House). They will, however, still benefit from some corporate advantages such as reduced personal liability for trustees. It is envisaged that many charities that previously would have incorporated as a company limited by guarantee may well in the future use the new CIO structure.

## 1. Background

The possibility of making provision for a charity-specific form of incorporation was discussed in the Company Law Review<sup>69</sup> Steering Group's Consultation Document in March 2000<sup>70</sup> and again, in a follow up document, later that year.<sup>71</sup> The proposal for a CIO was subsequently developed by an Advisory Group<sup>72</sup> set up by the Charity Commission. It welcomed the recommendation that there should be a new form of incorporated body specifically for charities and its suggestions were published in the Spring of 2001.<sup>73</sup> With the publication in July 2001 of the final Modern Company Law Report<sup>74</sup> came the formal recommendation that there should be a separate form of

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<sup>69</sup> Against a background of a framework of Company Law which was essentially constructed on foundations which were put in place by the Victorians in the middle of the last century, the Department of Trade and Industry (DTI) launched a thorough and wide-ranging review of core Company Law, back in 1999, which has now led to the passing of the Companies Act 2006.

<sup>70</sup> Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, London: DTI, March 2000. Previously, this had been a recommendation from the Deakin Report: Commission on the Future of the Voluntary Sector, *Meeting the Challenge of Change: Voluntary Action Into the 21st Century, Report and Summary of Evidence and Selected Papers*, London: NCVO, 1996, p.84.

<sup>71</sup> Company Law Review Steering Group, *Modern Company Law for a Competitive Economy - Completing the Structure*, London: DTI, November 2000.

<sup>72</sup> The members of the Advisory Group came from umbrella bodies and professional bodies advising charities with a wide experience of the charity sector.

<sup>73</sup> Charity Commission, *Charitable Incorporated Organisation*, Spring 2001.

<sup>74</sup> Company Law Review Steering Group, *Modern Company Law For A Competitive Economy: Final Report*, London: DTI, July 2001, para.4.63 ff.

incorporation for charities. This was then brought within the remit of the ongoing charity law reform project. Recognising that charities do not fit comfortably within existing limited liability vehicles, the Prime Minister’s Strategy Unit<sup>75</sup> report<sup>76</sup> included the recommendation that a new legal form designed specifically for charities, the CIO, be introduced, which would only be available for charitable organisations.<sup>77</sup> Following public consultation, the Government published its response in July 2003, setting out how it planned to take the reforms forward.<sup>78</sup> The Government’s response supported most of the Strategy Unit’s main proposals,<sup>79</sup> including the CIO recommendations.<sup>80</sup>

The Charities Bill was first published in draft in May 2004 for pre-legislative scrutiny by a Joint Committee of both Houses of Parliament. The Joint Committee, having considered evidence during the summer of 2004,<sup>81</sup> published its report in September 2004.<sup>82</sup> The Government’s response to that report was published in December 2004<sup>83</sup> alongside the Bill itself. The original Bill was timed-out by the May 2005 general election,<sup>84</sup> but the

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<sup>75</sup> The Strategy Unit was set up in 2002, bringing together the Performance and Innovation Unit, the Prime Minister’s Forward Strategy Unit, and parts of the Centre for Management and Policy Studies. Its aim is to improve government’s capacity to address strategic, cross-cutting issues and to promote innovation in the development of policy and the delivery of the government’s objectives. The Strategy Unit reports to the Prime Minister through the Cabinet Secretary.

<sup>76</sup> Strategy Unit, *Private Action, Public Benefit. A Review of Charities and the Wider Not-For-Profit Sector*, London: Strategy Unit, Cabinet Office, September 2002. For a discussion of the recommendations, see, D Morris ‘Strategy Unit Proposes Major Shake-Up of Charity Law – Part 1 and Part 2’, *Exempt Organization Tax Review* 38, 2002, 459 and *Exempt Organization Tax Review* 39, 2003, 201.

<sup>77</sup> Strategy Unit, *Private Action, Public Benefit. A Review of Charities and the Wider Not-For-Profit Sector*, London: Strategy Unit, Cabinet Office, September 2002, para.5.44. Further detail was given in a background paper: Strategy Unit, *Charitable Incorporated Organisation*, London: Strategy Unit, Cabinet Office, December 2001.

<sup>78</sup> Home Office, *Charities and Not-for-Profits: A Modern Legal Framework. The Government’s response to ‘Private Action, Public Benefit’*, London: Home Office, 2003.

<sup>79</sup> See D Morris, ‘Charity Law Reform: The Next Step’ *Exempt Organization Tax Review* 41, 2003, 409.

<sup>80</sup> Home Office, *Charities and Not-for-Profits: A Modern Legal Framework. The Government’s response to ‘Private Action, Public Benefit’*, London: Home Office, 2003, para.4.14-15.

<sup>81</sup> Joint Committee on the Draft Charities Bill, *The Draft Charities Bill, Vol 2: Oral and Written Evidence*, (HL 167-II/HC 660-II) London: TSO, September 2004.

<sup>82</sup> Joint Committee on the Draft Charities Bill, *The Draft Charities Bill, Vol 1: Report*, (HL 167-I/HC 660-I) London: TSO, September 2004.

<sup>83</sup> Secretary of State for the Home Department, *The Government Reply to the Report from the Joint Committee on the Draft Charities Bill*, Session 2003–04 HL Paper 167/HC 660, Cm 6440, December 2004.

<sup>84</sup> Charity Commission, *Charities Bill Fails To Be Enacted*, Charity Commission Press Release, 5 April 2005, GNN ref 114050P.

Queen’s Speech in May 2005 confirmed that the Government would re-introduce the Charities Bill and on 18 May 2005, Baroness Scotland (Home Office Minister) moved the First Reading of the Charities Bill.<sup>85</sup> The Bill completed its passage through the House of Lords in November 2005 after more than 60 hours of scrutiny by Peers and through the House of Commons in October 2006. Its final debate was in the Lords on 7 November 2006 and at long last the Charities Bill received Royal Assent on 8 November 2006.

The Charities Act 2006 will implement a majority of the accepted recommendations of the Strategy Unit, with the remainder to be (or, in some cases, having already been) implemented either through other legislation<sup>86</sup> or by administrative action. The Charities Act 2006 is being brought into force in stages,<sup>87</sup> with the first group of provisions having come into force on 27 February 2007.<sup>88</sup>

The basic principles and architecture for the CIO are included in the Act<sup>89</sup> while the more detailed requirements will be dealt with in secondary legislation. These regulations will be made by the Minister for the Third Sector and will set out how CIOs will be created and run. Drafts of two sets of regulations were published in September 2008.<sup>90</sup> Consultation will now take place before the final regulations are made and brought into force in 2009.

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<sup>85</sup> The Bill was revised to include those amendments agreed in Committee during its original passage through the House of Lords in the previous Parliament.

<sup>86</sup> See, e.g., Companies (Audit, Investigations and Community Enterprise) Act 2004, which contains provisions in Part 2 (ss.26-63) for the community interest company. See below.

<sup>87</sup> Cabinet Office, Office of the Third Sector, *Charities Act 2006: Updated Implementation Plan*, November 2007.

<sup>88</sup> Charities Act 2006 (Commencement No 1, Transitional Provisions and Savings) Order 2007 SI 2007/309.

<sup>89</sup> Part 2, Chapter 8 (s.34) and Schedule 7 of the Act provide for the CIO.

<sup>90</sup> Both the draft Charitable Incorporated Organisations (General) Regulations and the draft Charitable Incorporated Organisations (Insolvency and Dissolution) Regulations, together with the draft Model Constitution for a Charitable Organisation (‘Foundation’ version) and draft Model Constitution for a Charitable Organisation (‘Association’ version) were published on 10 September 2008. See [http://www.cabinetoffice.gov.uk/third\\_sector/Consultations/current\\_consultations/cio.aspx](http://www.cabinetoffice.gov.uk/third_sector/Consultations/current_consultations/cio.aspx)

The Charities Act 2006 includes in schedule 7 details of the new legal structure of the CIO. Schedule 7 proceeds by inserting a new Part (sections 69A-Q) and a new Schedule 5B into the Charities Act 1993 and by making various minor amendments to that Act.<sup>91</sup>

## 2. Nature and Constitution

CIOs must have a constitution, a principal office in England or Wales,<sup>92</sup> and one or more members.<sup>93</sup> Members may be either not liable to contribute to the assets of the CIO if it is wound up, or liable to contribute up to a maximum amount each.<sup>94</sup> The CIO's constitution, which must be in the form set out in the regulations, or as near to that form as possible<sup>95</sup> and must be in English if its principal office is in England (and in Welsh if its principal office is in Wales),<sup>96</sup> must include:<sup>97</sup> its name; its purposes; whether its principal office is in England or Wales; liability of members; eligibility and procedure for membership and trusteeship;<sup>98</sup> use of the CIO's property on dissolution; and, such other matters as are specified in regulations.

New schedule 5B to the 1993 Act sets out provisions some of which will, in due course, form the basis for the model CIO constitution. These include: powers; validity of CIO actions; duties of members and trustees; personal benefit and payments; internal procedures; and, constitutional amendment. One of the interesting differences between a CIO and a charitable company is that the directors of a charitable company, as charity trustees, must act in the interests of the charity when they are acting as directors /

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<sup>91</sup> For an early assessment of some of the main features of the CIO, see A Dunn and CA Riley 'Supporting the Not-for-Profit Sector: the Government's Review of Charitable and Social Enterprise' (2004) 67(4) *MLR* 632 at p 655-656.

<sup>92</sup> The Charities and Trustee Investment (Scotland) Act 2005 makes corresponding provision in Scotland. In Northern Ireland proposed legislation is being considered which includes a framework for a similar type of structure.

<sup>93</sup> CA 1993, ss.69(A)(1)-(5).

<sup>94</sup> Ibid, s.69A(6).

<sup>95</sup> Ibid, s.69B(5).

<sup>96</sup> Ibid, s.69B(4).

<sup>97</sup> Ibid, ss.69B(1)-(3).

<sup>98</sup> See also *ibid*, s.69B(6) concerning the inter-relationship between trustees and members of the CIO.

trustees,<sup>99</sup> but when they are acting as company members (i.e. in decisions at general meetings) there is no obligation to act in the interests of the charity. Under paragraph 9(a) in the new schedule 5B, the duty to act in the interests of the charity will apply to CIO members as well as trustees. Subject to permitted<sup>100</sup> modification in the CIO's constitution, trustees must exercise such care and skill as is reasonable in the circumstances, having regard in particular:<sup>101</sup>

- (a) to any special knowledge or experience that he has or holds himself out as having, and
- (b) if he acts as a charity trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

This mirrors the statutory duty of care for trustees laid down in the Trustee Act 2000.<sup>102</sup>

It was originally proposed that the CIO legislation would provide for both a two-tier 'association' format (members and trustees) suitable for a membership organisation, and a single-tier 'foundation' format where a membership is not required.<sup>103</sup> The latter will be particularly useful where the CIO replaces a classic form of charitable trust - where it will be preferable for the trustees to be the only persons involved in the structure of a CIO. The Act allows only for a two-tier structure, but it is clear that the members and trustees can be the same people.<sup>104</sup> Where this is the case, it is important for those concerned to understand in which capacity they are acting when taking any decision. In the parliamentary debates on the Charities Bill, Lord Bassam's response to these concerns, expressed by Lord Philips in Grand Committee, was to say: 'we believe that the burden

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<sup>99</sup> See discussion above on directors of companies limited by guarantee.

<sup>100</sup> Modification may be allowed by regulations made under CA 1993, Schedule 5B, para.10(2). The draft Charitable Incorporated Organisations (General) Regulations propose that the general duty of care may be disapplied in the CIO's constitution, subject to a minimum alternative duty – whereby trustees must not pursue any course of conduct which they know is not in the best interests of the CIO or do not care whether or not it is in the best interests of the CIO.

<sup>101</sup> CA 1993, Schedule 5B, para.10(1)(a)(b).

<sup>102</sup> Trustee Act 2000, s.1.

<sup>103</sup> See, e.g., Strategy Unit, *Charitable Incorporated Organisation*, London: Strategy Unit, Cabinet Office, December 2001, p 6.

<sup>104</sup> CA 1993, s.69B(6).

where the same people are to discharge different functions while wearing separate hats has been somewhat overstated. We think that the concerns that have been expressed can be satisfactorily addressed by the Charity Commission through the publication of model governing documents for CIOs under the powers provided in the Bill and through the issue of appropriate guidance.<sup>105</sup> Constitutions will also require careful drafting to ensure that the trustees from time to time are the only members of the charity and that a person is automatically admitted or removed as a member when they become or cease to be a trustee. In September 2008, the Charity Commission published drafts of two model constitutions for CIOs; one for an ‘association’ type of charity, and the other for a ‘foundation’ type charity.<sup>106</sup> The models take the form of complete constitutions and are set out in the same format as the Commission’s model governing documents for other charity structures. The constitutions contain provisions which are required to be included and best practice and have been prepared to provide what the Commission considers to be good governance. The notes accompanying the constitutions make clear which provisions must be included and which are recommended as best practice. Following the models will reduce the risk of ambiguity in the constitution and hopefully lessen the likelihood of internal disputes in the administration of CIOs. Using one of the model constitutions should also mean that the Charity Commission will be able to process applications for registration more quickly.

### 3. Name and Status

The CIO’s name must appear on specified documents, and if the name does not include ‘charitable incorporated organisation’, ‘CIO’ or the Welsh equivalent, the fact that it is a

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<sup>105</sup> Lord Bassam, Hansard debates, House of Lords, 14 March 2005: Vol 670, Col GC466. See also Lord Bassam’s similar comments on 12 July 2005: Lord Bassam, Hansard debates, House of Lords, 12 July 2005: Vol 673, Col 1072.

<sup>106</sup> Both the draft Charitable Incorporated Organisations (General) Regulations and the draft Charitable Incorporated Organisations (Insolvency and Dissolution) Regulations, together with the draft Model Constitution for a Charitable Organisation (‘Foundation’ version) and draft Model Constitution for a Charitable Organisation (‘Association’ version) were published on 10 September 2008. See [http://www.cabinetoffice.gov.uk/third\\_sector/Consultations/current\\_consultations/cio.aspx](http://www.cabinetoffice.gov.uk/third_sector/Consultations/current_consultations/cio.aspx)

CIO must also appear.<sup>107</sup> It is an offence, punishable by a fine, to issue or sign, or authorise to be issued or signed, a document that does not include the CIO's name and status when it should do so.<sup>108</sup>

#### 4. Registration of and Conversion to CIO

Section 69E sets out the basic procedures for registration with the Charity Commission, with the details to be set out in regulations. Any property vested in the applicants for the charitable purposes of the CIO becomes, on registration, vested in the CIO.<sup>109</sup>

As well as new organisations being able to register as CIOs, the Act contains provisions to enable a charitable company or a charitable industrial and provident society (IPS) (except for a company or IPS which has a share capital not fully paid up, or which is an exempt charity<sup>110</sup>) to convert to a CIO.<sup>111</sup> The Charity Commission will inform<sup>112</sup> the appropriate registrar (the Registrar of Companies or the Financial Services Authority) concerning an application for conversion and will consult that body<sup>113</sup> about whether or not to grant the application. If the application is made by a company limited by guarantee, the CIO constitution must specify the amount up to which the members are liable, which amount is not to be less than the amount to which they would be liable if the assets of the company were wound up.<sup>114</sup> This means that if the guarantee in the charitable company's constitution is for a significant amount, the constitution of the CIO must contain a

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<sup>107</sup> CA 1993, s.69C.

<sup>108</sup> Ibid, s.69D. See also *ibid*, s.69CA for the civil consequences of failing to comply with these requirements.

<sup>109</sup> Ibid, s.69F(3).

<sup>110</sup> Currently, all IPSs are exempt charities, but when Charities Act 2006, s.11 comes into effect, many IPSs will cease to be exempt.

<sup>111</sup> CA 1993, s.69G. Ss.69H-I contain supplementary provisions about the conversions of companies and IPSs.

<sup>112</sup> Ibid, ss.69G(4)(11).

<sup>113</sup> Ibid, s.69H.

<sup>114</sup> Ibid, ss.69G(8)(9).

members' guarantee for a similar or greater amount. Where the members' guarantee is £10 or less, it is automatically extinguished on conversion of the company to a CIO.<sup>115</sup>

The legal personality of the entity converting remains so that, for example, contractual relationships should not be affected by the conversion. Since the process of conversion will not interrupt the legal personality of the entity, liabilities of a charitable company or registered society are not affected by conversion to a CIO.<sup>116</sup> The existing corporate body simply becomes registered under different legislation.

Whilst it is likely that existing unincorporated charities will be most eager to convert to a CIO, the process for them is complicated. If trustees of charitable trusts and unincorporated associations wish to convert their unincorporated body into a CIO, they will need to set up a new CIO first. Then, section 69O applies the new section 74<sup>117</sup> of the Charities Act 1993,<sup>118</sup> giving the old unincorporated charity the power to resolve to transfer all its property to the newly formed CIO.<sup>119</sup> In order to use the power given in section 74, the trustees of the transferor charity must be satisfied that it is expedient in the interests of furthering the purposes for which the property is held for the property to be transferred in accordance with the resolution, and that the purposes (or any of the purposes) of the CIO to which property is to be transferred under the resolution are substantially similar to the purposes (or any of the purposes) of the transferor charity.<sup>120</sup> Unless the Charity Commission objects,<sup>121</sup> the resolution takes effect at the end of the period of 60 days beginning with the date on which the copy of it was received by the Commission (or from 42 days after any required public notice has been given). Where

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<sup>115</sup> Ibid, s.69G(10).

<sup>116</sup> See *ibid*, s.69I(9).

<sup>117</sup> For these purposes, *ibid*, s.74 is modified so that there is no requirement for a charity's gross income in its last financial year to be below £10,000: *ibid*, s.69O. The only limitation is that the charity must not hold any designated land (meaning land held on trusts which stipulate that it is to be used for the purposes, or any particular purposes, of the charity).

<sup>118</sup> As substituted by virtue of Charities Act 2006, s.40.

<sup>119</sup> The procedure is modified slightly under CA 1993, s.74B if the transferor charity has permanent endowment: *ibid*, s.74(15).

<sup>120</sup> *Ibid*, s.74(4).

<sup>121</sup> Under the provisions in *ibid*, s.74A.

such a resolution has taken effect, the trustees must arrange for all the property of the transferor charity to be transferred in accordance with the resolution, and on terms that any property so transferred is to be held by the CIO to which it is transferred, but when so held is nevertheless to be subject to any restrictions on expenditure to which it was subject as property of the transferor charity. The trustees of the transferor charity must arrange for the property to be so transferred by such date after the resolution takes effect as they agree with the trustees of the CIO. The trustees of the transferee CIO must secure, so far as is reasonably practicable, that the property is applied for such of its purposes as are substantially similar to those of the transferor charity. But this requirement does not apply if the CIO trustees consider that complying with it would not result in a suitable and effective method of applying the property.

Unlike with conversions of existing incorporated bodies to CIO status, conversions by unincorporated bodies will require the transferor charity to transfer all its assets and liabilities to the new CIO before the old charity is wound up. The Transfer of Undertakings Regulations<sup>122</sup> will be triggered, protecting the rights of any transferring employees. Contractual relationships will also need to be re-established with third parties. Questions arise as to the status of Gift Aid declarations made in favour of the old charity and whether they will be recognised as valid in relation to the new CIO.

Regulations will be made concerning the conversion of a community interest company<sup>123</sup> into a CIO.<sup>124</sup>

## 5. Merger of CIOs

There is a procedure for two or more CIOs to amalgamate into one new CIO.<sup>125</sup> There is, however, no specific provision for a charitable company or charitable industrial and

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<sup>122</sup> Transfer of Undertakings (Protection of Employment) Regulations 2006, SI 2006 No 246.

<sup>123</sup> See below.

<sup>124</sup> CA 1993, s.69J.

<sup>125</sup> Ibid, ss.69K-L.

provident society (IPS) to merge with a CIO, or for two companies or IPSs to become a CIO by merger. Section 69M sets out the procedure for a CIO to transfer all of its property, rights and liabilities to another CIO. Upon confirmation of the required resolution, all the property, rights and liabilities of the transferor CIO become the property, rights and liabilities of the transferee CIO and the transferor CIO is dissolved.<sup>126</sup> Gifts given to the transferor CIO are deemed to be given to the transferee CIO, if they are to take effect on or after the confirmation of the resolution.<sup>127</sup>

## 6. Winding Up, Insolvency and Dissolution

Regulations will provide for the winding up, insolvency, dissolution, and revival and restoration to the register following dissolution, of CIOs.<sup>128</sup>

## 7. The Anticipated Advantages of the CIO

As well as the obvious advantages that a corporate structure brings, such as legal personality and limited liability, the CIO - as a separate vehicle for charities, specifically attuned to their needs - will also enjoy the following benefits:

- (a) A single registration – a charitable company has to register with the Registrar of Companies at Companies House and the Charity Commission. A CIO will only need to register at the Charity Commission;
- (b) One annual return - charitable companies have to prepare an annual return under company law and (normally) a separate return under charity law;
- (c) Reduced filing requirements – CIOs will only have to send accounts, reports and returns to the Charity Commission. Charitable companies have to send these to both the Commission and to Companies House;
- (d) Simpler requirements relating to the reporting of constitutional and governance changes - CIOs will be subject to a less extensive range of reporting requirements

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<sup>126</sup> Ibid, s.69M(12).

<sup>127</sup> Ibid, s.69M(13).

<sup>128</sup> Ibid, s.69N.

- than charitable companies, and will only have to report to the Charity Commission, rather than both to the Commission and to the Registrar of Companies;
- (e) Lower costs for charities – the Charity Commission makes no charges for registration and filing of information, whereas Companies House does;
  - (f) Simpler constitutional forms – because the CIO will not be sharing a framework with commercial bodies, statutory default powers are provided covering ground which might otherwise need explicit constitutional provision;
  - (g) Greater constitutional flexibility - whilst the legal framework for CIOs contains some governance provisions which cannot be modified, in other respects CIOs can decide their own procedures;
  - (h) More straightforward arrangements for merger and reconstruction – the Charities Act 2006 contains a number of provisions designed to facilitate merger and reconstruction which are not available to charitable companies;
  - (i) An enforcement regime which does not penalise the charity for the misconduct of its directors - a commercial company, which ultimately operates for the financial benefit of shareholders, can be penalised for the misconduct of directors (which, in effect penalises the shareholders themselves). This is not the approach proposed for a CIO, which does not operate for the benefit of its members; and,
  - (j) A clear set of duties for charity trustees and members which specifically reflect the charitable nature of the CIO.

CIOs will therefore be attractive where the principal concerns are:

- (a) avoiding the inconvenience of dual regulation, or;
- (b) the ability to benefit from the tax advantages inherent with charitable status, or;
- (c) where there is anxiety about unlimited liability.

## 8. Questions over the CIO

Until the regulations are finalised and the law comes into force, however, there is clearly uncertainty as to the way in which CIOs will ultimately operate. The success of the CIO

will obviously depend upon the secondary legislation which will provide the flesh to the bones of the statute. Early clues as to the form which the CIO would ultimately take were found in the Skeleton Instructions for the Drafting of a Charitable Incorporated Institutions Act / Legislation,<sup>129</sup> produced as a background paper to the Modern Company Law Review,<sup>130</sup> and the ‘dummy’ regulations<sup>131</sup> published to accompany the version of the Charities Bill which ran out of parliamentary time (due to the general election) in 2005. These early indications did not bode well for the future. Instead of using the concepts and terminology current in the charitable sector, their content was closely based on the concepts and language associated with companies. This suggested that existing provisions of company law would transfer across to CIOs, with some modifications, and begged the question about the necessity or advantages of the CIO. If the regulations were simply to import company law concepts, to be regulated by the Charity Commission instead of Companies House, this could lead to more complexity and uncertainty. Company law is designed primarily to meet the practicalities of the commercial sector, rather than the different ethos of the not-for-profit sector. Fortunately, the later drafts of the regulations, produced in September 2008, appear to be more specifically tailored to the charity environment. For example, there is recognition that the company law provisions that protect members’ rights, including the statutory right to remove a director are not appropriate for a CIO. In relation to the removal of directors, it is not considered to be good charity governance that the members of a charity should have an automatic right to remove those who are responsible for managing it, without good reason in the interests of the charity. On the other hand, the draft Charitable Incorporated Organisations (Insolvency and Dissolution) Regulations, still contain references to large chunks of the Insolvency Act 1986 and the Company Directors Disqualification Act 1986 being applied to CIOs as they apply to companies, with, for example, references to ‘companies’ being treated as references to ‘CIOs’, or references to the ‘Registrar of Companies’ or the ‘Secretary of State’ being treated as references to the ‘Charity Commission’. Another example of importing company law is provided by the draft Charitable Incorporated

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<sup>129</sup> At that time, the CIO was provisionally known as the Charitable Incorporated Institution.

<sup>130</sup> See above. See also F Quint, ‘A New Charitable Incorporated Vehicle’ (2000) 6 *CL&PR* 199.

<sup>131</sup> Draft Charitable Incorporated Organisation Regulations, published 19 January 2005.

Organisations (General) Regulations, which largely follow the model of company law in connection with the provision of business information available to the public. In this regard, it is proposed that a CIO will be required to maintain registers of: members; trustees; charges over its property; and, any debentures issued by it.

Nevertheless, it is envisaged that a significant number of new entities will be incorporated as CIOs. In relation to existing charities,<sup>132</sup> it is anticipated that, initially, the CIO will be of most interest to unincorporated, medium-sized charities. Also, some previously excepted<sup>133</sup> charities, such as larger religious charities will have to register for the first time under the Charities Act 2006<sup>134</sup> - becoming a CIO might be attractive to them as well. This route may also be attractive to charitable industrial and provident societies that will lose their exempt status<sup>135</sup> under the Charities Act 2006<sup>136</sup> (unless they are Registered Social Landlords under Part 1 of the Housing Act 1996) and that, if they wish to preserve or achieve charitable status, will have to register with the Charity Commission (including showing that they exist for charitable purposes only and that they satisfy the public benefit test). Existing registered corporate charities might be less willing to abandon their corporate status and to enter unknown territory.

Another view is that, whilst the whole point of the CIO is to create a less burdensome legal environment for charities, the wholesale reform of company law<sup>137</sup> may mean that the charitable company structure ends up being simpler to operate than the CIO structure. In addition, some might say that the problems with dual regulation between Companies House and the Charity Commission are arguably over-stated, and could be ameliorated by greater co-operation between the two regulators. The extent to which the perceived

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<sup>132</sup> Currently 86% of the 190,000+ registered charities are unincorporated charities: Office of the Third Sector and Charity Commission, *The Charitable Incorporated Organisation (CIO). Consultation on the new corporate form for charities*, September 2008, Annex H, Draft Impact Assessment.

<sup>133</sup> Excepted charities are charities that at present are not obliged to register with the Charity Commission, though they are regulated by it.

<sup>134</sup> Under Charities Act 2006, s.9, which creates CA 1993, s.3A.

<sup>135</sup> Exempt charities are charities that at present are neither registered with nor regulated by the Charity Commission.

<sup>136</sup> Under Charities Act 2006, s.11, which amends CA 1993, Schedule 2.

<sup>137</sup> Being implemented in stages under the Companies Act 2006.

advantages of a single regulatory authority will be significant, cannot be determined at this point.

The main challenge for the Charity Commission, as regulator, is to achieve both administrative ease for charities and sufficient accountability to encourage public trust and confidence of those who deal with CIOs. In order for the CIO to be an attractive option for charities, its regulatory requirements must not be more onerous than those of existing charity structures. However, at the same time, it cannot be ignored that the CIO will provide the benefit of protection for its members and trustees from the liabilities of the CIO, and therefore the introduction of additional or different regulatory requirements to those which apply to unincorporated charities is inevitable. Getting the balance right will be crucial to the success of the CIO. The regulators are openly struggling with this tension. For example, the September 2008 draft regulations and accompanying consultation documentation acknowledge that the appropriate accounting framework for CIOs is yet to be determined. Should the stricter accounting framework that applies to all companies require all CIOs to produce accruals accounts? Or, in order to make the CIO an attractive and viable option to the 56% of registered charities that have an income below £10,000, should the framework that applies to unincorporated charities apply,<sup>138</sup> so that a CIO's accounting requirements are directly linked to its size?<sup>139</sup>

It also remains to be seen whether Dunn and Riley's observation that by 'developing the CIO as a legal vehicle outside the "stable" of statutory companies, it will not be tainted by their commercial values'<sup>140</sup> holds true.

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<sup>138</sup> Unincorporated charities with an income below £100,000 are able to opt to prepare simpler (and cheaper) receipts and payments accounts, rather than the more complex (and expensive) accruals accounts. The £100,000 threshold is to be increased to £250,000 by April 2009.

<sup>139</sup> Office of the Third Sector and Charity Commission, *The Charitable Incorporated Organisation (CIO). Consultation on the new corporate form for charities*, September 2008.

<sup>140</sup> A Dunn and CA Riley, 'Supporting the Not-for-Profit Sector: the Government's Review of Charitable and Social Enterprise' (2004) 67(4) *MLR* 632 at p.656.

Whilst the CIO has clear benefits over other corporate forms, it will still remain simpler to set up and run a charity as an unincorporated association. Charity trustees of CIOs will have the same duties and responsibilities as trustees of unincorporated associations, but there will be a number of additional requirements for CIOs:<sup>141</sup>

- (a) A CIO must keep registers of its charity trustees and members and make these registers available for public inspection;
- (b) A CIO must keep a register of any charges over its assets;
- (c) All CIOs must submit annual accounts, annual reports and an annual return to the Charity Commission, regardless of their income;<sup>142</sup>
- (d) The form of constitution for CIOs is less flexible than for unincorporated associations;
- (e) There are a number of criminal offences which could apply to the trustees of CIOs if they fail to meet the requirements set out in the legislation; and,
- (f) CIOs must notify the Charity Commission of certain charges over their property.

## 9. The Future

The Strategy Unit's recommendation was that the CIO should be introduced as an additional legal form available for charities, to operate alongside other legal forms for a period of say three years.<sup>143</sup> It was considered that this would provide sufficient time to assess take up and the efficacy of the new form in comparison with existing forms. At the end of this period, consideration might be given to whether other forms of incorporation should continue to be available for charities. Until public confidence in the proposed CIO structure is established, and an understanding is gained of its advantages and disadvantages, the CIO structure should remain optional rather than compulsory for

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<sup>141</sup> Some of these have just become apparent in the proposals contained in the draft Charitable Incorporated Organisations (General) Regulations, published in September 2008.

<sup>142</sup> For other charities only those with an income of over £10,000 must do so, and that threshold is to be increased to £25,000 by April 2009.

<sup>143</sup> Strategy Unit, *Charitable Incorporated Organisation*, London: Strategy Unit, Cabinet Office, December 2001, p 8.

charities. It is therefore envisaged that a formal assessment of the new structure will take place as part of the review of the impact of the Charities Act 2006 which is due to take place within five years of enactment, and which will report to Parliament.<sup>144</sup>

## COMMUNITY INTEREST COMPANIES

The Community Interest Company (CIC) is an entirely new hybrid form. Whilst it is a type of non-charitable company, it is nevertheless designed for social enterprises that want to use their profits and assets for the public good.<sup>145</sup> The CIC was introduced as a legal form in July 2005, and, already, over 2,000 CICs have been registered,<sup>146</sup> operating a wide range of community projects, such as childcare provision, social housing, leisure and community transport.

### 1. Background

The company form is attractive to many social enterprises. Company law is well developed and it is understood by professionals such as bankers and lawyers.<sup>147</sup> The company limited by guarantee form in particular is popular, and is used by some very large charities.<sup>148</sup> Against the popularity and strong image of companies, however, must be balanced the fact that the company ‘brand’ is almost exclusively associated with profit-making. Company Law was not originally designed with the needs of smaller scale community-based social enterprises in mind.<sup>149</sup> Companies without charitable status

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<sup>144</sup> Under Charities Act 2006, s.73.

<sup>145</sup> See A Dunn and CA Riley, ‘Supporting the Not-for-Profit Sector: the Government’s Review of Charitable and Social Enterprise’ (2004) 67(4) *MLR* 632 who strongly question the value of creating a form specifically for social enterprises, rather than for not-for-profits in general.

<sup>146</sup> [www.cicregulator.gov.uk](http://www.cicregulator.gov.uk)

<sup>147</sup> Strategy Unit, *Private Action, Public Benefit. A Review of Charities and the Wider Not-For-Profit Sector*, London: Strategy Unit, Cabinet Office, September 2002, para.5.19

<sup>148</sup> See above.

<sup>149</sup> Admittedly, a number of the reforms introduced in the Companies Act 2006 are intended to benefit small companies. The Final Report of the Company Law Review contained a range of recommendations for substantive changes to many areas of company law, and a set of principles to guide the development of the law more generally, including that it should be as simple and as accessible as possible for smaller firms and their advisers.

found it difficult to ensure that their assets were dedicated to public benefit, and the company limited by guarantee does not allow access to equity.

The proposal to introduce the CIC was included in the Strategy Unit report,<sup>150</sup> and subsequently, detailed policy proposals were developed and the Department of Trade and Industry launched a formal consultation in March 2003.<sup>151</sup> Primary legislation to create CICs, which came into force on 1<sup>st</sup> July 2005, was contained in Part 2 of the Companies (Audit, Investigations and Community Enterprise) Act 2004.<sup>152</sup>

## 2. Creation of CICs

The formation and registration process for a CIC is similar to that of any limited company.<sup>153</sup> The full range of limited company forms is available to CICs, including that of a company limited by guarantee and also by shares.<sup>154</sup> The CIC website<sup>155</sup> contains guidance notes, model governing documents for a company limited by guarantee and company limited by shares, model community interest statements, and other information. The memorandum and articles<sup>156</sup> are in different versions for a CIC with a large membership (a body of company members in addition to the company directors) and for a CIC with a small membership (usually where the company members are the same people as the directors). A CIC can be a private company or a public limited company. CICs register with Companies House, then apply for CIC status to the Regulator of CICs (similar to the current process, where an organisation registers as a company limited by

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<sup>150</sup> Strategy Unit, *Private Action, Public Benefit. A Review of Charities and the Wider Not-For-Profit Sector*, London: Strategy Unit, Cabinet Office, September 2002, paras.5.21-5.32.

<sup>151</sup> DTI, *Enterprise for Communities: proposals for a Community Interest Company*, March 2003.

<sup>152</sup> Companies (Audit, Investigations and Community Enterprise) Act 2004 contains the basic CIC provisions in Part 2 (ss.26-63). The Act confers on the Secretary of State power to make regulations in respect of various aspects of the conduct of CICs' affairs and their supervision by the Regulator of CICs. See now, Community Interest Company Regulations 2005, SI 2005 No 1788.

<sup>153</sup> See Companies (Audit, Investigations and Community Enterprise) Act 2004, s.36 for new companies and ss.37-38 for existing companies.

<sup>154</sup> Ibid, ss.26(1)(2).

<sup>155</sup> [www.cicregulator.gov.uk](http://www.cicregulator.gov.uk)

<sup>156</sup> These must be drafted in compliance with SI 2005 No 1788, Schedules 1-3.

guarantee and then applies to the Charity Commission for charitable status).<sup>157</sup> The name of a CIC must end in either ‘community interest public limited company (or plc)’ or ‘community interest company (or CIC)’ or their welsh equivalents.<sup>158</sup> A CIC cannot be formed to support political activities.<sup>159</sup>

The two main features that distinguish CICs from ‘normal’ companies are the asset lock and the requirement to satisfy the community interest test.

### *The Asset Lock*

Under general company law there is nothing to stop the members of non-charitable companies, even those set up for community benefit, from passing a resolution to distribute the companies’ assets to themselves. CICs, however, have an ‘asset lock’<sup>160</sup> which prevents assets from being used for purposes that are not for the benefit of the community. Neither the CIC nor its assets can be transferred into private ownership following a change in the constitution or a take-over by another organisation. This means, for example, that profits and other assets cannot be distributed to members of the CIC, except in very limited circumstances.<sup>161</sup> A CIC can pay its directors, provided that the payment is reasonable. A CIC can borrow money, but there is a limit, set by the CIC Regulator, on how much interest it can pay.<sup>162</sup> In order to raise investment, a CIC set up as a company limited by shares can issue shares that pay a dividend to investors. However, there is a cap, set by the Regulator,<sup>163</sup> on the level of dividends and on how

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<sup>157</sup> Companies (Audit, Investigations and Community Enterprise) Act 2004, ss.36-37.

<sup>158</sup> Ibid, s.33.

<sup>159</sup> Ibid, s.35(6) and SI 2005 No 1788, reg.6.

<sup>160</sup> Sometimes referred to as a non-distribution constraint.

<sup>161</sup> Companies (Audit, Investigations and Community Enterprise) Act 2004, s.30 and SI 2005 No 1788, regs.17-25.

<sup>162</sup> The cap on performance related interest is 4% above the Bank of England base rate: SI 2005 No 1788, reg.22(1)(c).

<sup>163</sup> The Regulator, taking the views of the social enterprise sector into account, is responsible for setting the cap in a way that will balance the need to encourage investment with the primacy of community interest.

much of the CIC's assets can be paid as dividend.<sup>164</sup> This may well create a barrier to investment. A CIC's assets can be given away or sold at below market value only to another asset-locked body (such as a charity or another CIC).<sup>165</sup>

Charities have always been subject to such an 'asset lock', but with the introduction of CICs in 2005, this was a new feature for non-charitable structures.<sup>166</sup>

### *Community Interest Test*

A company satisfies the community interest test if a reasonable person might consider that the activities that the CIC is undertaking are being carried on for the benefit of the community.<sup>167</sup> The Regulator must decide whether applicants for CIC status satisfy this test, which is intended to be 'light-touch'. By February 2007, only one application was turned down on this basis and this was from an organisation delivering support services to the sado-masochistic community.<sup>168</sup> The decisions of the Regulator are subject to review by an Appeal Officer, appointed by the Secretary of State.<sup>169</sup> 'Community' for the purposes of a CIC must be wider than the members of the CIC. It must also be wider than the employees who work for the CIC. The regulations made under the Act provide that any group of individuals may constitute a section of the community if they share a readily identifiable characteristic and other members of the community of which this group forms part do not share that characteristic.<sup>170</sup>

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<sup>164</sup> The cap is, at present, a maximum dividend per share of 5% above the Bank of England base rate and a maximum aggregated dividend of 35% of the distributable profits: SI 2005 No 1788, regs.22(1)(a)(b).

<sup>165</sup> See, e.g., SI 2005 No 1788, Schedule 1, para.1.

<sup>166</sup> Since the introduction of the Community Benefit Societies (Restriction on Use of Assets) Regulations 2006, SI 2006 No.264, it is also now possible for the members of this type of industrial and provident society to include such an asset lock in its constitution.

<sup>167</sup> Companies (Audit, Investigations and Community Enterprise) Act 2004, s.35. See also SI 2005 No 1788, regs.26-29.

<sup>168</sup> See 'Fetish group whips up a storm' *Times* 20 September 2005 and 'How to: Decide between charitable and CIC status' *Third Sector Online* 20 February 2007.

<sup>169</sup> Companies (Audit, Investigations and Community Enterprise) Act 2004, s.28 and Sched.4.

<sup>170</sup> SI 2005 No 1788, reg.5.

### 3. CIC Regulation

Under a simple regulatory regime, CICs must report annually to the CIC Regulator<sup>171</sup> (via the Registrar of Companies) on how they are passing the community interest test and on how they are involving their stakeholders in their activities.<sup>172</sup> This is in addition to the requirements to produce the usual accounts and returns to Companies House. The very active regulation which is necessary for charities is not required for CICs. For example, the new public benefit test, to which charities will be subjected under the Charities Act 2006,<sup>173</sup> will not apply to CICs. However, the Regulator has a range of powers to ensure that confidence in CICs is not undermined. The powers include the ability to:<sup>174</sup>

- (a) Investigate (or appoint someone else to investigate) the affairs of a CIC;
- (b) Require the CIC's accounts to be audited.
- (c) Bring civil proceedings in the name of a CIC;
- (d) Appoint or remove directors;
- (e) Appoint a manager in respect of the CIC's property and affairs;
- (f) Present a petition to the Courts for the winding up of a CIC; and,
- (g) Apply to the Court for an order that the dissolution of a CIC is void.

These powers are not expected to be used often - they should be exercised only to the extent necessary to maintain confidence in CICs<sup>175</sup> - but are available to the Regulator to use in cases raising matters of serious concern.

A memorandum of understanding between the Charity Commission and the CIC Regulator has been drawn up to establish liaison arrangements.<sup>176</sup> This is to ensure appropriate consultation and co-ordination of action when a charitable company proposes

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<sup>171</sup> See Companies (Audit, Investigations and Community Enterprise) Act 2004, s.27 and Schedule 3 relating to the establishment of the office of Regulator of CICs.

<sup>172</sup> Ibid, s.34 and SI 2005 No 1788, regs.26-29.

<sup>173</sup> Charities Act 2006, s.3.

<sup>174</sup> Companies (Audit, Investigations and Community Enterprise) Act 2004, ss.42-51.

<sup>175</sup> Ibid, s.41(1).

<sup>176</sup> Charity Commission, *Memorandum of Understanding between the Charity Commission and the Regulator of Community Interest Companies*, December 2005.

to convert to a CIC, or vice versa.<sup>177</sup> In addition, it will promote appropriate and effective regulation of the company, and property held by it, after conversion has taken place. Both the Charity Commission<sup>178</sup> and the CIC Regulator<sup>179</sup> will encourage the disclosure and exchange of information between them where appropriate, in order to maximise the efficiency of their respective functions. Where it appears expedient in the interests of achieving effective and proportionate regulation, the Commission and the Regulator may conduct regulatory casework jointly. In conducting such cases, both the Regulator and the Commission will each pursue their respective functions but will share resources and pool information. The Commission and the Regulator will consult each other prior to issuing or publishing any guidance, advice or best practice recommendations relating to the conversion of a charitable company to a CIC or vice versa.

#### 4. Conversion of a Charity to a CIC

A CIC must be a limited company. Therefore an unincorporated charity cannot convert to a CIC. If trustees of charitable trusts and unincorporated associations wish to convert their unincorporated body into a CIC, they will need to set up a new CIC first. The new CIC may be appointed as a corporate trustee of the charitable assets belonging to the unincorporated charity and may then apply the charitable assets for the furtherance of the charity's objects. If the CIC was formed with the same objects as the unincorporated charity or trust, the assets may be transferred to the CIC for the furtherance of its objects.

If the assets of the unincorporated association or trust are depleted to a point where there are no assets remaining, and there is no permanent endowment, it may be wound-up.

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<sup>177</sup> See below.

<sup>178</sup> CA 1993, s.10 permits the disclosure of information between the Commission and any person or organisation discharging functions of a public nature where the disclosure is made for any purpose connected with the discharge of that person's or organisation's functions.

<sup>179</sup> Companies (Audit, Investigations and Community Enterprise) Act 2004, s.59 permits the disclosure of information between the Regulator and any public authority where the disclosure is made in connection with the functions of either the Regulator or the public authority.

Additional provisions apply to an existing charitable company that wishes to become a CIC.<sup>180</sup> The key procedural provision is that the Charity Commission must consent to the change of name.<sup>181</sup> If consent is refused, the Commission will inform the CIC Regulator accordingly.<sup>182</sup> The Charity Commission has a right to apply to the High Court for an order quashing the conversion of any charity that was made without its consent.<sup>183</sup> If a charitable company, immediately prior to its conversion to a CIC, owns property, the property will, upon conversion, become impressed with a trust for charitable purposes and the CIC will be the trustee.<sup>184</sup>

The CIC Regulator will provide to the Charity Commission details of any charity that completes the process of conversion to CIC, together with the effective date of conversion.<sup>185</sup> Where a charitable company converts to a CIC and, as a consequence, becomes the trustee of charitable property, the Commission and the Regulator will discuss and agree the most appropriate and effective arrangements for the submission by the CIC of annual accounts and / or reports.

## 5. Conversion of a CIC to a Charitable Company

If a CIC wishes to give up its CIC status and become a charitable company, it must change its name and make any other appropriate changes to its constitution by special resolution.<sup>186</sup> Such changes must be notified to the Registrar of Companies.<sup>187</sup> Where changes to the memorandum are made, the company must not submit its application to

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<sup>180</sup> Ibid, s.39.

<sup>181</sup> This is required under *ibid*, s.37(1)(c) for conversions from existing companies to CICs: *Ibid*, s.39(1).

<sup>182</sup> Charity Commission, *Memorandum of Understanding between the Charity Commission and the Regulator of Community Interest Companies*, December 2005.

<sup>183</sup> Companies (Audit, Investigations and Community Enterprise) Act 2004, s.39(2). The Charity Commission's right to apply for such an order is without prejudice to the power of the Attorney General to apply to court to quash a registration which has been improperly or erroneously allowed.

<sup>184</sup> *Ibid*, s.39(3).

<sup>185</sup> Charity Commission, *Memorandum of Understanding between the Charity Commission and the Regulator of Community Interest Companies*, December 2005.

<sup>186</sup> Companies (Audit, Investigations and Community Enterprise) Act 2004, s.54(1).

<sup>187</sup> *Ibid*, s.54(2).

give up CIC status until either the changes have been confirmed by the court, following the raising of objections, or the deadline for objections (under Company Law provisions) has passed.<sup>188</sup> For CICs with their registered offices in England and Wales, or in Wales, conversion to a charitable company will not be permitted without a written statement from the Charity Commission (which must be sent to the Registrar of Companies together with a copy of the memorandum and articles of the company as altered by the special resolutions<sup>189</sup>) that in its opinion, the converted body will have charitable status (and will not be an exempt charity) once the special resolutions have taken effect.<sup>190</sup> Upon receipt of the special resolutions, the memorandum and articles as altered by the special resolutions and the Charity Commission statement, the Registrar of Companies must forward a copy of each of the documents to the CIC Regulator, and retain them pending the Regulator’s decision.<sup>191</sup> The CIC Regulator must then decide whether the CIC seeking to become a charity is eligible to cease to be a CIC.<sup>192</sup> The company will not be eligible if the Regulator has exercised certain supervisory powers<sup>193</sup> in respect of that CIC, and the exercise of those supervisory powers is still ongoing.<sup>194</sup> If the Regulator decides that the company is not eligible to cease being a CIC, the company may appeal to the Appeal Officer against the decision.<sup>195</sup> If the Regulator gives notice to the Registrar of Companies of a decision that the company is eligible to cease being a CIC, the Registrar of Companies will enter the new name of the company on the register and will also retain and record the special resolutions and the statement.<sup>196</sup> On the date on which the certificate of incorporation is issued, the alterations to the company’s articles and memorandum made by the special resolutions take effect and the company ceases to be a CIC.<sup>197</sup>

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<sup>188</sup> Ibid, ss.54(3)(4)(5).

<sup>189</sup> Ibid, s.54(6).

<sup>190</sup> Ibid, s.54(7).

<sup>191</sup> Ibid, s.55(1).

<sup>192</sup> Ibid, s.55(3).

<sup>193</sup> These are outlined in *ibid*, ss.55(4)(a)-(h).

<sup>194</sup> Ibid, s.55(4).

<sup>195</sup> Ibid, s.55(8).

<sup>196</sup> Ibid, s.55(6).

<sup>197</sup> Ibid, s.55(7).

The CIC Regulator will provide the Charity Commission with details of all CICs which convert to charitable company status so that the Commission is able to pursue, if appropriate, any subsequent failure by a company to register as a charity.<sup>198</sup>

## 6. Uses of the CIC

The CIC has been designed to help to meet the need for a transparent flexible model, clearly defined and easily recognised. Its special characteristics are intended to make it a particularly suitable vehicle for some types of social enterprise - essentially, those that wish to work for community benefit within the relative freedom of the non-charitable company form, but with an assurance of non-profit-distribution status. The non-charitable social enterprise sector is developing fast, both in size and sophistication, and it is important to ensure that new projects are set up with the correct legal structure to suit their particular objectives and stakeholders. The CIC is proving to be a useful addition to the range of legal forms available for operating such projects in the community.<sup>199</sup>

CICs are intended to address the legal problems that confront many social enterprises; on the one hand, if they are established as charities, they can be financially constrained with limited opportunities for growth, or access to capital. On the other hand, if they are incorporated as private companies, they risk losing public trust. The CIC ‘brand’ will be attractive to social enterprises that wish to have both a ‘quasi-charitable’ image and company status, rather than having to choose between the two. They are transparent with publicly available community interest statements and they are overseen by the CIC Regulator. Demonstrating community interest is of value to those seeking grant funding or philanthropic investment. CIC status may help to attract the kind of lottery and grant-aided funding from public sources, charities and philanthropists normally reserved for

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<sup>198</sup> Charity Commission, *Memorandum of Understanding between the Charity Commission and the Regulator of Community Interest Companies*, December 2005.

<sup>199</sup> For an early assessment of some of the main features of the CIC, see A Dunn and CA Riley, ‘Supporting the Not-for-Profit Sector: the Government’s Review of Charitable and Social Enterprise’ (2004) 67(4) *MLR* 632 at p 650-655.

charitable organisations. The extra CIC regulation is likely to provide further comfort to investors, or grant or fund administrators, when choosing where investments and grants should be given, and external investors can get a return on their capital by way of dividends (subject to the cap set by the CIC regulator). The combination of ‘charity-like’ features together with the dynamism associated with entrepreneurialism may well project a good image for many social businesses.

CICs may also be of interest to local authorities wanting to enter into joint ventures with private sector partners. The use of a CIC allows the local authority both to protect assets and also to highlight the social purpose of the venture.

Some existing charities that have trading subsidiaries<sup>200</sup> may decide that the distinction that the CIC confers, clearly differentiating their charitable work from the pursuit of profits for the social good, is valuable to them. In this way, a CIC will be able to run a charity shop and pass all the profits back in a tax efficient manner to the charity that owns it.

There are many unincorporated bodies running recreational, village and community facilities (many with valuable heritable assets) which may see incorporation as a CIC as helping to protect these assets, and through the limited liability principles of company law, protecting those who run them at the same time. In addition, a CIC, as an incorporated body, has continuity of purpose,<sup>201</sup> existing until it is dissolved.

Nevertheless, it should be noted that CICs do *not* have charitable status, even if their objects are wholly charitable,<sup>202</sup> so they are not entitled to the associated tax and rate reliefs. This may be a considerable disadvantage if the organisation is likely to have

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<sup>200</sup> See above.

<sup>201</sup> Private purpose trusts, on the other hand, come up against a number of legal hurdles, one of which is the rule against perpetuities. As to the application of the rule against inalienability to CICs, see I Dawson, ‘The Rule Against Inalienability – A Rule Without a Purpose?’ [2006] *Legal Studies* 414.

<sup>202</sup> Companies (Audit, Investigations and Community Enterprise) Act 2004, s.26(3).

significant surplus profits. Specific regional relief and access to lottery<sup>203</sup> and other funding may be open to CICs, due to the types of activities undertaken or their location. A CIC may also be eligible for relief from non-domestic rates if it is a not-for-profit pursuing educational objectives. There may well be a delicate balancing act to perform, weighing up the possible advantages of forming a CIC against the disadvantage of failing to attract the tax concessions open to registered charities.

CICs are therefore suitable for a social enterprise whose activities are not wholly charitable, or where those involved need greater operational flexibility or where tax advantages are not a material consideration.

### CHARITABLE COMPANIES, CICS AND CIOs – SOME EARLY OBSERVATIONS

The similarities and differences between the new hybrid forms, together with their benefits have been outlined. The differing organisational, operational and legal frameworks relating to charitable companies, CICs, and CIOs clearly offer more choice for social traders. The charity sector is extremely diverse, both in terms of size of organisations<sup>204</sup> and activity, and the development of any new legal entity will surely enhance the diversity and flexibility that the sector demands. It is no coincidence that legal forms for charitable and non-charitable activity are starting to overlap somewhat at the same time that there is a noticeable blurring of the line between charitable and commercial undertakings. Charities are increasingly collaborating with business and businesses are increasingly collaborating with charities.<sup>205</sup> The development of the boundary-crossing CIC – a

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<sup>203</sup> The National Lottery etc. Act 1993, ss.38(1) and 44(1) provides that the National Lottery Charities Board may make grants to both charities and institutions, other than charities, that are established for charitable purposes (whether or not those purposes are charitable within the meaning of any rule of law), benevolent purposes or philanthropic purposes.

<sup>204</sup> The latest figures from the Charity Commission reveal that at the end of March 2008, there were 190,387 charities on the Register. Of these, 21,054 were subsidiaries or constituents of other charities. The majority of registered charities have an income of £10,000 or less. These small charities represent over 50% of registered charities but have less than 1% of the income recorded. At the other end of the scale, around 8% of charities receive over 90% of the total annual income recorded. The largest 706 charities (0.42% of those on the register) attract nearly 50% of the total income.

<sup>205</sup> See, e.g., Charity Commission, *Charities and Commercial Partners*, RS2, London: TSO, July 2002.

halfway house between charity and business – is a timely one. It is predicted that the charitable sector will continue to diversify, and boundaries are likely to blur further with commercial activities such as those carried out by CICs being increasingly associated with more traditional charitable organisations.

The law regulating any legal form needs to be well understood. A CIC is a very different animal from a CIO and is designed to serve a different purpose. Already, however, there has been some confusion between the two new legal forms. Whilst it has been described as ‘bizarre’,<sup>206</sup> a CIC (even with charitable purposes) cannot be a charity,<sup>207</sup> and a charity cannot be a CIC – the two are mutually exclusive. On the other hand, the very essence of a CIO is that it is both a charity and a company. So, whilst a CIO must be established for exclusively charitable purposes, a CIC can be established for any purpose so long as its activities are carried on for the benefit of the community (which is a wider test than the ‘public benefit’ test applicable to charities). However, it is already possible for a CIC to convert to a charity and a charity to convert to a CIC. In the future, there could well be CIO to CIC conversions and vice versa. It is more likely though that charities will apply to register a CIC as a subsidiary company.

Company law applies to CICs, whilst CIOs will have their own form of regulation. The operation of companies is well understood. This may provide greater certainty for those involved in the running of a CIC when compared with a CIO, for which no body of case law yet exists. This might, initially, make it difficult (and more expensive) to acquire legal advice relating to the setting up of CIOs. Whilst one can question the appropriateness of company law’s application to charitable bodies, at least it is an area of law with which many lawyers are familiar. Many charities have either no or very limited funds to acquire professional advice and consequently the new forms and their legislative framework should be as clear and readily understandable as possible to all concerned. There might also be issues with funders and lenders, unaware of the new structure. While the concept

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<sup>206</sup> See Lord Phillips of Sudbury, Official Report of the Grand Committee on the Companies (Audit, Investigations and Community Enterprise) Bill [HL] 25 Mar 2004: Column GC318.

<sup>207</sup> Companies (Audit, Investigations and Community Enterprise) Act 2004, s.26(3).

of a company is globally understood, CIOs are unknown and untested. This may cause problems for charities relying on foreign support. Simplicity is fundamental.

Even CICs, falling back on the familiarity of the company law framework, are suffering through lack of understanding. A forum for CICs has been created under the aegis of the Social Enterprise Coalition. At its first meeting in May 2008, a number of CICs reported that their biggest problem was that nobody knows what they are and that they have to spend all their time explaining what they do.<sup>208</sup> Members of the forum felt that there was a need for greater recognition of the CIC model as a trustworthy brand, so as to generate confidence amongst funders. More widespread education and knowledge about CICs is needed within CICs and across government, support bodies and funders in order to promote use and awareness and to prevent conflicting advice.

The closely connected regulatory frameworks also provide opportunity for confusion, for both social entrepreneurs and their funders. Whilst the policy reason for the continued separate treatment of charities remain (and in particular, one needs to remember their favourable tax status), the risk of blurring the distinction between charitable and non-charitable organisations in a way which might mislead the public is a real one. Whilst CIOs (under the supervision of the Charity Commission) should ultimately simply provide a new legal structure to be used to pursue traditional charitable purposes, CICs, conversely, (under the supervision of the CIC Regulator) are not just an adjunct to charity law. With their simplified regulatory regime, the asset lock to provide donor, investor and public confidence, and the yearly social reporting, CICs are proving to be attractive to a new breed of social entrepreneurs.

With the blurring of boundaries between charitable and (not quite) charitable activity and the proliferation of cross-sectoral partnerships, there is a need for regulation to be more joined up across the borders. Regulators must work more effectively with each other and infrastructure bodies to deliver effective balanced regulation which protects the public

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<sup>208</sup> 'Bland hits out over lack of cash for CIC promotion' *Third Sector Online* 23 July 2008.

interest. There may well have been a less pressing need for the development of the CIO, had the Charity Commission and the Registrar of Companies been able to enjoy a better dialogue. The Memorandum of Understanding between the Charity Commission and the CIC Regulator signals an important step, with both regulators outlining the ways in which they will be exchanging information, for example, and ensuring consistency as policy is developed. The regulators should also play their part in addressing the need for greater clarity and allaying public confusion. Uncertainty about what the charitable sector is and what it is for could lead to a decrease in charitable donation and volunteer activity in the future. The sector itself will need to explore ways of maintaining and promoting the voluntary ethos, and to identify and promote its distinctiveness from both the state and the private sector.

8 October 2008