

Fostering social entrepreneurship. **Linklaters**

Legal, regulatory and tax barriers: a comparative study

Recommendations for Governments, policymakers and
social entrepreneurs in Brazil, Germany, India, Poland,
The United Kingdom and the United States

Presented at the
World Economic Forum in Davos

January 2006



SCHWAB FOUNDATION FOR **SOCIAL ENTREPRENEURSHIP**

THE VOICE OF SOCIAL INNOVATION

**Fostering Social Entrepreneurship:
A Comparative Study of the Legal,
Regulatory and Tax Issues in Brazil,
Germany, India, Poland, UK and USA**

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INTRODUCTION

1 What is this Report?

This Report has been prepared by Linklaters with the assistance of the Schwab Foundation for Social Entrepreneurship ("**Schwab**") and various Schwab "fellows" around the world. It analyses (and makes recommendations in respect of) various legal, regulatory and taxation issues relating to social entrepreneurship in six selected countries across a broad geographical and economic spectrum: Brazil, Germany, India, Poland, the United Kingdom and the United States (the "**Selected Countries**"). Linklaters has offices in each of these countries (with the exception of India, in relation to which the bulk of the research work was carried out by J. Sagar Associates).

2 What is Social Entrepreneurship?

Social entrepreneurs combine innovation, opportunity and resourcefulness to transform social systems and practices in a wide variety of fields, including, for example, health, employment, education, environment, housing and technology. While social entrepreneurs have existed throughout history, the concept of social entrepreneurship is a relatively recent one. The term "entrepreneur" made its first appearance in the English language around 1475 as "one who undertakes; a manager, controller; a champion" (OED 2003 [1989]). Unlike Adam Smith, whose "invisible hand" de-emphasised the value of the entrepreneur, JB Say celebrated the entrepreneur as a value-creator who shifts economic resources out of an area of lower and into an area of higher productivity and greater yield.

Social and business entrepreneurs share common traits including an innovative, risk-taking approach to a challenge, the ability to seize opportunities, transforming "business as usual" and mobilizing scarce resources toward that end. The economist Joseph Schumpeter called business entrepreneurs the "change agents in the economy". He wrote that by serving new markets or creating new ways of doing things, they move the economy forward". Social entrepreneurs are the change agents in the social sector. However, in contrast to business entrepreneurs, the way to best measure their success is not how much profit they make, but the extent to which they improve the lives of those they mobilise through their actions.

Social entrepreneurs can set up their initiatives as for-profit or not-for-profit organisations, and that choice will be a function of their vision and theory of change.

Most social enterprises are hybrid organisations. That is to say, they operate along business lines and may indeed aim to make a profit, but their primary goal is to promote social change.

Similarities:

Both not-for-profit and for-profit hybrids apply innovative, transformational approaches to address government or market failures to provide goods, services and opportunities to excluded or marginalised sections of society.

Differences:

Not-for-profit hybrids may recover some of their costs, as in, for example, health service provision, education, and/or technology but in order to sustain their activities and respond to their clients effectively, they must mobilise other sources of funds from the public sector and/or the philanthropic community.

For-profit hybrids are able to fully recover their costs and also generate a profit margin with the main aim being to expand their social ventures and reach more people effectively. Personal wealth accumulation is not a priority for the entrepreneur – and in many cases profits are reinvested in the enterprise in order to fund expansion.

Nevertheless, any definition of social entrepreneurship needs to take account of the different categories and the often blurred distinctions between them. For example, when judging what constitutes a social entrepreneur, one should look at the following factors:

- the percentage of funding that comes from state grants/other benefits ;
- the standard of sustainability which allows for other sources of non-state sector income apart from revenue from the main activity; and
- a minimum number of customers/clients and/or diversified sources of income.

Appendix A to this Report sets out a number of examples of social enterprises. As can be seen, some of these examples show a pure case of identifying a social need and creating a market where customers/clients are willing to pay for the added value which leads to the creation of jobs on an ongoing basis.

For many social entrepreneurs, charity is essentially about philanthropy, whereas social enterprise is about empowering people who are socially disadvantaged to improve their financial, social and moral status and well being. These entrepreneurs are individuals who seize the initiative to tackle the problems affecting those who are socially disadvantaged.

Social entrepreneurship has been referred to as “a distinct approach, a way of catalysing social transformation that is independent of sector or discipline. Deeply committed to generating social value, these entrepreneurs identify new processes, services, products or unique ways of combining proven practice with innovation, driving through pattern-breaking approaches to resolve seemingly intractable problems. Social entrepreneurs work at the bleeding edge of the market, where the risks are the greatest but the potential positive social impact is also enormous. These are men and women who seize the problems created by change as opportunities to transform societies”.¹

3 How Does the Law Impact on Social Entrepreneurship?

There are many factors which may potentially enhance or inhibit the development of a social enterprise in a particular country. These include social attitudes, religious beliefs and prevailing cultural factors. In addition, legal, regulatory and taxation rules will also play an important role. One of the challenges for governments wishing to encourage social enterprise is that the legal, regulatory and taxation environment can operate as a restraint on its development. For example, an organisation established for "social" profit may make a financial or accounting profit which may give rise to a tax liability unless a specific exemption (for example, charitable status) applies.

¹ “Wanted: Social Entrepreneurs to stimulate Sustainable Development”, Pamela Hartigan, Managing Director, Schwab Foundation for Social Entrepreneurship

In most countries there is no "in between" type of legal entity (i.e. an entity falling somewhere between a fully commercial organisation and a registered charity), and thus social entrepreneurs can be faced with a difficult choice as to the most effective legal vehicle through which to carry out their activities. Furthermore, a wide range of regulations (often designed largely to protect employees and consumers against unscrupulous business operators and employers) can constrain the establishment or development of imaginative and worthwhile social enterprises. Examples include financial regulations such as minimum capital requirements which can apply to microfinance organisations, and telecommunications regulations which can affect businesses such as helplines.

4 How this Report was Compiled

The process through which this Report was compiled was as follows. The initial phase of the project involved a "desk top" study. The Schwab Foundation selected a group of social entrepreneurs (not necessarily Schwab "fellows") in each of the Selected Countries. These social entrepreneurs were invited to complete a questionnaire giving information relating to legal, regulatory and taxation issues which have impacted upon the development of their respective businesses. They were also asked to comment on issues such as the availability of finance.

On the basis of these responses, Linklaters and (in India) J. Sagar Associates (each with the assistance of Schwab) also carried out its own desk research. We also looked at linked issues and a number of sector specific issues in the Selected Countries.

Our research led us to some preliminary findings. The second phase of the project comprised the testing of these findings "in the field" by speaking directly to social entrepreneurs in each of the Selected Countries. In addition to testing our preliminary findings we spoke more generally with some social entrepreneurs about the prevailing conditions (whether social, economic, financial, political or cultural) affecting their businesses, and whether (and if so how) these differ from the conditions that they would consider to be ideal to enable their businesses (and perhaps social entrepreneurs generally) to thrive in their particular country or region. This phase provided us with first-hand encounters with selected social entrepreneurs and their organisations.

5 Findings

This Report contains a separate chapter relating to each Selected Country. Each of these chapters is divided into three sections as follows:

5.1 The legal framework

This section sets out a discussion of the current position in relation to certain key legal, regulatory and taxation issues in each of the Selected Countries under the following headings:

- (i) Forms of establishment/corporate status (what options are available in terms of the type of legal entity through which the relevant activity/operations can be conducted?)
- (ii) Tax regime and benefits (is there any scope for the relevant business to obtain any beneficial tax treatment?)

- (iii) Regulatory regime (are there particular rules applicable to the relevant sector in terms of qualification, licensing, reporting, training etc?)
- (iv) Access to finance (is financing readily accessible for social entrepreneurs operating in the relevant sector?)
- (v) Competition issues (do competition law issues present any problem, for example in relation to granting social entrepreneurs exemptions in any of the areas referred to above?)

5.2 Case studies and responses to questionnaires

In this section some specific case studies in the relevant Selected Country are discussed together with an analysis of the key matters raised in the responses we received from social entrepreneurs to the questionnaires which were sent to them by the Schwab Foundation.

5.3 Proposals for improvement

This section suggests ways in which the legal systems of Selected Countries may be reformed and improved in order to encourage social enterprise.

6 Summary of Findings and Common Issues

Our findings relate to the following main categories:

- consideration of tax exemptions or for tax subsidies for social entrepreneurs;
- consideration of a commonly recognised and standardised model of social entrepreneurship in each country, somewhere between a charity and a full profit company;
- tools to deal with the effects of bureaucracy and regulation which is in some cases heightened by a lack of standardised models;
- improved access to finance, whether it be debt or equity funding; and
- information and awareness for social entrepreneurs.

Each of these is discussed in the sections below.

As an exception to the six countries reviewed, Germany, as yet, has relatively few social entrepreneurs and those that there are perceive that the greatest barrier to social entrepreneurship is the difficulty of raising funds for establishment and growth. Traditionally, activities that have not been regarded as being sufficiently profitable for entrepreneurs (hospitals, kindergartens, care of the elderly etc.) have relied heavily on the state and the support of large church foundations. These church foundations have not relied on charitable or voluntary donations as their main sources of income but have instead been financed predominantly through taxes imposed upon the members of the Lutheran and Catholic Churches in Germany.

6.1 Tax issues

A common issue in all jurisdictions is the extent of tax exemptions available for social entrepreneurs and the availability of any tax credits or subsidies.

Brazil

Under Brazilian tax legislation not-for-profit entities are entitled to certain tax benefits provided they meet certain requirements. As in other jurisdictions, generally, gains derived from financial investments made by a not-for-profit entity are not exempt from tax - which make cash flow and self-sustainability for the institutions more difficult. Although social enterprises may have access to some tax advantages, the fulfillment of the requirements to qualify are time consuming and expensive.

India

The major issues faced by social entrepreneurs in India during start up derive from certain tax provision, and, in particular, restrictions on foreign donations under the Foreign Contributions Regulations Act ("**FCRA**"). Although a complete deregulation of the FCRA would be ideal, we would view a softening of its requirements as a positive step forward.

Poland

The tax consequences for an entrepreneur willing to conduct social activities are generally positive. There are numerous ideas for new solutions that could be implemented which are set out in detail in section 6.5 of the report on Poland. These are broken down into ideas with respect to the beneficiaries of the work of social enterprises, including a 0% VAT tax rate and tax exemption for organisations providing non-gratuitous "common interest services" which could enable such organisations to offer their services at cheaper rates. With respect to the personal income tax of the donors, it would be advisable to increase the percentage given to the CIOs as the 1% of the tax due may be too low to be effective.

United Kingdom

Funding is the key issue facing social entrepreneurs in the UK. We therefore propose that consideration be given to further tax concessions being granted to providers of equity finance. The new Community Investment Tax Relief ("**CITR**") rules do go some way to encouraging loan finance but entrepreneurs understandably often prefer equity financing. We propose that all taxes on capital gains (as an aspect of any corporation tax payable) be waived for social enterprises and that a capital gains tax concession should be offered to equity investors in social enterprises. We also make specific recommendations about the new CITR regime to make it more effective by increasing the current cap of £250,000, reducing the need to fund Community Interest Companies through a Community Development Finance Institution and enabling those who fund through a loan (or shares) to be entitled to a tax concession as above. We also propose that the time limit of five years be extended and that some kind of roll-over should be permitted to allow lenders to transfer tax concessions from one loan to another.

USA

Section 501(c)(3) of the Internal Revenue Code allows not-for-profit organisations to be exempt from taxes on any revenue generated by their business activities to the extent that any such income is related to a not-for-profit public purpose. However, the distinction between unrelated and related business income can be fairly tricky and income generated by a not-for-profit entity which is unrelated to its public purpose is taxed at the applicable

corporate rate. Our recommendation is to normalise tax benefits so that not-for-profit organisations are not excluded from the eligibility criteria.

6.2 Standardised model

In most jurisdictions, no specific coherent legal model has been developed for the establishment of social enterprises. The upshot of this has been that those that do exist have sometimes been weighed down by excessive bureaucracy and regulation, and have sometimes not benefited from any favourable tax treatment in their respective countries. Both Poland and the UK have tried to address this by creating new forms of entity, Community Interest Organisations and Community Investment Companies respectively, but critics of these contend that neither of these provide a clear enough structure for the future growth of social enterprise.

In the other jurisdictions, social entrepreneurs have had to choose between a range of legal frameworks ranging from for-profit companies under a traditional corporate structure through to entities with charitable status. A separate legal form for social enterprises which are trading commercially for profit does not yet exist in any jurisdiction.

In India, the availability of a vast range of legal frameworks has led to the development of microfinance institutions. In most jurisdictions, the ability to attain charitable status is restricted to entities that are adjudged to fulfil strict public benefit criteria (for example, whether their purpose is linked to education or health care). In India, social enterprises have developed in the telecommunications and micro-credit sector.

6.3 Bureaucracy and regulation

A common thread throughout the analysis of social enterprise in all the jurisdictions reviewed is the burden of regulation and bureaucracy which is often regarded as excessive. This stems from the fact that regulators may be unsure as to how to treat social enterprises since they are not exclusively profit driven and are sometimes not sufficiently charitable in their purpose. In this regard, employment legislation, in particular is a major burden for social entrepreneurs, especially when it comes to the issue as to whether those who are effectively volunteers can be remunerated for their services.

In Poland, further detailed work has revealed that, with respect to Community Interest Organisations and other social enterprises, a number of legal requirements could potentially be changed. Amongst other things, it would be better if a single government body were the recipient of all performance reports (at the moment they have to go to at least three different bodies), accounting rules and requirements could be simplified with respect to CIOs and that there could be an obligation on donors to social enterprises to use a small percentage (for example between 1 and 3%) of donations for administrative expenses.

One of the biggest issues facing social enterprises in the UK on a commercial level is the fact they are often excluded from taking part in the activities they seek to promote because they have insufficient financial reserves and quality assurance measures in place to be eligible for the local council procurement process. Local councils are often restricted by European procurement legislation from including social enterprises in the contract procurement process. It would therefore be helpful for social enterprises if such restrictions were to a greater or lesser extent removed.

6.4 Access to finance

For all entrepreneurs access to finance is often a major issue and the results of the questionnaires have borne this out. To an extent, India, where social enterprise has developed over a longer period of time, has seen the growth of micro-financing which is now widely recognised as an important source of funding for social enterprise in India. There are also private initiatives in the form of self-help groups which are encouraged by the government. There is, however, no legal framework in place for specific governance and as such, microfinance institutions are not required to follow standard rules. Although this approach has enabled enormous innovation, particularly in the design of new products and processes, the management and governance of microfinance institutions remain weak as there is no compulsion to adopt widely accepted systems of procedures and standards.

In Poland, the government, local and national, provides approximately 30% of the financing source of social enterprises and 20% of the income of social enterprises is generated by the business activity of the enterprises themselves. The most popular source of finance is from private individuals. Funds may be collected either through deductions from income (up to 10%) or by way of public canvassing. Although funding from private individuals is the most popular source of funding, social entrepreneurs identified the lack of adequate information on access to funds as a problem.

The main source of finance comes from private individuals, either the entrepreneurs themselves or private donors. In Poland, for example, the local and central government authorities provide around 30% of the financing for social enterprises while 20% of the income of social enterprises is generated by the business activity of the enterprises themselves.

6.5 Information and awareness

Lack of access to information is a problem in several countries. Social entrepreneurs often do not have access to the information or awareness to know how best to set up their enterprises, what vehicle to consider, the consequences of each, and then how to navigate their business through the regulatory and bureaucratic environment as well as how to obtain the most efficient tax exemptions, subsidies or credits. In this respect, for the UK report, we have recommended a think tank along the lines of the model of "Wall Street without walls" as in the USA. The "Wall Street without walls" idea is a vehicle for lawyers and financial institutions to work together to provide advice, support and assistance to social entrepreneurs.

Poland and Brazil (amongst others) could also benefit from educational promotion programmes aimed to improve communication between local governments and social entrepreneurs as well as a general educational effort to inform society.

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Linklaters is a law firm which specialises in advising the world's leading financial institutions, companies and governments. With offices in major business and financial centres, we deliver an outstanding service to our clients anywhere in the world.

As a global law firm, Linklaters' business is making possible the goals of our clients by providing them with solutions and finding ways to help them succeed. Our Community Investment programme, aims to provide the same service to our community partners. Our community partners work with disadvantaged communities close to our offices. We have identified the following areas where we can support them in achieving their goals. These are:

- **Achievement** - empowering emerging talent to achieve its potential
- **Enterprise** - encouraging enterprising and entrepreneurial people
- **Access to Justice** - asserting legal rights and responsibilities

We aim to achieve these goals by sharing with community partners the skills and expertise of all our staff through pro bono work, employee volunteering and awarding funding. In return, we aim to gain from these partnerships by our own people (and in turn the firm) receiving invaluable experience, skill development and a new perspective. Linklaters is committed to contributing a minimum of 1% of its global pre-tax profits to the community, through this strategy.

The India section of the report was undertaken by J. Sagar Associates of New Delhi, India. Linklaters would like to express its sincere thanks for the contribution made by J. Sagar Associates in the compilation of this report.

BRAZIL

Legal Framework

1 Forms of Establishment/Corporate Status

1.1 Overview

Under Brazilian law, social enterprises in Brazil are usually structured either as associations or foundations. This is because corporate forms tailored to commercial purposes (i.e. the Brazilian limited liability companies “*Limitadas*” and the Brazilian Corporations “*Sociedades Anonimas*”) are, in principle, not eligible for several benefits awarded to not-for-profit entities. Most benefits available to social entities are related to those in the not-for-profit sector rather than to those with corporate status. The main characteristics of foundations and associations are described below.

The formalities required to incorporate a Brazilian company and to obtain all the pre-requisite certificates and licences to operate it are excessively time-consuming and expensive. For not-for-profit entities, there are even more onerous procedures to be followed in order to meet requirements and become eligible for the benefits available. Furthermore, given the Brazilian governmental framework, not-for-profit entities must make regular public disclosure of their accounts to various public authorities. Bureaucracy is an enormous obstacle in Brazil, especially in terms of delays in getting permits, licences and official documents.

Social entrepreneurs aim to identify economic opportunities that may develop the community through professional training and the use of local resources and that are therefore conducive to a sustainable environment. Projects are implemented through the not-for-profit sector in order best to circumvent the existing major social obstacles, and thereby combine governmental and private efforts.

Given the extent and variety of social problems in Brazil, social entrepreneurs can play a major part in motivating communities to solve their problems. Such activity is even more important because of the government’s incapacity for attending to or providing for all Brazilian social needs.

Brazilian legislation has few mechanisms to support private social initiatives and leaves such initiatives in the hands of the government. The main reason for this seems to be the government’s desire to be responsible for the success of social programmes and its concern to prevent companies from obtaining concessions under false pretences.

Despite this, there is significant community support from the private sector. This additional support has been given greater impetus by a popular desire to tackle Brazil’s increasing social problems.

1.2 Foundations

A foundation is a legal entity created through the contribution of assets, such that these assets can serve a given (non-commercial) purpose, as defined by the contributor and set forth in the foundation by-laws. It can be incorporated either by the public authorities or by the private sector. For the purposes of this memorandum, only private sector foundations are considered.

The incorporation of foundations requires the fulfilment of mandatory legal requirements, the most important of which is the prior approval of the by-laws by the Public Prosecutor's Office and the registration of the by-laws on the Public Register. Specific regulations for the amendments of by-laws of foundations also apply after their incorporation.

The creation of a foundation is administratively onerous and therefore very time-consuming. The activities of a foundation are also under continuous scrutiny from the Prosecution Office. This seems to be the main constraint for the incorporation of foundations, as the founders of social enterprises are usually private companies or nationals that tend not to want any public interference with their day-to-day affairs. For this reason foundations are less popular than associations

1.3 Associations

Generally, an association is a not-for-profit legal entity incorporated to achieve a pre-determined objective of a non-commercial nature, as set forth in its articles of association. For the incorporation of an association to be effective, all members must have the same objectives. As with foundations, in the case of dissolution the assets of an association must be transferred to another entity with the same objectives.

1.4 Public interest organisations (Organização da Sociedade Civil de Interesse Público – “OSCIP”)

OSCIP is a qualification granted to not-for-profit private entities with at least one of the following social purposes: (i) social assistance, (ii) culture, (iii) education, (iv) health or, (v) environmental protection. Importantly, OSCIPs must execute a partnership agreement with the government to set out the main guidelines for the performance of the social activities.

The main characteristic of an OSCIP is the non-distribution of any profits. OSCIPs must comply with a large number of requirements, such as: (i) the creation of an audit committee or similar to examine its financial and accounting reports, and real estate affairs of the entity, (ii) the adoption of certain management and administrative policies, (iii) the disclosure of accounting reports and financial statements and (iv) exposure to due diligence regarding the allocation of resources in accordance with the partnership agreement entered into with the public authorities.

Only a small number of entities qualify as OSCIPs, since the large number of requirements discourages entities from achieving and maintaining this status. Nevertheless, once an entity qualifies, it is entitled to access a great number of benefits, one example of this being access to grants from the government.

2 Tax Regime and Benefits

2.1 Overview of tax regime

The power to levy taxes is shared by the Federal Union, the States and the Municipalities and for this reason the tax burden is considered high. The main taxes applicable in Brazil are:

2.1.1 Taxes on income (Federal)

- (i) Corporate Income Tax (“IRPJ”) is a federal tax. It is charged on a company's accounting profit on a worldwide basis and is adjusted by non-deductible expenses and non-taxable revenues. It applies to taxable

income at a rate of 15%, and as a surcharge of 10 % on annual income which exceeds R\$240,000.

(ii) Social Contribution tax (“**CSLL**”)

2.1.2 Social contribution tax is also a federal tax and it is currently applied at a rate of 9% on taxable income. The tax base is similar to that of the corporate income tax, although some minor differences exist.

2.1.3 Taxes on transactions

(i) *IPI (Federal)* - This tax is levied on all goods and products whether imported or exported. The rate at which it is applied varies according to the tax classification of the product.

(ii) *ICMS (State)* - This tax is payable on the physical movement of merchandise, including that which is imported. It also applies to communication and transport services.

2.1.4 Taxes on gross revenue

(i) *PIS (Federal)* - In general, PIS is levied at a rate of 1.65% on all revenue of the company, though credit is granted for certain acquisitions and expenses.

(ii) *COFINS (Federal)* - COFINS is levied at a rate of 7.6% on all revenues of the company, though credit is granted for certain acquisitions and expenses.

2.1.5 Taxes on services

(i) *ISS (Municipal)* - Services subject to the ISS tax are defined by federal law. The rate varies according to the municipality involved, from between 2 and 5%.

There are other taxes in addition to the taxes described above. These include: property taxes (at federal and/or municipal levels); inheritance and gift tax (at state levels); and the CPMF (federal) tax levied on the movement of funds from bank accounts.

2.2 Tax benefits

2.2.1 Not-for-profit entities

According to the Brazilian tax legislation, not-for-profit entities may be entitled to constitutional immunity or ordinary tax exemptions. Educational and social assistance institutions are entitled to this immunity. Other not-for-profit entities may be entitled to ordinary tax exemptions. As described below, although the social enterprises may have tax advantages in Brazil, in many instances, the fulfilment of the requirements is time-consuming and expensive. In addition, generally, gains derived from financial investments made by an entity are not exempt from tax, which makes the cash flow for the maintenance of the project more difficult. Limitations such as these prevent entities from providing a self-sustainable environment. From a tax perspective, Brazilian legislation encourages endowments and sponsorships for cultural and artistic projects.

2.2.2 Educational and Social Assistance Institutions

According to Article 150 of the Brazilian Constitution, the property, income and services of educational and social assistance institutions are not subject to taxes at federal, state or municipal levels. Entities engaged in education and social assistance activities that are not-for-profit are entitled to certain tax benefits provided they meet certain requirements. The Brazilian Constitution defines education as a social right, establishing that such right is an obligation to be granted by the government. Education, as mentioned in the Constitution, has the objective of developing the potential of the human being in all of its aspects, its preparation for the working environment and for the exercise of civil rights. Social assistance includes, amongst others, all actions related to the integration of people into the working market.

In order to obtain such benefits, both educational and social assistance entities must comply with the specific requirements set forth in the Brazilian Tax Code (“**CTN**”) and other pieces of legislation. Some of the requirements that these entities must meet in order to obtain and keep the benefits are:

- (i) not to distribute any share of its assets, revenue or income, in any denomination;
- (ii) to apply all resources in Brazil for the maintenance of its objectives as set forth in the articles of association;
- (iii) to keep accounting records of all revenues and costs;
- (iv) not to remunerate its managing officers for any of the services rendered; and
- (v) to transfer its assets to other not-for-profit entities in the case of dissolution.

Furthermore, social assistance entities must also comply with the following requirements:

- (i) the entity must be recognised by federal authorities as having public utility (*utilidade pública*) by enrolling with the Ministry of Justice. Such enrolment requires, amongst other documents, a previous statement from local authorities recognising the regular operation of the entity for the last three years;
- (ii) the entity has to be recognised by the State or Municipality where it is located as having public utility (*utilidade pública*);
- (iii) the entity must be enrolled at the National Council of Social Assistance (“**CNAS**”). This requires prior enrolment before state or municipal councils for social assistance;
- (iv) the entity must apply any income it makes in the implementation of its objectives;
- (v) the entity must not remunerate any of its directors, partners, contributors, etc; and
- (vi) the entity must not have outstanding social security obligations.

After enrolment with the CNAS, the entity has to obtain a certificate issued by this authority and must then claim the social contribution exemption from the National Institute of Social Service (“INSS”).

With regard to ICMS tax, there is a convention ratified by some states granting exemptions on sales of products manufactured by not-for-profit entities as well as donations received from abroad to be used for social or educational programmes. The ICMS benefits may require that specific conditions are met by the social or educational entity.

There may also be municipal tax incentives applicable in some cases. These incentives vary according to the municipality in which the entity is established and are, in general, related to services and property taxes.

2.2.3 Other not-for-profit entities

Law n. 9.532/1997 provides an IRPJ and CSLL exemption for not-for-profit entities. This exemption is granted to various entities including foundations, associations and charity organisations. In order to be entitled to such exemptions, the not-for-profit entities must comply with the requirements described above. Additionally, not-for-profit entities which comply with such requirements are exempt from COFINS and are subject to the PIS at a rate of 1%, levied on the payroll. Additional requirements may apply in order for the entity to be entitled to PIS and COFINS benefits.

2.2.4 Deduction of donations made by corporations

As a general rule, for donations to be deductible from the IRPJ and CSLL tax base the entity that receives the donation must be recognised by federal authorities as having public utility (*utilidade pública*), as described above. Further, the deduction is limited to a maximum of 2% of the operational profit of the corporation. This limit would apply to payments in cash or in kind.

3 Regulatory Regime

3.1 Employees and volunteers

Under Brazilian employment law, an employment relationship arises whenever there is (i) regularity of the rendering of services, on a routine basis, by a certain individual, (ii) subordination of such individual to the contractor of the service, and (iii) payment of remuneration. As such, an employment relationship arises regardless of whether or not there is a written agreement.

Voluntary services are governed by a specific law which establishes that these services must be rendered (i) by a natural person, (ii) to public entities or private not-for-profit making entities, (iii) without the payment of remuneration, and (iv) under a voluntary term entered into between the volunteer and the benefited entity, determining the services to be rendered and the working conditions. These services must be spontaneously and gratuitously rendered and aimed at social benefits.

Although the volunteer must not be remunerated, the law allows the volunteer to receive (i) reimbursement of the costs related to his/her services, provided that such costs are duly evidenced and (ii) financial assistance. However, this financial assistance must not be higher than R\$150.00 per month and must not be granted for more than six months.

Further, the benefited entity must be previously registered with the Ministry of Labour to be allowed to grant such financial assistance to its volunteers.

All the abovementioned legal provisions related to voluntary services must be duly observed, otherwise an employment relationship between the volunteer and the benefited entity may be recognised by Brazilian Labour Courts. If this occurs, the entity may be obliged to pay all the labour rights legally established if a lawsuit is filed, observe all the relevant labour provisions and may be obliged to pay administrative fines in the case of inspection by the Ministry of Labour.

As there is no legal provision prohibiting not-for-profit entities contracting with volunteers and employees, it is important the entities treat volunteers and employees carefully in accordance with their position. As such, we suggest that entities:

- (i) execute an agreed term with the volunteers; and
- (ii) do not remunerate any volunteer, over and above the legal limits and requirements.

3.2 Labour rights and social security contributions

3.2.1 Salary

Employees are entitled to a minimum salary of R\$260.00 per month. All payments (including the average of overtime payments) and fringe benefits regularly granted by employers to employees are considered a salary for legal purposes. Only payments, fringe benefits and allowances expressly excluded by law are not considered as part of an employee salary.

3.2.2 Other payments

In addition to the salary, employees are entitled to the following payments: (i) a Christmas bonus equal to one month's salary; (ii) 30 days' remunerated vacation per year accrued with an additional payment of one third of the regular monthly salary; (iii) overtime payments amounting to a supplement of at least 50% of the payment for regular working hours; (iv) additional payment for work performed on days of remunerated rest or holidays amounting to a supplement of 100% of the payment for regular working hours; (v) a supplement of 20 % of the payment for regular working hours for overnight work (from 10 p.m. to 5 a.m.); (vi) an additional payment whenever work involves risk to the employee's health or is performed under dangerous conditions; (vii) profit sharing; (viii) Government Severance Indemnity Fund for Employees ("FGTS"); and (ix) retirement due to disability, matured social security contributions; (30 years for men and 25 years for women), or age (65 years for men and 60 years for women).

3.2.3 Working hours

For the majority of Brazilian workers, regular working hours shall not exceed eight hours per day and 44 hours per week. Moreover, Brazilian labour law provides for a reduced working hour of 52.5 minutes whenever the work is performed between 10:00 p.m. of one day and 5:00 a.m. of the next. Brazilian employment law also provides for several breaks, such as a one-hour lunch break, an 11-hour break between working days, a remunerated weekly day-off (preferably on Sundays), a twenty-minute break for each one-hour and forty minutes of work, when performed under very cold or hot conditions and a break for working activities that demand repetitive movements.

3.2.4 Severance pay

As a general rule, severance pay consists of: (i) the balance of the monthly salary; (ii) indemnification for the prior notice period, if the employer does not want the employee to work during such period (30 days); (iii) a proportional Christmas bonus; (iv) salary related to untaken leave (whether matured or not) together with an additional vacation payment of one third of the regular monthly salary; (v) salary related to proportional vacation accrued with additional vacation payment of one third of the regular monthly salary; and (vi) penalty payments for deposits made for the employee's benefit under the Government Severance Indemnity Fund for Employees ("**FGTS**").

3.2.5 Job stability

Under Brazilian law, some employees cannot be dismissed during determined periods established by law. Mainly these periods are granted to (i) employee representatives of the Internal Committee for Accident Prevention ("**CIPA**"), who cannot be dismissed during their term of office or within one year after expiration thereof; (ii) employees who have suffered work-related accidents or occupational diseases and have had medical leave for more than 15 days (these employees are entitled to receive social security benefits until the end of their medical leave and cannot be dismissed within the 12-month period as from the date they return to work); (iii) trade union leader representatives of employees, whose job stability is valid as from the date of registration of their appointment as a candidate until one year after the end of their term of office, and (iv) pregnant employees, who have job stability counted as from the date of the confirmation of their pregnancy until five months after the birth.

4 Access to Finance

4.1 Overview

The government provides social entrepreneurs with access to various sources of financing, the type of which depends upon their focus activity. However, to receive government funding, several requirements must be observed, which at times represent a barrier for social entrepreneurs.

The Brazilian Social Development Bank ("**BNDES**") is responsible for most of the financing programmes available for social enterprises. The Microcredit Programme is one of them, aiming at supporting the micro-entrepreneurs, formal or informal, and the production and service co-operatives.

In order to obtain BNDES Microcredit, a social entrepreneur must file a request with any local bank authorised by BNDES, which will determine the necessary documentation to be provided, analyse the likelihood of receiving the grant of credit and negotiate the financial conditions and guarantees. The credit may be granted at a maximum value of R\$10,000.00 for up to a 24-month term.

Besides Microcredit, there are other types of financial resources that may be obtained from the government, such as allowances (which derive directly from the budget), contributions (which are granted by means of a special law) and conventions (which require mutual resource co-operation between entities and the government).

4.2 Finance for environmental initiatives

With respect to environmental initiatives, there are numerous funds and projects promoting environmental protection, although most of the support to this area arises from foreign investment.

The Financial Programme for Biodiesel Investments granted by BNDES is a good example of a governmental environmental financing programme. This programme aims to support (i) investments in all phases of biodiesel production, (ii) the acquisition of legally ratified and registered machines and equipment for biodiesel or crude vegetable oil use, and (iii) investments that will benefit biodiesel co-products and sub-products.

Moreover, projects bearing the "Social Fuel" seal may receive a greater amount of financial support from BNDES. The "Social Fuel" seal is granted by Ministério do Desenvolvimento Agrário - MDA (Ministry of Agrarian Development) to biodiesel producers who promote the social inclusion of agricultural families, which supply them with raw materials. To obtain the "Social Fuel" seal, the biodiesel producer must comply with the objective criteria established by MDA.

Despite the various sources of benefits offered by the government, the application processes which the entity must perform are complicated. Much of the time, entities are unaware of the possibility of a concession. Furthermore, it is often the case that concessions are announced by the government via the internet and as such do not reach those entities which do not have access to this communication service.

5 Case Studies and Responses to Questionnaires

5.1 Research was undertaken by interviewing the following social entrepreneurs in Brazil:

- an organisation that offers teenagers from poor families the opportunity to develop an active and dignified role in society, thereby demonstrating the concepts of work and citizenship;
- a cooperative which offers cooking classes for unemployed persons, sharing the profits derived from these classes amongst those involved in the project;
- an organisation which aims to generate income for drought affected and poor communities by creating work alternatives and revitalising and developing traditional workmanship;
- an organisation to help young impoverished people and at the same time raise awareness of cultural traditions in northern parts of Brazil. The project uses theatre to educate teenagers and to teach social awareness; and
- an organisation that promotes integrated and sustainable local development by means of education and the performance of the "leading-role teenagers", such a phrase being used to symbolise the belief of the Institute that the teenager is the main actor and author of his life.

5.2 Most social entrepreneurs are not aware of the benefits provided by Brazilian legislation to support and encourage private social initiatives. Although social entrepreneurs are generally people who have received higher education their knowledge of legal issues is mostly poor.

In order to obtain the benefits provided by the law, social entrepreneurs need to face mass bureaucracy and the procedures that must be followed in order to obtain relevant certificates and licenses are both time-consuming and expensive. In addition, the requirements that must be fulfilled by entities in order to access such benefits are themselves difficult to attain.

Most social entrepreneurs noted that they succeeded in establishing new partnerships. Such success was particularly prolific when considering partnerships that were established with the government or with large companies and foundations, such as the National Bank of Social and Economic Development (“**BNDES**”), the Ford Foundation and the Kellogg Foundation.

Smaller scale social entrepreneurs and those, who are in the initial stages of developing their ideas, stated that it was difficult to receive donations, since the donors (companies and/or individuals) hold more trust in large, well-known entities than in small, developing entities. This attitude reflects a pervasive worry in Brazil as to the honesty and soundness of not-for-profit entities, which stems from the existence of certain corrupt entities that claim to be not-for-profit but are, in fact, quite the contrary.

All social entrepreneurs that were interviewed indicated the high costs of maintaining employees as one of their main difficulties. Observations were made as to the expense of registering an employee and the payment of related charges. Due to this, most of the social entrepreneurs interviewed are not registered and rather work as service providers.

Most social entrepreneurs maintain training programmes in order to increase the expertise of their staff and had also succeed in both launching and improving the quality of new products. However, they face difficulties in accessing new markets, especially when finding themselves in competition with profit-driven companies, whose sound infrastructure and ability to mass-produce enables them to sell at lower prices.

6 Proposals for Improvement

6.1 Executive summary

There is substantial work to be done in terms of educating the Brazilian public sector about social enterprise and the benefits this area can bring to Brazilian society. It is, therefore, important to encourage people and to try to change their attitude towards social entrepreneurship, as Brazil has huge potential to increase professional involvement in attempts to resolve a variety of social problems.

Most social entrepreneurs are not aware of the benefits provided by Brazilian legislation that support and encourage private social initiatives. The profile of the social entrepreneur mainly indicates a person with higher education, but with little knowledge of legal issues and therefore a lack of awareness as to the benefits that can be obtained under the law. There is a need for the Brazilian government and the media to publicise the existence of such benefits. Small social entrepreneurs and those starting out, face particular difficulty in this regard as usually they do not have legal assistance and/or experience in social entrepreneurship.

The government does support social entrepreneurs by providing financing, subsidies and micro-credit. However, any tax concessions are dependent upon compliance with onerous bureaucratic red tape.

The high cost of maintaining employees is one of the main difficulties faced by social enterprises. It is very expensive to register an employee and to pay all related charges; therefore most social enterprise employees are not registered as such, but rather work as service providers.

Most social entrepreneurs maintain programmes of training in order to increase the expertise of staff and have succeeded in launching new products and improving the quality of those that already exist. However, they face difficulties in accessing new markets, especially when encountering competition from profit-making companies which have better infrastructures and produce on a large scale thus presenting lower prices to the market.

6.2 Proposal details

Although the Brazilian legal system provides a range of mechanisms to support private initiatives, these mechanisms still fall some way short of adequately meeting the needs of social entrepreneurship. The various sources of benefits granted to social enterprises by differing areas of government – such as tax benefits, credit incentives and governmental funding – were created according to the immediate needs of society and, as such, they suffer from a lack of coherence, which in turn raises difficulties in terms of comprehension and practical application.

Importantly, social entrepreneurs do not have much access to information or legal assistance. To encourage a better understanding of the legal aspects of social entrepreneurship, it would be helpful to consolidate the laws currently in force into one single law which addresses all sources of benefits and incentives available.

Brazil currently ranks as the sixth most time consuming country in which to incorporate a company (an average of 152 days). Social entrepreneurs, in particular, have to fill out a large number of forms and wait for a long period of time until they are permitted to receive benefits. It would therefore be hugely beneficial if specific legal mechanisms were created for social enterprises, permitting them to be incorporated swiftly.

As mentioned previously, the high cost of maintaining employees is one of the main difficulties faced by social enterprises. Brazilian Labour Law forbids those volunteers committed to social projects from receiving any kind of remuneration and because of this, volunteers must dedicate themselves to other activities through which they can be remunerated in order to earn enough to cater for their basic needs. This is an immense obstacle which hinders those persons aiming to focus solely on social entrepreneurship activities. As such, we would recommend regulations be created that allow the possibility of remunerated volunteer work, allowing social entrepreneurs to be completely committed from the outset.

GERMANY

The Legal Framework

1 Forms of Establishment/Corporate Status

1.1 Overview

In Germany, social enterprises could be carried out under any of the generally available legal structures, e.g. partnerships, corporations, foundations (*Stiftung*) or, possibly, as registered associations (*eingetragener Verein*). Each of the legal structures has its own advantages and disadvantages but, typically, social entrepreneurs will be interested in limiting their personal liability, beneficial tax treatment and manageable, affordable corporate governance structures.

Social entrepreneurs will try to qualify as “acting for the common benefit” (*Gemeinnützigkeit*), since various tax advantages are attached to this status. As this status can only be attained by corporations, foundations and registered associations, many social entrepreneurs may not want to consider partnerships as an investment vehicle. On the other hand, partnerships are flexible, inexpensive, offer a high level of shareholder control over the business and allow a direct allocation of tax losses to the partners which can be set off against profits from other activities. In an early stage of investment where losses may still be generated, a partnership may be the most appropriate vehicle, in particular where *Gemeinnützigkeit* is not attainable. Finally, registered associations may not maintain a commercial business and have, for this reason, been excluded from the descriptions below. They are, however, statistically the most common vehicle for charitable organisations and the most frequently used legal form for organisations recognised as *gemeinnützig*.

1.2 Foundations

A foundation is a legal entity that has received its assets from its founders for the permanent pursuit of a defined goal or purpose. The foundation is a permanent establishment insofar as it is protected against dissolution except when the foundation's purpose has been fulfilled. Its permanence is secured by protecting its assets against any type of disposal, the ability of the foundation to spend any funds being limited to the interest on the foundation's assets. A foundation may be established for almost any purpose. However, it will require approval by the State, in this case the *Bundesländer*. The approval to set up a foundation will in practice not be granted if the purpose of the foundation is merely to pursue commercial activities. After its initial establishment the foundation will exist independently of its founders who cannot change or amend its purpose. The board of the foundation has strong fiduciary duties, ensuring that only the purpose of the foundation is pursued. The foundation is subject to regular and permanent supervision by the public authorities.

While the foundation is a powerful instrument for pursuing charitable activities, the limitations outlined above may prove harmful in pursuing a commercial business, even if the necessary consent could be obtained. Establishing a foundation is also very capital intensive since the full foundation capital must be donated to the foundation and its spending is limited to the interest gained from the investment of the foundation capital. The inability to pay out any return makes a foundation an unsuitable vehicle for attracting equity

investment. A foundation may, however, provide the possibility of giving an established social enterprise a high degree of permanence for the future.

1.3 Limited partnership

A limited partnership (*Kommanditgesellschaft, KG*) is characterised by the existence of at least one general partner who has unlimited liability for all obligations of the partnership and at least one limited partner whose liability is limited to a certain sum agreed in the partnership agreement and published in the commercial register. Typically, the limited partner will make a contribution covering the liability sum agreed, thereby extinguishing its liability. Often, a limited liability company is used as the general partner, creating a so-called GmbH & Co. KG, effectively limiting the liability of all investors in the limited partnership.

The benefit of a limited partnership is that it is transparent for income tax purposes. Therefore, any profits and losses will be allocated to the partners in the limited partnership directly and, in particular, losses can be immediately off-set against gains from other sources of income. The combination of limited liability and direct allocation of tax losses has made the limited partnership an appropriate vehicle for investments in projects that will initially generate losses.

As the limited partners have only limited influence on the management of the business, the limited partnership can be used successfully for raising equity investments from a larger group of investors. Its corporate governance structures can easily be adapted to cater for a large group of shareholders without jeopardising the tax treatment outlined above.

Other forms of partnerships, such as *Gesellschaft bürgerlichen Rechts* (for non-commercial enterprises) or *offene Handelsgesellschaft* will offer the same tax treatment but may not be considered ideal for social enterprises because all partners will be subject to unlimited liability.

Partnerships are excluded from obtaining the status of *gemeinnützig* (acting for the common good). *Gemeinnützigkeit* is only granted where a sufficiently large degree of independence of the legal entity and its shareholders is guaranteed as to ensure that the entity will pursue its charitable goals. Generally, partnerships with the potential for unlimited personal liability of the partnerships are not considered to be inadequately independent.

1.4 Limited liability company

The other common form for commercial enterprises in Germany is the limited liability company (*Gesellschaft mit beschränkter Haftung, GmbH*). The liability of all shareholders in a limited liability company is limited to the contribution agreed for the issuance of shares. A limited liability company is not transparent for income tax purposes. In practice, this is the main difference from a limited partnership.

Corporate governance of a limited liability company will be more onerous than that of a limited partnership. Several resolutions of the shareholders require notarisation in order to be valid and the transfer of shares must also be notarised.

Large limited liability companies with more than 500 employees will as a rule be subject to co-determination (*Mitbestimmung*). Co-determination means that the company will have to establish a two tier corporate governance structure with a supervisory board comprising representatives of both the shareholders and the employees. For a company with 500 to 2,000 employees, one third of the supervisory board members would be employee

representatives; for a company with more than 2,000 employees, half of the members of the supervisory board would be employee representatives. Co-determination is not mandatory for enterprises pursuing, *inter alia*, charitable purposes, an exception that would possibly apply to many social enterprises.

An alternative corporative legal entity would be the stock corporation (*Aktiengesellschaft*). A stock corporation would offer greater access to equity capital markets. It is, however, subject to more stringent corporate governance rules and is not generally considered suitable for small and medium size businesses that do not actively finance themselves in the capital markets.

2 Tax Regime and Benefits

The tax regime of the different legal vehicles described above does not change merely because the entity is engaged in business as a social enterprise.

Partnerships are transparent for corporate income tax purposes; the taxation of the partner will depend on the personal situation of the partner. However, partnerships do allow partners to set off losses generated by the partnership's activities against other positive income. A partnership engaged in a business activity will, furthermore, be liable for trade tax, which varies substantially depending on the municipality where the partnership has its seat, and is also obliged to charge VAT of 16% on its fees.

Foundations and corporations are as a rule subject to corporation tax, trade tax and obliged to charge VAT. However, foundations and corporations may attain the status of *Gemeinnützigkeit*, with which substantial tax benefits are connected.

The status of *Gemeinnützigkeit* is granted by the relevant tax authorities. Initially, the decision will be based on whether the articles of association limit the entities' activities to privileged activities, and the recognition will be limited to an 18-month period. At the end of the first business year the tax authorities will, as part of their audit review, decide whether the activities of the entity in practice qualify for preferential treatment and, if so, will renew the recognition. The renewal will generally be granted for a period of three years and be subject to review accordingly.

2.1 Requirements for *gemeinnützigkeit*

In order to be recognised as being *gemeinnützig* an entity must exclusively and directly serve the common good or interest. In order to qualify as for the 'common good', the benefits must be available to the general public indiscriminately. This requirement may pose difficulties for social enterprises established for special purposes.

The proceeds from an activity qualifying as *gemeinnützig* may only be used for the promotion of the charitable purpose set forth in the articles of association. In particular, the entity may not distribute any profits to its shareholders and upon liquidation of the entity any proceeds exceeding the initial capital contributions must be used for a privileged purpose. Arm's length agreements of the privileged entity with its shareholders may be permissible. For example, employment of a shareholder would be allowed.

The proceeds must serve the common interest directly and, therefore, profits must be used or reinvested for the purpose set out in the articles more or less contemporaneously. However, under certain circumstances capital reserves can be made for future reinvestment.

Commercial activities that are undertaken for profit will not jeopardise the treatment as *gemeinnützig* as long as the charitable activities remain the primary focus of the entity.

2.2 Consequences of *gemeinnützigkeit*

From the point of view of a social enterprise, *Gemeinnützigkeit* is a highly desirable position. Several substantial tax benefits flow from this. Privileged entities are exempt from corporation tax and trade tax and a lower rate of VAT is applicable.

Insofar as an entity that has qualified as *gemeinnützig* also pursues commercial activities, the tax benefits are limited to the privileged activities. However, the benefits may apply to all activities if the commercial activities are negligible (currently the threshold is approximately €30,000) and the entity can demonstrate that the scope of the commercial activities is immaterial.

Donations to an entity recognised as *gemeinnützig* are tax deductible for the donor. Various other privileges may come with the recognition of *Gemeinnützigkeit*, such as benefits in relation to real estate tax and inheritance tax.

3 Regulatory Regime

3.1 Overview

Social enterprises are subject to the same regulatory rules, such as employment (including social security), health and safety, environmental, data protection, consumer protection, unfair trade and competition issues as other companies.

3.2 Employment

Germany is often seen as a highly regulated economy with employment law being considered the most onerous area of regulation. Of all employment regulations the provisions of the Act against Unfair Dismissal (*Kündigungsschutzgesetz*) and the Shop Constitution Act (*Betriebsverfassungsgesetz*) are the most invasive. Both Acts provide for exemptions for small enterprises (five employees or less). In particular, young enterprises may benefit from a *de facto* exemption from the Act against Unfair Dismissal under the Act on Part Time Employment which allows enterprises to limit the term of the employment contract of newly hired employee to two years.

Obviously, salaries in Germany are generally high, although the ancillary cost of employment (social security, etc.) does not significantly differ from other Western European economies. Although exemptions are not available for social enterprises, we do not believe that this is perceived as a major impediment to the establishment of social enterprises in Germany.

4 Access to Finance

For social enterprises organised as partnerships or corporations, finance can be raised in the usual manner, as in any commercial enterprise. Beneficial tax treatment of investments in social enterprises, however, is not available.

For foundations or corporations that have been recognised as *gemeinnützig*, the ability to offer tax deductibility for donors opens charitable donations as an alternative possibility to raise financing. However, the necessity to invest all income in the privileged activity limits the ability to raise equity finance.

5 Proposals for Improvement

5.1 Executive summary

Germany does not have an established culture of charitable giving. For the past 125 years, Germany has relied heavily on a system of state welfare (as introduced by Bismarck in 1883) and the support of certain activities that are sometimes perceived as not being sufficiently profitable for entrepreneurs (hospitals, kindergartens, care of the elderly etc.) by the two large Christian churches. The churches in turn have not relied on charitable or voluntary donations, but have been financed via 'taxes' imposed upon the members of the Lutheran and Catholic church in Germany and collected as a PAYE withholding tax by the German tax authorities. The general public tends to view the amount of taxes (both income and church taxes) being paid for maintaining the welfare state as substantial and as a sufficient contribution of the individual to socially responsible projects.

Potential social entrepreneurs see this established culture as the greatest impediment to social entrepreneurship in Germany because of the difficulties in raising funds. In the current economic environment it is very unlikely that tax rates will drop significantly in the near future. Also, it is highly unlikely that the system of 'church tax' will be abolished, although this would, at least initially, provide an incentive for many to rethink how and where to use their disposal income.

The tax deductibility of donations explains why the limited amount of funds made available in Germany is channelled into institutions that are recognised as *gemeinnützig*. Projects of a charitable nature have, therefore, often concentrated on supporting and developing projects that fall into this category.

Social enterprises in Germany would benefit from easier access to public funds and a breakdown of the perceived barrier between entrepreneurial, profit-making enterprises and purely charitable projects.

5.2 Proposal details

For Germany it is difficult to make specific proposals to the legislator on how to improve the legal environment for social entrepreneurs. First and foremost, change in Germany is made on a social and economic level. Both entrepreneurship and charitable activities play a lesser role in German society than in many other parts of the world, in particular the United Kingdom and the United States of America. The greatest impediment to increasing the role social entrepreneurship plays in Germany is, in our view, a general lack of interest in or awareness of its potential. We believe that this perceived lack of interest would not be materially altered by changes in the legal environment if these are not preceded by cultural changes.

However, a single change to the legal environment, that could entice potential entrepreneurs to consider social activities more strongly, would be broadening the activities that qualify as *gemeinnützig* in order to allow more not-for-profit commercial activities to fall within the scope of the benefits such statutes provide.

INDIA

The Legal Framework

1 Forms of Establishment/Corporate Status

1.1 Overview

In setting up any form of corporate establishment, it is important to consider the nature of the venture and, accordingly, the type of vehicle needed. The first distinction is between unincorporated and incorporated organisations.

Unincorporated businesses have no separate legal identity and liability rests with those who own and/or manage them. However, there are some benefits, including certain tax advantages and less stringent regulation, which can give the business greater flexibility.

An incorporated business is a legal entity in its own right and can enter into contracts, employ staff, lease property and have obligations and liabilities. If the nature of the organisation carries high risks, this corporate identity and the resulting limit on individuals' liability is an important consideration. However, incorporated entities face a more stringent set of regulation and disclosure requirements. Generally, banks and financial institutions provide loan finance to incorporated entities, and only if their investment is recoverable. This means that charitable organisations or enterprises with few assets may find it difficult to arrange financing.

Furthermore, no association which has a definite cultural, economic, educational, religious or social programme can accept foreign contributions unless such an association is registered with the Central Government under the Foreign Contribution (Regulation) Act (1976) ("**FCRA**"). Although FCRA does not specify any time limit for submission of an application for registration, the Central Government does not consider applications from organisations that have been in existence for less than three years.

If such an association is not registered with the Central Government, it may accept foreign contribution only after obtaining the prior permission of the Central Government. The association has to furnish information to the Central Government with regard to the amount, source and manner in which the foreign contribution is received, and the purpose for which and the manner in which such foreign contribution will be utilised.

The following vehicles are commonly used by business organisations.

1.2 Company limited by shares (private and public)

Companies limited by shares have their own legal identity. The liability of shareholders is limited to the amount of capital remaining unpaid on the shares held or subscribed for by them.

1.3 Company limited by guarantee

These companies are incorporated with/without share capital and are similar to companies limited by shares except that the liability of the members is limited by the memorandum to such amount as the members may respectively agree to contribute to the company in the event of it being wound-up.

1.4 Companies with unlimited liability

In such companies the liability of each member is not limited and extends to the whole amount of the company's liabilities. Creditors cannot directly institute legal proceedings against the individual members. However, the official liquidator can call upon the members to discharge any debts and liabilities without limit.

1.5 Charitable companies (section 25 companies)

These are formed for promoting commerce, art, science, religion, charity or other useful objects and can only invest capital for the purpose for which they are formed. While they are allowed to drop the word 'limited' from their name, they enjoy the protection of limited liability.

1.6 Charitable and educational societies

Under Indian law, societies may be registered for the granting of charitable assistance, creation of military orphan funds, promotion of science, literature, fine arts, instruction or the diffusion of useful knowledge, and political education etc. They are not-for-profit entities and therefore the profits earned by them are not distributed to their members, but rather applied in promotion and furtherance of their objects. As their objects are charitable, they are eligible for tax exemptions on the income they earn.

1.7 Co-operative societies

A co-operative society is a body corporate known by the name under which it is registered. They have perpetual succession. They may hold property, enter into contracts, instigate and defend law suits and conduct all other operations to achieve the purpose for which they are formed. They are characterised by features such as voluntary and open membership and democratic control. The rule for such entities is benefit equal to investment.

1.8 Trusts

A trust is an obligation to use one's property for the benefit of another in whom it is concurrently vested. Certain kinds of trusts require mandatory registration under the Indian Trusts Act (1882).

1.9 Partnerships

There is only one type of partnership under Indian law, in which the partnership and the partners that constitute it are not separate legal entities. The partners share the profits, costs and liabilities of the partnership and run the partnership under an agreement. Their potential liability as partners is unlimited.

1.10 Hindu Undivided Family ("HUF")

HUF is an entity found in India. It consists of all persons lineally descended from a common ancestor, and includes their wives and unmarried daughters. There is community of interest and unity of possession between all the members over the family property. A member of an HUF has no definite share in the co-parcenary property, but has an undivided interest in the property. The property belonging to an HUF is ordinarily managed by the father or another senior family member.

1.11 Association of Persons (“AOP”)

AOPs arise when persons come together with a common intention to involve themselves in an income producing activity.

2 Tax Regime and Benefits

2.1 Overview

India has a well-developed three-tier tax structure, comprising the Union Government, the State Governments and the Urban/Rural Local Governments. The power to levy taxes and duties is distributed among these three tiers of government, in accordance with the provisions of the Indian Constitution. Tax can either be direct or indirect. This report is restricted to direct taxation in India (i.e. Income Tax), which is governed by the Income Tax Act (1961), applicable throughout the country.

It is noteworthy that fiscal incentives and concessions may be granted to entities set up for certain purposes such as charitable or educational purposes, infrastructure services and to induce relocation of industries to developing areas. Under the central statute, the term “charitable purpose” has been very clearly defined and is divided into four heads:

- (i) relief of the poor;
- (ii) education;
- (iii) medical relief; and
- (iv) advancement of any object of general public utility.

This means that any organisation carrying on any of the these activities would be carrying on the activity of a charitable purpose and would be exempt from tax. Further, upon fulfilment of certain conditions, the income from property held for charitable or religious purposes is also exempt from tax.

2.2 Companies – limited by shares or guarantee and companies with unlimited liability

Companies resident in India are liable for income tax on their global income, subject to double taxation relief in respect of foreign income taxed abroad. Income tax is calculated in financial years (called the “previous year”), each of which is assessed in the next financial year, called the “assessment year”. Presently, the tax rate is 30% of a company’s profits earned in the previous year. From the assessment year 2005-06, an additional surcharge (called the Education Cess) of 2% of income tax (inclusive of surcharge) will also be levied to finance the government’s commitment to universalise basic quality education.

In the case of companies not resident in India, income tax is only charged on income received, accruing or arising in India or income deemed to be so. In addition to tax on profits, companies must also pay capital gains tax.

2.3 Charitable and educational societies

Social enterprises (including companies licensed under section 25 of the Companies Act (1956) formed or created for charitable or religious purposes or for the promotion of science, literature, education, sports, or fine arts are entitled to exemptions from tax if they are duly registered with the Indian tax authorities.

2.4 Co-operative societies

Co-operative societies pay tax at different rates to companies. The rate of taxation is progressive, ranging from 10 to 30% and in addition, an education cess at a rate of 2% is also charged. The co-operative societies may also benefit from the same business deductions as companies. There are a variety of deductions available to co-operative societies on their income, depending on the nature of their activities.

2.5 Trusts

Trusts, including private and public charitable/religious trusts, are taxable entities. The income of a trust is assessable as an individual in the hands of its trustees or the beneficiaries. However, trusts which are formed for religious and charitable purposes and for the promotion of scientific research, education, sports, certain professions and village industries are entitled to total exemption from tax.

2.6 Partnerships

Partnerships are taxed at the same rate as companies, that is, (30%) plus a surcharge of 10% of income tax and a 2% education cess.

2.7 Hindu Undivided Family (“HUF”) and Association of Persons (“AOPs”)

HUF and AOPs are subject to the same rate of taxation as individuals, (charged at a progressive rate ranging from 10 to 30%) depending on the level of income.

2.8 Societies Registration Act (“SRA”)

Tax issues may arise for social entrepreneurs as a result of the failure of the Indian Tax Authorities to differentiate correctly between “volunteer” and “voluntary”, the former being a person who does not receive remuneration and the latter being a form of agency that may well employ salaried staff. As such, all NGOs are categorised as being the same whether they are charities or social enterprises. The tax consequences of this lack of distinction can be problematic.

2.9 Reduction of taxing timeframes

Previously, if a social enterprise did not spend 85% of its income, the balance could be set aside for 10 years and not be subject to tax provided the entity specifies by notice to the income tax officer the purpose and the period for which the income is being accumulated or set apart. However, under the Finance Act (2001), with effect from 1 April 2002, any income accumulated or set apart on or after 1 April 2001 can now only be set aside for a period of five years. This reduction in the time has an important impact in the ability of social enterprises to expand.

3 Regulatory Regime

3.1 Overview

In general terms there are no specific hurdles to setting up a social enterprise. Social enterprises which employ staff are subject to the laws applicable to employers.

3.2 Employment

3.2.1 General requirements

Indian law requires employers to clearly define their conditions of employment and to make those conditions known to their employees. Once certified, those conditions bind all those in a company's employment as well as any new employees.

3.2.2 Insurance

The Employees' State Insurance Act (1948) ("**ESI Act**") applies to all factories employing 10 or more persons carrying on manufacturing with the aid of electricity or 20 or more persons carrying on manufacturing without the aid of electricity. The provisions of the ESI Act may be extended to industrial, agricultural, commercial or other companies. Each employee who receives wages of up to 6,500 Rupees per month is entitled to be insured under the ESI Act.

3.2.3 Disciplinary and grievance procedures

The Industrial Disputes Act (1948) ("**IDA**") applies to all industrial establishments throughout India, whatever the strength of its workers may be. The law provides that no employee in any industrial establishment who has worked for more than one year may be dismissed without being given one month's notice in writing indicating the reason for dismissal. The employee is also entitled to compensation of 25 days' salary for each year of service.

3.2.4 Working time regulations

The Shops and Commercial Establishment and Factories Act (1948) regulates the working time of employees in commercial establishments and factories.

3.2.5 National minimum wage

The Minimum Wages Act (1948) provides for minimum statutory wages for scheduled employment. This minimum wage is revised periodically to keep it in line with rising prices.

3.2.6 Statutory sick pay

The ESI Act states that every employee is entitled to paid leave of up to 12 days on the grounds of any sickness incurred or accident sustained by him or for any other reasonable cause.

3.2.7 Equal remuneration

The Equal Remuneration Act (1976) provides for equal remuneration for men and women and prevents discrimination against women on the ground of gender in matters of employment. The law also prohibits discrimination against women in recruitment and for their terms and conditions of service such as promotions, transfers, etc.

3.2.8 Payment of gratuity

The Payment of Gratuity Act (1972) applies to all factories, mines, oil fields, plantations, ports and railway companies irrespective of the number of their employees. It also covers shops and establishments where 10 or more persons are employed, or were employed on any day in the preceding 12 months. Every

employee other than an apprentice is entitled to receive gratuity after he has rendered continuous service for five years or more. A statutory right of gratuity has also been given to all employees whose services are terminated on account of superannuation, retirement, resignation, death or disability.

3.2.9 Payment of bonus

The Payment of Bonus Act (1965) guarantees that every employee who has worked in a company for 30 or more working days in that year shall be entitled to be paid a minimum bonus of at least 8.33% of the salary or wages earned by that employee during the accounting year. This is applicable to every company employing more than 20 employees on any day in an accounting year. This benefit is available to every employee who receives a salary or wage of up to 3,500 Rupees per month and has worked for at least 30 working days in that year.

3.2.10 Contract labour regulation

The Contract Labour (Regulation and Abolition) Act (1970) applies to every company that employs more than 20 employees on any day in the preceding 12 months as contract labour. This Act aims at placing contract labour at par with labour employed directly with regards to working conditions and certain other benefits available under labour law.

3.2.11 Employees' provident fund

Every employer must set up a compulsory contributory fund for the benefit of employees which is to be paid out following an employee's retirement, or is paid to an employee's dependants in the case of such employee's premature death. The monthly contribution to the provident fund set at 8-10% of basic salary plus a cost of living allowance. The Employees' Provident Funds and Miscellaneous Provisions Act (1952) extends to all establishments in India employing 20 persons or more.

4 Access to Finance

4.1 Overview

A number of different forms of finance are available to social entrepreneurs. Financing an organisation may take the form of debt or equity. Below is an outline of sources of funding, their principal characteristics and their advantages and disadvantages.

4.2 Equity investment

Equity investment is a form of finance under which capital is invested in the organisation by the owners who are called the shareholders. Unlike debt, equity finance is permanently invested in the organisation. The organisation has no legal obligation to repay the sum invested on a set date or to pay any interest on that sum. Equity investors will typically analyse the growth potential of an organisation and expect to be compensated for their investment by dividends paid out of the enterprise's earnings and capital gains realised upon the sale of their equity interest.

4.2.1 Advantages

- (i) an increased capital base can strengthen the balance sheet and help secure loans in the future;

- (ii) no security is required;
- (iii) there is no contractual agreement to repay; and
- (iv) a hands-on equity investor can provide managerial expertise which the enterprise may lack.

4.2.2 Disadvantages

- (i) must give up ownership/control of part of the organisation;
- (ii) the equity investors are not sure of getting rewards on their investment and share the risk in the business of the organisation; and
- (iii) in the event of winding up, the holders of equity are last to be repaid their capital investment.

4.3 Private debt

Debt finance is usually available in the form of a loan. However, it may also be raised by a bond issue or debentures, in which private investors rather than banks lend the money.

4.3.1 Advantages

- (i) loans can be relatively quick to obtain and can be put to more flexible use;
- (ii) a loan application will be assessed on its own merits rather than in competition with other applications; and
- (iii) debt finance can be short, medium or long term.

4.3.2 Disadvantages

- (i) a loan has to be repaid with interest;
- (ii) it may be difficult to obtain if an organisation does not own sufficient assets that can be offered as security; and
- (iii) assets can be lost if finance is not repaid.

4.4 Donations

Charitable, educational societies and other forms of social enterprise receive their finance from donations and grants made either by private bodies or the government. While donations have the advantage of not being required to be repaid, they may be restrictive if they are given with instructions that the money should be used for a specific purpose. There is also a danger of organisations adapting their programmes to attract donations rather than fulfilling their original social objectives.

The issue of donations faces a major obstacle because the FCRA specifies that an organisation may not receive foreign funds unless it has been registered under this Act (for which it has to be at least three years old). As such, social entrepreneurs at an early stage may be completely impeded from obtaining the funds they require to support growth.

4.5 Micro finance

Micro finance is increasingly recognised in India as an important source of finance both for the generation of social capital and in the not-for-profit sector. These microfinance requirements in India are met through a number of schemes offered by a diverse range of

organisations, which can be broadly categorised into formal institutions and informal institutions. The former category comprises APEX development financial institutions, commercial banks, regional rural banks, and co-operative banks that provide microfinance services in addition to their general banking activities and are referred to as microfinance service providers. On the other hand, the informal institutions that undertake microfinance services as their main activity are generally referred to as micro Finance Institutions (“mFIs”).

The main microfinance service providers in India are National Bank for Agriculture and Rural Development (“NABARD”), Small Industries Development Bank of India (“SIDBI”) and, Rashtriya Mahila Kosh (“RMK”). At the retail level, commercial banks, regional rural banks, and, co-operative banks provide microfinance services.

Notably, private initiatives in this area in the form of Self-Help Groups (“SHGs”) are encouraged by the government as well as the mFIs. It must also be noted that, while the above structure is operational in India, there is as yet no legal framework in place for specific governance. As a result, mFIs are not required to follow standard rules and many have been highly innovative in their approach, particularly in designing new products and processes. However, the flip side of this is that the management and governance of mFIs generally remains weak as there is no compulsion to adopt widely accepted systems, procedures and standards.

4.6 Endowments

Until 31 March 2003 social enterprises were permitted to accumulate 25% of their surplus income as an endowment for future work. However, the Finance Act (2002) reduced this to 15% The Act also provided that the accumulated endowment money can only be invested in government securities (which yield a very low rate of return).

5 Case Studies and Responses to Questionnaires

Research was undertaken by interviewing social entrepreneurs who had experience of founding socially-minded organisations in India. Amongst the enterprises interviewed were the following:

- an organisation that enables and empowers rural families to improve the water and sanitation facilities in their villages;
- an organisation that creates and markets sustainable technologies for use in rural areas; and
- an organisation that provides 24-hour phone access for children in distress in a large number of Indian cities and puts them in touch with other child-service organisations.

These organisations are at various stages of development but have all been reliant on the drive, commitment and connections of their educated founders. However, all agree that the following have been and continue to be a hindrance to their efforts to develop their respective organisations further:

- the fact that not-for-profit organisations are not given favourable tax treatment;

- the fact that not-for-profit organisations can only accumulate 15% of their surplus income and these surplus assets have to be invested in government securities which do not bear a high rate of interest;
- the difficulty of finding sources of capital for further expansion;
- the lack of understanding amongst the banking community of the benefits of investing in the not-for-profit organisations which means it is very difficult for them to obtain bank funding;
- the difficulty of recruiting highly-skilled graduates and employees to work for these types of organisation, especially those operating in rural areas;
- the Foreign Contributions Regulation Act which stipulates that an organisation cannot receive foreign funds unless it has been registered, and the fact that to qualify for registration, the organisation must be at least three years old; and
- the extensive reporting requirements if an organisation receives grants from the Indian government or from external organisations.

6 Proposals for Improvement

The major issues faced by social entrepreneurs when initiating business seem to derive from the FCRA and certain tax provisions.

6.1 Executive summary

The major issues faced by social entrepreneurs when initiating business seem to derive from the FCRA and certain tax provisions.

A softening of the requirements imposed by the FCRA would be a positive step forward for social enterprises. At present, the Home Ministry administers the FCRA, However, if the responsibility for its functions was transferred to the Finance Ministry, the obstacles posed by the FCRA would be significantly diminished, as it is in the interests of the Finance Ministry to encourage social enterprise. A re-assessment of the existing tax provisions as regards promoting social enterprises would be beneficial.

6.2 Proposal details

6.2.1 Common legislation

There are various laws dealing with social enterprises which pose complications for the operation of social enterprises. At present, there are several pieces of legislation concerning the formation and regulation of social enterprises and this legislation is overseen by a number of different bodies. In order to simplify matters, existing legislation for the incorporation of social enterprises should be reviewed, consolidated and amended on a national level so that the regulations governing social enterprises can be standardised and more easily understood by those who want to become involved in this sector. It should then be possible to register any social enterprise under that law. In addition, all the compliance procedures that are required to be adhered to by social enterprises should be explicitly mentioned in this common legislation and preferably there should be a single window clearance mechanism.

6.2.2 Institutional structure

The monitoring and regulation of social enterprises is done by different government departments which creates problems for the social enterprises. A charities directorate or similar body carrying out the same functions should be created under provisions contained in the new legislation. This body would be the main regulatory agency and would oversee compliance with the legislation by social enterprises. There should be state-level registering offices created under the aforementioned legislation and these offices would perform the function of registration only. In addition, it would be advisable to have a not-for-profit organisation (“NPO”) advisory group, which would advise the charities directorate or similar body on issues including policy guidance, the functioning of social enterprises and the mechanisms for review. This advisory group should consist of representatives from social enterprises, professionals (for example, lawyers and accountants), and experienced officials who have worked with social enterprises.

6.2.3 Restriction under the FCRA

Social enterprises cannot, at present, receive any foreign contribution unless they are registered with the government under the FCRA. The restriction that only associations registered with the central government under the FCRA are eligible to accept foreign contributions should be removed. The Home Ministry (which is currently in charge of registration) does not consider applications from organisations, which have been in existence for less than three years. An immediate solution, before the deregulation of the FCRA, would be to transfer the responsibility for registration to the Finance Ministry as it is in the interests of the Finance Ministry to encourage the growth of social enterprise.

6.2.4 Registration and other compliances

Social enterprises are incorporated under various laws and the registration of these enterprises is complicated and time consuming. It is therefore recommended that under the common legislation the registration process should be simplified and that applications for registration should be processed within a fixed period of time.

6.2.5 Tax issues

Social enterprises have to file applications for exemption certificates under the Income Tax Act, 1961, in order to obtain an income tax rebate. Delays in obtaining such certification leads to the delayed payment of refunds. A re-assessment of tax provisions with regards to promoting social enterprises is required.

6.2.6 Training and capacity building

Social enterprises find it difficult to access information relating to compliance procedures amongst other things. This information should therefore be disseminated by government agencies in the form of simple information booklets, written guidance on government websites, seminars and discussions. Moreover, there has to be an effective dialogue between social enterprises and governmental agencies.

POLAND

Legal Framework

1 Forms of Establishment/Corporate Status

1.1 Overview

Under Polish regulatory law, there is no concept of a social enterprise as a separate entity. Various legal forms may be used for carrying out social/community interest or charitable activities and the way in which they are regulated is largely determined by the type of structure used. Foundations (and to some extent associations) are the vehicles most suitable for conducting not-for-profit activities. Other vehicles, such as partnerships and capital companies, jointly referred to as “commercial companies”², are very rarely used for this purpose.

1.2 Recent developments / statistics

A rapid development of social enterprises in Poland occurred after the system change in 1989. By 2002 the number of social enterprises registered had increased tenfold. However, most of these organisations are still operating with very limited financial means.

The most important problem affecting the operation of non-governmental organisations is a lack of dialogue between the authorities and such organisations. Another factor preventing the faster development of social enterprises is the lack of professional human resources, both on the side of the authorities as well as on the side of the social enterprises.

The important fact in the development of social enterprises is the legislation concerning Community Interest Activities and Volunteer Work (the “**Community Interest Act**”). This piece of legislation provides a number of important regulations for social enterprises including, among others, the possibility for individuals to transfer 1% of their personal income tax to a chosen social enterprise. The act also provides for the creation of the Community Activities Council, which will be a consultative committee by the ministry responsible for social aid.

There are more than 58,000 social enterprises currently registered in Poland (correct as of October 2004), of which over 35,000 are associations and over 5,000 are foundations. Over 1,700 of the social enterprises have obtained the status of a community interest organisation.

1.3 Foundations

Under Polish law, a foundation is a vehicle established with a start-up capital designated for a not-for-profit economic or a social utility purpose. The objectives of a foundation need to be provided for in the foundation’s articles and its constitution. The most common purposes of a foundation, as specified in the Foundations Act 1984, include education, economic development, culture and art, health care, charity and welfare, ecology and protection of historic buildings.

² “Commercial company” is an expression used under Polish law both for partnerships and companies, all of which are regulated by the Commercial Companies Code, as opposed to a “civil law partnership”, which is a civil law expression denoting a special type of agreement, regulated by the Polish Civil Code. In this report we have preserved the terminology used in the Commercial Companies Code.

To qualify, the headquarters of the foundation must be located in Poland. When a foundation acquires money or other property by inheritance, donation or legacy, it is free from inheritance tax and donation tax.

The activity carried out by the foundation can be wider than just managing the property/assets given by the founder. The foundation may conduct a business activity provided that the activity/conduct is covered by the articles and constitution of the foundation. The constitution should include details of business activities that may be carried out by the foundation.

A business activity may only be undertaken if it is in proportion to the purpose of the foundation. The amount of the capital designed for the economic activity cannot be lower than PLN 1,000 (approximately €240) and cannot exceed the capital designated for the statutory purpose.

A foreign foundation is permitted to set up a branch in Poland if it obtains a special permit issued by the relevant ministry (this will depend upon the foundation's activity and purpose). To be issued with a permit the foreign foundation must comply with the same restrictions applicable to Polish foundations. Additionally, certain special regulations apply to branches of foreign foundations conducting business activities in Poland.

1.4 Associations

An association, according to the 1989 Act on Associations, is a voluntary, self-governing permanent organisation formed for not-for-profit objectives. "Voluntary" means with freedom to create, to join or to withdraw from an association. "Permanent" means that the existence of the association is independent from its current member composition.

An association may not distribute its profits between its members. It may conduct business, but income shall be distributed for charitable purposes only. In general, members of an association work voluntarily for its benefit, but the association may employ persons to carry out its administrative work.

Generally, only individuals may be members of associations. A legal person (i.e. a company) may only be a supporting member of an association. Detailed provisions concerning supporting members shall be included in the constitution.

There are two types of association provided for under Polish law; ordinary association and registered association:

1.4.1 Ordinary association

An ordinary association must be formed by at least 3 persons (who may only be natural persons), (the "**promoters**"). The promoters must agree on a name for the association, define its aims, and then issue a resolution of internal procedure, choose a headquarters and a representative who will be empowered to act on behalf of the association. After the registration process, the association may commence activities, so long as, within 30 days from its registration, a prohibition is not issued by the relevant supervising authority. A common association is not a legal entity, and it cannot create branches or conduct business activities or accept gifts and public donations.

1.4.2 Registered association

A registered association becomes a legal entity after its registration in the National Court Register. It has to be formed by at least 15 persons, who give their consent to the statute of association and choose from amongst them a founding committee.

1.4.3 An association may source funds from the following sources:

- membership fees;
- testator's wills;
- gifts;
- sponsorship agreements;
- donations (public fundraising); and
- business activities.

1.5 Partnerships

The Polish Commercial Companies Code provides for six types of so-called "commercial companies".

There are four types of partnership:

- registered partnership;
- professional partnership;
- limited partnership; and
- limited joint-stock partnership,

and two types of capital company:

- a limited liability company; and
- a joint stock company.

A legal partnership is described as a company operating as an enterprise under its own name. An enterprise is formed in order to conduct a business activity with the aim of making a profit. Therefore partnerships may not be founded in order to conduct a not-for-profit activity.

1.6 Capital companies

A limited liability company as well as a joint stock company may be formed for any purpose allowed by law. Therefore, they may also be formed as not-for-profit organisations.

Limited liability companies are rarely used to conduct not-for-profit activity because they are difficult to set up and have a complex internal structure. In order to form a limited liability company, its future shareholders have to contribute at least PLN 50,000 (approximately 12,000 Euros) in start-up capital. In the case of a joint stock company this obligation is even more difficult to meet as the minimum start-up capital amounts to PLN 500,000 (approximately 120,000 Euros).

The liability of shareholders in capital companies is limited to the amount they have subscribed for the company's shares (in a limited liability company the total amount will have to be actually contributed to the company before the company can be registered).

A joint stock company is much more strictly regulated than a limited liability company. It is used for larger operations and usually the shareholders play a less active role in the operation of the company than in a limited liability company.

1.7 Community Interest Organisations

CIOs are regulated by the Community Interest Act. As indicated above, the Community Interest Act does not regulate a specific form of organisation, but sets out the requirements that any entity established in the available legal forms described above has to fulfil to be granted the beneficial status of a CIO.

The major advantages of CIO status are that:

- (i) in relation to their community interest activities, they are released from the duty to pay a number of statutory dues and levies;
- (ii) they enjoy wide access to the media; and
- (iii) each fiscal year individuals may designate 1% of their personal income tax for a selected CIO (this is described in more detail in section 2.2.2 below).

An entity must comply with a number of statutory requirements to be granted the status of a CIO. The most important are that:

- (i) the entity must be established to act for the benefit of the whole society;
- (ii) the objectives of the entity must be limited to a designated, finite list of activities stipulated by government legislation; and
- (iii) the purpose of these activities must be to further these objectives alone and not for profit motives.

The entity's articles should prohibit certain conduct including:

- the provision of loans or securing obligations of the entity by using as security the assets of the entity, when dealing with its members, members of its governing bodies, relatives of such members etc.;
- the transfer of the property of the entity to its members, members of its governing bodies, relatives of such members etc. other than on arm's length terms (especially if the transfers are gratuitous or on terms otherwise privileged); and
- the purchase of products or services on special terms from legal persons and other organisations in which the members of the association, members of its governing bodies, and relatives of such members etc. have some interest.

CIOs have certain statutory reporting and audit obligations designed to ensure the transparency of their activities. There are also certain specific requirements regarding the statutory bodies of the CIO, including the obligation to set up a supervisory committee and certain prohibitions regarding the composition of its management board (such as a prohibition of family ties between the members of

the management board and the members of the supervisory committee), with the purpose of ensuring the transparency and integrity of its operations.

Upon filing an application to the court, an entity may have CIO status conferred upon it. The entities most likely to obtain CIO status are foundations and associations. It is doubtful whether a capital company may be registered as a CIO following an opinion issued by the Ministry of Social Affairs in which it stated that capital companies may not be given CIO status. The reason given was that a CIO may only be an organisation whose activity is not aimed at gaining profit. As capital companies are registered in the register of entrepreneurs and are treated as enterprises for tax and accountancy purposes, they cannot also be registered as CIOs. However, one court has registered a limited liability company as a CIO. The court accepted the argument that as the capital companies may be formed for any purpose allowed by law, they may also be registered as CIOs. It is difficult to determine whether the court will follow this ruling in the future.

2 Tax Regime and Benefits

2.1 Overview

The purpose of this section is to discuss any concessions and tax benefits available under Polish tax law that are applicable to entities with a charitable status and to taxpayers supporting their activities.

The main tax advantage of charitable gifts is the donor's ability to deduct charitable donations from taxable income (6% with respect to personal income tax and 10 % in respect of corporate income tax), or even from tax due (1% in respect of personal income tax) and a corresponding tax exemption in respect of the income thus generated by the beneficiary of the donation. Moreover, Polish tax law provides for a number of specific exemptions for CIOs in respect of real estate tax, civil law transaction tax and stamp duty.

A description of the specific tax benefits applicable to donors and beneficiaries is given below.

2.2 Tax benefits for donors - personal income tax

2.2.1 Taxable income

According to the Personal Income Tax Act (the "**PIT Act**"), in the 2004 tax year, the taxpayer was entitled to deduct an amount of up to PLN 350 from its taxable income on account of donations made to Non-Governmental Organisations ("**NGOs** ") as defined in the Act on Community Interest Activities and Voluntary Services for the purposes of carrying out specified activities in accordance with Article 4 of the PIT Act.

With effect from 1 January 2005, the PIT Act has been amended, increasing the amount of permissible deductions on account of charitable donations to 6% of a taxpayer's taxable income.

2.2.2 Annual tax

According to the PIT Act, a taxpayer is further entitled to deduct from its annual tax an amount up to 1% of the tax due if an equivalent amount has been donated to CIOs. For the 2004 tax year, such donations needed to be made between 1

January 2005 and the last day for submitting an annual tax return for that year, i.e. 30 April 2005.

With effect from 1 January 2005, the PIT Act was amended. In order to make deductions for the 2005 tax year, charitable donations to CIOs can be made between 1 May 2005 and the last day for submitting an annual tax return for the 2005 tax year, i.e. 30 April 2006. The above cap of 1% will remain unchanged.

2.3 Tax benefits for donors - corporate income tax

According to the Corporate Income Tax Act (the “**CIT Act**”), in the 2005 tax year, the taxpayer is entitled to reduce the amount of its taxable income on account of donations made to NGOs for the purposes of carrying out specified activities in accordance with Article 4 of the CIT Act by an amount up to 10% of its taxable income computed in accordance with the provisions of the CIT Act.

2.4 Tax benefits for beneficiaries

2.4.1 General exemption

According to the CIT Act, the income generated by a charity (other than a CIO) that conducts scientific, academic, sports or other statutory activities is tax exempt up to the amount of the expenditure it has incurred on such statutory activities. This provision applies to foundations that do not have CIO status.

2.4.2 Special provisions for CIOs

Under the CIT Act, CIOs are entitled to a tax exemption in respect of taxable income in the amount of any expenditure incurred in relation to their statutory activities, but not in relation to any business activities.

2.4.3 Inheritance tax

Donations for the benefit of CIOs are not subject to inheritance tax.

2.4.4 Real estate tax

Real estate concerns designated for the purpose of conducting not-for-profit activities are exempt from real estate tax.

2.4.5 Stamp duty and civil law transaction tax

Civil law transactions subject to civil law transaction tax and other activities subject to stamp duty are tax exempt when carried out by CIOs in conducting their not-for-profit statutory activities.

3 Regulatory Regime

3.1 Employment relationship versus voluntary services

A natural person is regarded as performing voluntary services if he/she:

- (i) is employed by or provides services for public benefit organisations and public administration units;
- (ii) provides services that are aimed at providing social benefits; and
- (iii) receives no remuneration.

Voluntary services are performed on the basis of an agreement between a volunteer and the benefiting entity. The agreement determines the scope, manner and timeframe of the provision of voluntary services as well as a termination clause. Upon a demand by the volunteer the aforementioned agreement must be confirmed in writing.

The social enterprise is obliged to:

- (i) inform the volunteer about health risks and other threats connected with the services performed and about the rules of protection from such threats;
- (ii) secure safe conditions of work for the volunteer and secure the volunteer with means of personal protection, on the same principles as they would be secured for an employee;
- (iii) cover the costs of business trips and any allowances of the volunteer on the same principles as would be applicable in relation to an employee; and
- (iv) provide accident insurance in relation to the volunteers who render their services for period not longer than 30 days.

The social enterprise may also cover, on the principles applicable to employees, other costs borne by the volunteer in connection with the services rendered by him/her.

On the principles applicable to the employee, the volunteer has the right to services due in the situation of an accident which occurred during the performance of the voluntary services and may have the right to health care benefits.

The obligations imposed upon social enterprises with regard to volunteers are substantial. This may be one of the factors which hinders the development of social enterprises in Poland.

4 Access to Finance

4.1 Financing CIOs

The CIOs within the framework of broadly understood social services, health care, education and ecology may be financed in various ways.

The most popular source is donations from private entities (natural persons may deduct up to 6% of their income and legal persons up to 10% of their income for the purpose of donations). The funds may also be collected by way of public fundraising.

The aforementioned organisations and foundations are also entitled to carry on not-for-profit activities. In particular, such activities may be conducted by fulfilling public tasks entrusted to these entities for consideration as well as selling goods and services produced and performed by persons gaining from public benefit activities or selling goods donated to the organisation. The income from these activities can only be used to pursue the statutory objectives of the organisation.

4.2 Financing of all social enterprises

The government provides various sources of financing to social entrepreneurs. There are numerous funds and projects promoting social enterprises on both the local and national level.

A good example of a governmental financing programme is the so-called Civil Initiatives Fund. The programme is aimed at supporting social initiatives, non-governmental organisations and foundations which conduct public benefit activities. The programme is active in the following fields: social protection, social cooperation, human rights and freedoms, science, culture, education and public security. The funds are distributed competitively. The application process is intended to be simple and efficient.

According to Strategy of Support of Civil Society prepared by the Ministry of Social Policy, local and governmental funds constitute approximately 30% of the total finance to social enterprises. Twenty% of the income of social enterprises is generated by the business activity of these organisations.

5 Case Studies and Responses to Questionnaires

5.1 Background

Social entrepreneurs in Poland have recently been confronted with an entirely new legal system concerning NGOs. Many legislative enactments applicable to the activities of social enterprises have been passed during the last two years (including the Community Interest Act, the current VAT Act and significant amendments to the Personal and Corporate Income Tax Act).

5.2 Research and the general views

During our research, social enterprises expressed great interest in commenting on the functioning of the new provisions of the law as well as on a number of proposals for further innovations. We contacted various Polish social enterprises along with a number of state institutions responsible for the legal aspects of social enterprise activities and discussed their views on the implementation of the new laws mentioned above. In general, the amendments and new legislation were received positively. We have used a number of suggestions made by our respondents in section 6.2 below.³

Respondents from the Barka Foundation for Mutual Help noted that social enterprises are in the process of drafting suggested amendments for the Ministry of Finance regarding aspects of tax legislation.

5.3 Major complaints

The majority of our respondents complained that:

- the operational costs of social enterprises in Poland are too high;
- the unification of the reporting standards and procedures for dealing with and accounting for funds acquired from various bodies is essential;
- there is a lack of adequate information available on access to funds;
- there ought to be less complicated procedures concerning “small grants”;
- it has proved difficult to recover input tax on VAT; and
- several legal terms require clearer definitions.

³ A report prepared by the Polish Ministry of Social Policy, which has proven very useful for the purposes of our report, is available at <http://www.pozYTEK.gov.pl/files/pozYTEK/Samorzad/sprawozdanie.doc>

5.4 Consultation with academics and social enterprises

We have also consulted Professor Hubert Izdebski of the Warsaw University, a scholar who was involved in drafting the Community Interest Act. Professor Izdebski emphasised the need for a coherent theoretical system for the operation of social entrepreneurs in Poland, which could then be implemented by comprehensive legislation. He also pointed out that a comprehensive legislative framework concerning "not for profit companies" is required and warned against fragmented regulatory actions by the authorities. He suggested that a detailed analysis of the effects of the implementation of regulations pertaining to social entrepreneurs in foreign jurisdictions should be undertaken.

We also contacted and consulted with major social enterprises including: The Polish Association of Legal Education, the Barka Foundation for Mutual Help, Habitat for Humanity and Academia Iuris Foundation.

6 Proposals for Improvement

6.1 Executive summary

A number of burdens and problems which hinder the development of social enterprises in Poland still exist, the most important being the lack of proper communication between the authorities and social organisations (a consequence of lack of internal communication within the social enterprises), bureaucracy, lack of professional human resources and inconsistent and unclear regulations.

Recent developments, such as the Community Interest Act are aimed at supporting the development of social enterprises in Poland. It is still too early to judge the impact of the Community Interest Act on social enterprises, but, although it includes provisions which may hinder the development of such organisations (e.g. obligations towards the volunteers), it also seems likely that it will positively influence the development of social enterprise in Poland.

Access to EU funds and further implementation of democratic standards in Poland (connected with the accession to EU) should also result in a better climate for the further development of social enterprises in Poland and may lead to an increase in their number.

6.2 Proposal details

Below we have described detailed proposals aimed at removing the major obstacles to the further development of social enterprises.

6.2.1 The operational costs of social enterprises

With respect to CIOs and other social enterprises, a number of legal requirements should be changed, in particular in relation to:

(i) Filing performance reports

The number of recipients of a CIO's annual performance reports should be limited. Currently, a CIO has to submit a performance report to:

- (a) the Ministry of Social Policy;
- (b) in the case of foundations, the Ministry corresponding to the activity of the foundation; and

(c) the National Court Register.

For supervisory purposes, a single governmental body should be selected as the recipient of the performance reports.

(ii) Accounting system

The provisions that apply to companies also apply equally to CIOs. In the view of many CIO activists, accounting rules and requirements should be simplified with respect to CIOs.

(iii) Court registration fees

The new Court Fees in Civil Proceedings Act (the “**Court Fees Act**”) introduced a registration fee of PLN 500 (approximately €125⁴) for the obligatory registration of social enterprises in the National Court Register, and an additional PLN 150 (approximately €40) for modifying any registered information (e.g. change of the management board etc.). Under the previously binding law, certain social enterprises, including foundations, were statutorily exempted from the obligation to pay registration fees.

Moreover, the obligations under the Court Fees Act are inconsistent with the provisions of the Community Interest Act in that it discharges CIOs from having to pay court registration fees. The Ministry of Social Policy is aware of the discrepancy but they have informed us that are not aware of any steps taken by the Polish government to amend it.

The new law was passed with the intention of simplifying the system. Nevertheless, it is recommended that a free-of-charge registration procedure for CIOs and other social enterprises be expressed directly in the statutory provisions.

The information that a social enterprise has acquired CIO status needs to be announced in the Court Journal (*Monitor S•dowy i Gospodarczy*), and that announcement is subject to a fee of PLN 500 (approximately €125). It is recommended that the ordinance governing the fees for publication in the Court Journal is changed, so that any announcements related to CIOs are free of charge. It appears that the announcements regarding CIOs constitute only a small percentage of the announcements in the Court Journal (the majority being announcements regarding companies) and that any such exemption would not constitute a material loss of revenue to the government.

(iv) Procedure for obtaining the CIO status

The documents that need to be attached to an application for obtaining CIO status are not specified clearly enough in the applicable provisions of the law. This means that the requirements of various district divisions of the National Court Register vary for entities planning to obtain the CIO status. Uniformity of the registration requirements could be achieved by introduction of clearer instructions into the relevant provisions (in particular, in the Community Interest Act) as well as by issuing internal court instructions unifying the requirements of the various court divisions.

⁴ This sum may seem small, but for many social enterprises in Poland this is a relatively high expense.

Social enterprises seeking CIO status have had trouble with properly classifying the scope of their activities in court applications. Such activities should be specified in accordance with the Polish Classification of Activity (*Polska Klasyfikacja Działalności*, "PKD") but these do not exactly match the activities listed in the Community Interest Act and with the internal constitutions of many CIOs. It is recommended that the classifications listed in the PKD should be extended to cover the activities listed in the Community Interest Act.

(v) Administrative expenses

Since administrative expenses (such as fees for the maintenance of premises, phone costs, bank account costs, mail costs etc.) have been reported to pose a major obstacle for social enterprises, especially for the smaller social enterprises, some way of facilitating the funding of such expenses ought to be considered. Placing an obligation on the donors to allow social enterprises to use a small percentage (e.g. 1 - 3%) of donations for administrative expenses might be an appropriate solution. Currently this is not always possible, as often 100% of the grant or donation is required to be used for a particular purpose (e.g. scholarships etc.) with no funds designated for the administration of the grant.

6.2.2 Unification of reporting standards

The standards of reporting (i.e. financial statements) on the use of grants (financial resources) by social enterprises regarding funds received from the state and certain local governments should be unified. Common standards regarding the application procedure and documentation required for the application for public grants should be developed.

6.2.3 Information on the access to public funds

Coherent information on access to public funds is essential. The procedures for accessing funds should be clarified along with as the information about the utilisation of the financial resources obtained by CIOs. This would require the creation of databases or a web page ("**Internet Blackboard**") containing information on the public resources available to social enterprises/CIOs in certain regions of the country.

6.2.4 Gathering and processing data concerning CIOs and other social enterprises

There should be a clear division of competences between public institutions concerning the gathering and processing of data on social enterprises. Information about CIOs and social enterprises should be included in public statistics. The Central Statistical Office of Poland should co-ordinate the process of data gathering, processing and publication.

6.2.5 The partnership projects

Co-operation between local governments and CIOs should be broadened and standardised. Programmes for co-operating with NGOs and other entities (the "**Programmes**") based on Article 5 §3 of the Community Interest Act should be developed by both central and local government. The scope of the Programmes should be extended for a period of time longer than one year.

6.2.6 Access to public media

The law⁵ provides generally that CIOs should be able to publicise their activities for free in the media. An ordinance (*rozporz•dzenie*) will have to be enacted by the National Radio and Television Council (*KRRiTV*) to regulate this issue in detail. The possibility for CIOs to present their activities and aims on public TV or radio is likely to have a substantial influence on the community. A society being more aware of the scope and importance of action undertaken by the CIOs, is likely to become more generous (1% of the tax due donation, grants). Furthermore an appropriate information campaign could be helpful in gathering volunteers.

6.2.7 Introduction of a not-for-profit company

Comprehensive regulations concerning not-for-profit companies should be introduced. It is not as yet clear whether a capital company may acquire CIO status. A new type of a not-for-profit company should be introduced to enable CIOs to be effective entrepreneurs. Differences between not-for-profit companies and commercial, enterprises with a profit motive should exist in respect of taxation, corporate law requirements etc.

6.3 Tax proposals

The tax consequences for an entrepreneur willing to conduct social activities are generally positive. There are, however, numerous ideas for new solutions that could be implemented.

6.3.1 With respect to beneficiaries

A number of changes can be recommended with respect to Value Added Tax (“VAT”).

(i) VAT status

Organisations are not generally tax exempt but may choose to be if their net annual turnover does not exceed €10,000. The threshold of €10,000 is generally considered adequate for organisations to decide whether to opt for the exemption or not⁶. However, if a surplus was zero-rated, this would allow social enterprises to recover input VAT. Such a preferential rate is already available for a number of transactions (mainly in respect to the import and export of goods).

(ii) Services and goods delivery

Organisations criticise the fact that, pursuant to the Act on the Tax on Goods and Services of 2004 (the “VAT Act”), their sales and donations constitute a “delivery of goods” and thus are subject to standard taxation. Furthermore, in the case of social activities like the providing shelter or meals to people in need, the additional taxation seems unnecessary and

⁵ Article 26 of the Community Interest Act and Article 23a of the Act on the National Radio and Television Council. Article 23a.3 delegates power to the council to enact an ordinance detailing the procedure.

⁶ The idea of the Value Added Tax is to tax the value added at each stage of the transaction. The seller does not need to pay the full tax on the price of the product but may decrease it by the amount of tax paid by his suppliers. Thus entities that decide for a tax exemption may not recover the input tax by deducting it from the output tax they had previously paid. Due to this fact when an entity decides to carry on any kind of entrepreneurial activity in most cases it will rather choose to become a taxpayer.

does not significantly increase the state's budget. Moreover, most EU programmes and many private donors do not warrant their grants to be spent on what they believe should be paid for out of government taxation.

Services and goods deliveries are subject to taxation not only in the case of sales and donations but even when they are carried out between two subsidiaries of the same organisation. The organisations are currently in the process of discussing changes with the Ministry of Finance which could be introduced regarding this matter.

The most sought after change would be a tax exemption for organisations providing non-gratuitous "common interest services" which would enable such organisations to offer their services at cheaper rates.

6.3.2 With respect to donors

(i) Personal Income Tax

Payment of 1% of the tax due: it is widely accepted that the procedure for the tax reduction with regards to the 1% of the tax due donated to CIOs should be simplified. Currently, it is the taxpayer that has to compute the value of the donation and on his/her own transfer it to the organisation he/she chooses. This discourages many taxpayers from this minor donation as it imposes these unreasonable requirements. There are suggestions that it should be the task of the tax office to take care of the transfer, for example, as has been introduced in Hungary. The tax office could make the transfer collectively, based on the organisation's number noted by the taxpayer in the declaration. There are also suggestions that the percentage given to the CIOs should be increased as the 1% of tax due might be too low to be effective.

Entitlement to deduct 1% of the tax due: it is also considered unfair that the "1% of tax due" may be deducted by natural persons paying scale tax while certain other taxpayers are not allowed to make such a deduction.⁷ Furthermore, entities paying corporate income tax are outside the scope of this regulation. It would be desirable if all taxpayers could take advantage of the regulation.

Limits on donations: it is also recommended that the limits on donations be increased or abolished. In Poland, an individual may deduct the value of a donation for common interest purposes from his/her income (which is a broader legislative term than the community interest relating to CIOs) up to 6% of his/her taxable income.⁸ In Slovakia, the Czech Republic and the United Kingdom a system of a minimal limit for donations has been introduced while, in the USA, it is possible to deduct 50% of income and Lithuania allows for a 100% deduction. This suggestion needs further discussion as it could lead to the creation of a number of criminal tax havens.

⁷ Such a possibility is not open, e.g. to individual entrepreneurs who carry out independent professions (including e.g. lawyers, doctors, brokers or managers) and those whose turnover in the previous year exceeded €250.000. The natural persons carrying on entrepreneurial activities selecting the linear tax of 19% are also not allowed to make deductions of "1% tax due" for the benefit of CIOs.

⁸ Previously the limit was set at PLN 350 (approx. €80).

(ii) VAT

The organisations also hope that some changes can be introduced with respect to the VAT treatment of donors.

Donations vs. Wasteful Disposal: currently it is often more favourable for corporate donors to dispose of their products than to donate them to charity. The reason for this lies in the VAT rules which at present do not give any special treatment to such donations. Donors who had recovered input tax by deducting it from the output tax charged on supplies do not have to correct their tax declarations if the products are disposed of. If they decided to donate such products, the deducted VAT needs to be repaid.

The organisations would like to see a change with respect to this matter and hope that such donors will be able to use the reduced zero% tax rate. For the time being a preferential rate is already available for the supply of computers to educational entities but some consider that the sale and donation of goods connected with statutory activities should also be brought within the scope of this rate. The introduction of a zero% rate would, however, have to be made in accordance with the 6th Directive and the Accession Treaty and could only be temporary, unless some changes in this respect are introduced at EU level.

Samples: another problem is the lack of precision of the wording of the VAT Act and, consequently, problems with the interpretation of the term “sample product”. Companies from time to time decide to donate such samples to charitable organisations. In the Netherlands, Germany and the United Kingdom the definition of the term ‘sample’ is narrowly construed, while in Poland it depends on the specific situation and the discretion of the tax office, which is discouraging for potential donors.

6.3.3 Non-legislative recommendations

(i) Educational promotion

Educational promotion programmes both for central administration and local governments should be broadened to create a platform for the exchange of experiences.

There is much room for improvement in the communication between local governments and social enterprises as well as in the general educational effort to inform society of the potential benefits of involvement in and support for social entrepreneurship. Local governments could improve the situation by getting actively involved in the promotion of social entrepreneurship tailored to the needs of particular regions.

(ii) Rent for leasing premises

Local governments acting as lessors could facilitate the provision of premises for CIOs and other social enterprises on preferential conditions. CIOs are statutorily exempted from the payment of real estate tax. However, only the most affluent of them own real estate.

UNITED KINGDOM

Legal Framework

1 Forms of Establishment/Corporate Status

1.1 Overview

Six main factors generally drive the choice of legal vehicle for any social enterprise:

- (i) limitation of liability – possibly an important factor for social entrepreneurs tend to be relatively risk averse;
- (ii) access to capital – social entrepreneurs often need access to relatively large amounts of start-up and working capital;
- (iii) tax – social entrepreneurs will want to use the most tax efficient vehicle;
- (iv) stakeholder participation – some social entrepreneurs will want to structure their undertaking to allow participation from a large number of people, whereas some will want to limit participation to themselves;
- (v) regulatory burden – social entrepreneurs will want to limit the amount of regulation to which they are subject; and
- (vi) succession planning – how will the founders involve others now or later (although it has to be admitted that this issue is often left to one side).

The potential vehicles for social enterprises and their advantages and disadvantages are described below.

The choice of the appropriate legal form can be a major problem for budding social entrepreneurs – especially those without a business/finance background. The number of options available in the UK often causes confusion, and there are many cases where none of the possible forms fits properly.

1.2 Company limited by shares (private and public)

Both public and private companies limited by shares have their own legal identity. Shareholders contribute capital into the company by the subscription of shares and their liability is limited to the amount of this contribution. A company may raise additional capital easily by issuing further shares.

This is the most frequent corporate form used in the UK, and banks are used to lending money to these companies.

Company profits are often distributed to shareholders, and not re-invested in the company itself. Even if the constitution is set up to provide for no distributions, this can be changed by a vote of 75% of the members at any time.

More complex structures involving different types of equity and quasi-equity are available, and are common in the commercial sphere, but are outside the scope of this paper.

1.3 Company limited by guarantee

These are companies incorporated with or without share capital (although it is more usual for them not to have share capital). The major difference between these companies and

companies limited by shares is that the liability of the members of the company is limited to such amount as the members agree to contribute to the assets of the company in the event it is wound up. Due to the nature of these companies, funding is not achieved by issuing shares but comes from parties who do not expect any dividend or financial return.

These companies generally cannot distribute their profits to their members, and are therefore normally the vehicle of choice for charities in the UK (and often for social enterprises which are akin to charities).

1.4 Community Interest Company

In October 2004, the UK Parliament passed the Companies (Audit, Investigations and Community Enterprise) Act to create a new form of entity specifically for social enterprises. Community Interest Companies (“CICs”) are designed for businesses which use their assets and profits for the public good. Their primary purpose is to provide benefits to the community, rather than to the individuals who own, run or work in them. The UK government intends that, rather than delivering essential public services in core sectors such as hospitals and schools, CICs should develop to meet the needs of local communities, complimenting core government services in areas such as childcare provision, social housing, leisure and community transport.

CICs are set up in much the same way as ordinary companies and are formed under the Companies Act 1985 but are governed by an independent regulator to ensure they are providing their intended benefit to the community. It has only been possible to form CICs since 1 July 2005. Unlike other not-for-profit organisations, companies seeking to incorporate as a CIC have to pass a “**Community Interest Test**”. To become and remain a CIC, an organisation needs to satisfy the Regulator (in a “**Community Investment Statement**”) that the purpose towards which its activities are ultimately directed could be regarded by a reasonable person as being for the provision of benefits to a community or a section of the community, in the UK or elsewhere. Unlike a charity, a CIC can benefit its shareholders and employees but it must not solely do so. The company must also confirm that access to the benefits it provides is not confined to an unduly restricted group. A CIC must continue to satisfy the Community Interest Test for as long as it remains a CIC.

A statutory “**asset lock**” prohibits CICs from distributing more than a limited amount of their assets or profits to their members. The prohibition is designed to ensure that the assets of the CIC are retained within the CIC and used for the community purposes for which it was formed. Unlike ‘normal’ companies with share capital, dividends cannot be declared by the directors of CICs alone but must be declared by ordinary or special resolution of the members. Dividends are subject to a cap set by the Secretary of State and which can be adjusted by the Regulator (the “**Dividend Cap**”). Interest payable on debts or debentures where the rate is linked to the performance of the CIC (in a similar way to equity returns) is also capped (the “**Interest Cap**”). The asset lock does not prevent CICs from using their assets efficiently in pursuit of their objects. For instance, they will be able to use assets for normal trading or other business activities and to meet their financial obligations. Assets can also be transferred to another asset locked body.

In order to incorporate a CIC, the Community Investment Statement and an “**Excluded Company Declaration**” (a declaration that the company is not formed by any company that is a political party, controlled by a political party or engaged in defined political activities) must be filed with the Registrar of Companies with the usual incorporation documents. The Memorandum and Articles of Association filed must comply with the

Regulations. This means that the core principles of community interest and transparency shape these documents. For example, the intended activities of the company and the community which will benefit should be spelt out in explicit terms.

The Regulator is able to investigate complaints from stakeholders and will have powers to act if it is found that a CIC is not working in the interest of the community or that the asset lock is not being observed. While the CIC regime envisages a "light-touch" regime rather than pro-active supervision of individual CICs, CICs will nevertheless need to file their accounts along with an annual "**Community Interest Company Report**" at Companies House. This Report must contain information on directors' remuneration, details of what the CIC has done to benefit the community, details of how it has involved its stakeholders in its activities, details of dividends declared or proposed and information on transfer of assets. The UK government is reluctant to set any limits with regard to the remuneration of directors as this could hold back the development of the CIC sector. However, the stakeholders will have recourse to the independent regulator if they feel the directors remuneration is inconsistent with the CIC's purposes.

CICs as limited liability companies, are subject to general company law and can take one of three forms, a private company limited by shares, a private company limited by guarantee or a public limited company. As the CIC is a company, it will be able to issue share capital which it is hoped will address certain difficulties currently faced by social enterprises in trying to raise finances, although the usual challenges facing small businesses trying to access private capital still apply.

A charity which already has a corporate form can convert to a CIC with the consent of the Charity Commission. A charity may also operate a CIC as a trading subsidiary. An existing company can also convert to a CIC through a filing procedure at Companies House.

CICs do not have a charitable status and as such, they do not receive charity-style tax exemptions. However, they benefit indirectly from tax relief such as Community Investment Tax Relief ("**CITR**"), under which individuals and companies can receive tax relief for investing in Community Development Finance Institutions ("**CDFIs**") (major financial or micro-credit institutions), which in turn are permitted to invest in CICs. This tax relief, and its stated aim to promote private financing of social enterprises, is the key benefit to being a CIC, rather than another type of company. However, experience since 1 July 2005 seems to suggest that the restrictions on CICs (such as the asset lock) and the restrictions on CITR itself (see section 2.5 below) are unduly complex to protect this tax relief from abuse, and as such, many social enterprises continue to use other forms such as the more flexible partnership model or the more mainstream company limited by shares or guarantee.

1.5 Industrial and provident societies

The industrial and provident society falls in the middle ground between a company and an unincorporated association. Whilst it has rules of association similar to an unincorporated association, it is an incorporated body which benefits from limited liability. An industrial and provident society must either be a co-operative society for the mutual benefit of members, or for the benefit of the community ("**BenComs**"). Those set up for the benefit of the community could be eligible for charitable status. Profits of BenComs are distributed to the wider community.

The incorporation procedure can, however, be expensive and time-consuming. Few professional advisers, including banks, will be familiar with the regime for such societies, which makes them somewhat disadvantageous in terms of financing.

1.6 Unincorporated associations

Unincorporated associations are usually groups of individuals that form together voluntarily for a particular purpose, under a constitution which sets out the duties and obligations of the members. The members of the unincorporated association are also responsible for the contractual obligations of the association. Unincorporated bodies are relatively free from the burden of corporate regulation.

1.7 Sole trader

The business of a sole trader is not separate from the individual in any way. There is no separate legal entity and all liabilities of the business are personal to the owner.

1.8 Partnerships and limited partnerships

There are three types of partnership under UK law. In a traditional partnership, the partners share the profits, costs and liabilities of the partnership and run the partnership under a partnership agreement. Their potential liability is unlimited.

Limited partnerships are less common and are constituted by a number of limited partners and a general partner. The major difference between these and traditional partnerships is that here only the general partner has unlimited liability and the limited partners' liability is limited to their initial subscription.

The third and newest type of partnership is the limited liability partnership. A limited liability partnership is a body corporate with a separate legal personality from that of the partners.

With all the forms of partnership, the return of an investment to partners is in most cases a block on obtaining charitable status, although the lack of restrictions applicable to limited liability partnerships means that they may be an interesting form for social enterprises.

The advantage of the partnership model (limited or otherwise) for social enterprises is that it allows the entrepreneur and the funders to write their own deal, simply and plainly, without the need for extensive (and expensive) structuring and regulation. In almost all cases, what is agreed between the parties will be binding, even if that may seem unreasonable to an outsider.

1.9 Charitable status

In suitable cases, charitable status makes fundraising easier on a practical level. Charities are exempt from Income and Capital Gains Tax, provided the income is applied for charitable purposes only, and additional relief is also available on "**Gift Aid**" donations. Some finance providers only have authority to fund registered charities.

Charitable status is obviously inappropriate for the kind of social entrepreneur who wants to make an impact and achieve some degree of profit (albeit as a secondary motive).

The difficulty in the context of social enterprise is that charities must be 'exclusively charitable', which is much more strict than the "Community Interest Test" employed for CICs, and can often prove unduly restrictive upon the actions of business oriented projects in the not-for-profit sector. Also, charities may find it difficult to engage in raising finances

from banks due to the restrictions on the use of their assets within the confines of legally permitted purposes. However, there is nothing to stop charities setting up their own CICs not only to benefit the community as well as to raise further funds for the main charity.

To be charitable, an enterprise's purpose must be considered to be of such value and importance to the community as to deserve special status. The categories include:

- (i) the relief of poverty;
- (ii) the advancement of education;
- (iii) the advancement of religion; and
- (iv) other purposes beneficial to a significant section of the community declared as such either by statute or in case law.

There is currently a bill before the UK Parliament which intends to broaden these categories to include, amongst others:

- (i) the advancement of citizenship or community development;
- (ii) the advancement of the arts; and
- (iii) the relief of those in need, by reason of youth, age, ill-health, disability, financial hardship or other disadvantage.

2 Tax Regime and Benefits

The tax regime applicable to social enterprises will depend on the form chosen to establish it.

2.1 Companies

Companies resident in the UK, whether limited by shares or guarantee, must pay corporation tax on the whole of their profits worldwide including both income and chargeable gains. Deductions are allowed for charges on income and special capital gains provisions apply to various transactions by companies.

2.2 Partnerships

In respect of partnerships in the UK, each partner is taxed separately in proportion to his/her share of the partnerships' income and gains. UK LLPs carrying on a trade or profession can obtain tax advantages including interest, loss, overlap and double taxation relief.

2.3 Friendly provident societies

Many friendly provident societies are completely exempt from corporation tax, whether relating to profits, income or gains. Certain societies are, however, only partially exempt. Taxation, of benefits received by members follows normal income tax and capital gains tax principles. All though, in practice, most products are exempt from the latter.

2.4 Charitable status

A charity is exempt from corporation tax in respect of most sources of income which are applied for charitable purposes. In addition, a charity is exempt from corporation tax on a capital gain applied for charitable purposes.

A wide range of exemptions are available in respect of particular types of income of a charity. Income that forms part of the income of a charity must be applied to charitable purposes only.

The trading profits of charities (whether carried on in the UK or elsewhere) are only exempt if certain conditions are fulfilled. Firstly, the profits must be applied solely to the purposes of the charity. Secondly, either the trade must be exercised in the course of the actual carrying out of a primary purpose of the charity, or, alternatively, the work in connection with the trade must be mainly carried on by the beneficiaries.

Under the Gift Aid Scheme certain single cash donations to charity are treated as charges on income (i.e. they can be deducted from a company's total profits when calculating its corporation tax). It should be noted:

- 2.4.1 there is no requirement to deduct tax from such payments;
- 2.4.2 there is no requirement to provide a certificate for the deduction of tax;
- 2.4.3 there are few restrictions on close company donations (close companies are generally companies with five or fewer directors/participants or connected parties);
- 2.4.4 there is no minimum amount of payment allowable;
- 2.4.5 certain gifts of shares and securities, or land and buildings to a charity are treated as charges on income; and
- 2.4.6 it includes a donation under covenant.

A capital gain is not a chargeable gain if it accrues to a charity and is applicable and applied for charitable purposes. The statutory exemptions relating to both income and capital gains may be restricted to the extent that a charity incurs non-qualifying expenditure.

2.5 Community investment tax relief

The Community Investment Tax Relief (“**CITR**”) scheme is intended to stimulate private investment in disadvantaged communities by providing a tax incentive to tax paying individuals and companies that invest in not-for-profit and profit-seeking enterprises in or serving those communities. Obviously, for the relief to be beneficial, the investor would need to be tax paying in the first place.

The tax relief is targeted at investors in accredited intermediary organisations, which then invest (directly or indirectly) in enterprises in or serving disadvantaged communities. The CITR scheme aims to encourage the growth of these intermediary organisations, termed Community Development Finance Institutions (“**CDFIs**”), which specialise in providing funding to businesses, social and community enterprises in under-invested areas.

CDFIs may take a range of forms including:

- (i) community loan funds, which make capital available to community regeneration initiatives and businesses;
- (ii) microfinance funds, which make very small loans, usually at near-market rates of interest, to the smallest businesses, e.g. sole traders; and
- (iii) social banks – profit-seeking financial service providers or subsidiaries, dedicated to social or environmental objectives.

Subject to certain conditions, CITR is available to an individual or company who invests (by way of loan, securities or share capital) in an accredited CDFI institution.

The tax relief is worth up to 25% of the value of the investment in the CDFI and is apportioned over five years. Slightly different rules apply where the investment in the CDFI is by way of a loan.

However, the rules which permit CITR are very restrictive. There is a cap of £250,000 on the investment, and a time limit of five years on the relief. A further difficulty with the CITR regime is that it is only available for investments made through CDFIs. There are no other tax incentives for investors directly in CICs, who are not able to utilise CITR.

3 Overview

In the UK social enterprises are treated by reference to the corporate form they adopt. There are no exemptions available based on the social benefit that the social enterprise creates for the community as a whole.

3.1 Employment

3.1.1 General requirements

The UK has comprehensive employment legislation. All employers must provide employees with written particulars of employment within two months of commencing employment, setting out the main terms and conditions of employment. Changes to the written statement must be notified at the earliest opportunity. Employers are liable to pay secondary tax contributions, but these can be deducted from the payment of earnings on which that contribution has been calculated.

3.1.2 Insurance

Employers must insure against liability for personal injury or disease sustained by employees and arising out of and in the course of their employment in the UK. Employers must currently insure for £5,000,000 in respect of claims relating to any one or more employees arising out of any one occurrence.

3.1.3 Maternity and paternity leave

Statutory maternity leave is 26 weeks. Women who have 26 weeks' continuous service at the end of the fifteenth week before the expected week of childbirth are entitled to an additional period of 26 weeks.

Employees eligible for paternity leave can take up to two weeks' paid leave to care for their new baby and support the mother.

3.1.4 Disciplinary and grievance procedures

The Statutory Disciplinary and Dismissal Procedure must be applied when employers contemplate taking dismissal or disciplinary action against an employee. This usually involves the employer setting out in writing the allegations, meeting the employee to discuss the matter and allowing the employee an appeal. A similar process applies where an employee wishes to raise a grievance with its employer.

3.1.5 Working time regulations

Employers must take all reasonable steps to ensure that workers do not work more than an average of 48 hours a week. Employees may opt out of the limit in writing, although it is anticipated that the European Commission may well recommend an end to this exemption.

Workers are also entitled to an in-work rest break of 20 minutes when the daily working time is more than six hours, a rest period of 11 consecutive hours between each working day, an uninterrupted rest period of not less than 24 hours in each seven day period, and four weeks' annual paid leave. It is not possible for employees to contract out of these requirements.

3.1.6 National Minimum Wage

The national minimum wage for workers over 22 is currently £5.05 per hour. There are lower rates for younger workers. Employers cannot contract out of the National Minimum Wage and there is no exemption for small employers or charities.

3.1.7 Statutory Sick Pay

Employers are responsible for paying Statutory Sick Pay (“SSP”) to their employees for up to 28 weeks of absence due to sickness during any three year period. Employers are entitled to recover part of their payments if their SSP payments made in any month exceed 13% of their employer national insurance contributions liability for the same month.

4 Access to Finance

The lack of access to appropriate finance, along with a general lack of understanding and awareness of social enterprise business models, has been identified as a major barrier to the growth potential of social enterprises in the UK. In July 2003, the Bank of England published the results of a comparative study into access to finance for social enterprises. It identified a number of demand and supply side issues holding back the growth of this sector.

On the demand side, factors which have discouraged social enterprises from accessing commercial finance include: risk aversion from taking on debt, limitations arising from legal structures or grant funding conditions, concerns about giving personal guarantees, and perceptions about the cost of loans versus grants. On the supply side, because providers of commercial finance tend to look for a track record of income generation as well as high growth potential, there has been a general reluctance to lend to social enterprises. An often heard complaint is that there is not enough “seed money” available from non-public sources and thus too much funding takes the form of debt when the social enterprise really needs equity.

4.1 Overview

A number of different forms of finance are typically available to social enterprises, including both public and private finance, and these may take the form of debt or equity. Private finance may carry a higher financial cost than public funding but it also has a number of advantages. It is very often longer term than annual grant funding and thus can free up management from constant fundraising. It is also generally more flexible because funds received are not tied to specific outputs and sometimes not even to specific projects.

Below is an outline of four separate sources of funding, their principal characteristics and their advantages and disadvantages.

4.2 Donations

Donations from private individuals or charitable organisations may be suitable where no market exists for the goods or services being supplied, where start-up costs are substantial or where there is no immediate prospect of income generation. While donations have the advantage of not being required to be repaid, they may be restricting if they are given with instructions that the money should be used for a specific purpose. There is also a danger of organisations adapting their programmes to attract donations rather than fulfilling their original social objectives.

4.3 Equity investment

Equity investment is a form of finance under which capital is invested in an organisation by the owners (shareholders) and is sometimes also known as seed or grant equity. Unlike debt, equity finance is invested on a long-term basis (normally permanently) in the organisation. The social enterprise has no legal obligation to repay the sum invested at a set date or to pay any interest on that sum. Equity investors will typically analyse the growth potential of an organisation and expect to be compensated for their investment by dividends paid out of the enterprise's earnings and/or a capital gain realised upon the sale of their equity interest.

4.3.1 Advantages

- (i) An increased capital base can strengthen the balance sheet and help secure loans in the future.
- (ii) No security is required.
- (iii) There is no contractual agreement to repay.
- (iv) A hands-on equity investor can provide managerial expertise which the enterprise may lack.

4.3.2 Disadvantages

- (i) This form of financing involves giving up ownership/control of part of the social enterprise. many social entrepreneurs (especially founders) are thus uncomfortable with equity funding.
- (ii) Social enterprises will not always exhibit the characteristics that equity investors are seeking, such as high growth potential or capital gains.
- (iii) Legal and ownership structures of social enterprises can restrict their ability to take equity finance.

Although there have been attempts to create social venture capital funds, there is currently little supply of venture capital to the social enterprise sector because of the difficulty in providing a commercial return and a lack of clear exit strategies for investors to realise their returns. It is hoped that CICs will encourage more private equity investment in social enterprises.

4.4 Private debt

Debt finance may be available in the form of a loan or bond issue.

4.4.1 Advantages

- (i) Loans can be relatively quick to obtain and can be put to more flexible uses than grants.
- (ii) A loan application will be assessed on its own merits rather than in competition with other applications.
- (iii) Debt finance can be short, medium or long term.

4.4.2 Disadvantages

- (i) Capital has to be repaid with interest.
- (ii) May be difficult to obtain if social enterprise does not own sufficient assets that can be offered as security.
- (iii) Assets can be lost if finance is not repaid.

Patient capital loans are designed to ease the transition from grant dependency into commercial funding. These are very long-term loans designed to favour the borrower through the inclusion of terms which provide for low interest payments, renewable terms, loan repayment holidays, subordination to other finance and no security. Such capital is currently in short supply in the UK, but it is hoped that the creation of CICs, along with CTR, will encourage more private debt investment in social enterprises.

4.5 Public Funds

Social enterprises often receive part of their funding through grants from charitable foundations, government or European funds. Where there is no market for goods or services or where the initial operating costs are large, a grant may be the most appropriate way of funding certain activities. Grants have the significant advantage of not having to be repaid but there are also some important drawbacks to consider.

4.5.1 Advantages

- (i) Nothing to repay.
- (ii) Can be used to fund non-income generating activities as well as to cover start-up costs while revenue-generating activities are built up.
- (iii) Helpful to undertake activities that have a high social impact but are considered risky by commercial financiers.

4.5.2 Disadvantages

- (i) Often short-term and unpredictable.
- (ii) Grants often paid in arrears, which can cause cash flow difficulties.
- (iii) Restrictions on the use of grants can limit an organisation's ability to borrow in the future.
- (iv) Increasingly difficult to obtain.

- (v) May need to account for how the money is spent.
- (vi) Hidden costs associated with grant funding, such as time spent fundraising and reporting.

4.6 Venture philanthropy

Recently in the UK there has been a limited supply of 'venture philanthropy'. Venture philanthropy aims to apply the hands-on technique of venture capitalists to grant-making by pledging funds over a number of years and providing managerial assistance to help strengthen the enterprise's organisational capacity.

5 Competition Issues

5.1 European Union state aid provisions

The EU rules on state aid are aimed at creating a level playing field for all industries in the EU by preventing enterprises from gaining an unfair competitive advantage as a result of government assistance. Where social enterprises benefit from financial support by the government, state aid issues may arise. Member States must notify the European Commission of intended grants. If this is not done, the beneficiary may be under an obligation to repay the aid plus interest. However, aid for regional development, employment, research and development is permitted in certain circumstances. There is no general exemption for social enterprises or the good causes they serve.

Where Government funding is less than €100,000 over a three-year period, the state aid rules do not apply (except in the agriculture, fisheries and transport sectors). Further, social enterprises may benefit from a discretionary exemption in respect of so-called lesser amounts of state aid ("LASA"). Under current draft proposals, the European Commission will grant an exemption for LASA, provided it is limited to 30% of the project costs for the development of a certain activity, and a total of €3 million per enterprise over a one year period.

5.2 Government contract procurement

Contracts which the government or statutory authorities wish to conclude with social enterprises may be subject to the rules on public procurement.

Councils are increasingly recognising that the procurement models they use may put social enterprises at a disadvantage vis-à-vis their more conventional competitors. Contractual regulations which require bidders to have significant financial reserves and quality assurance measures in place, for example, can thwart the ambitions of smaller organisations. Contracting authorities are required to base the award of contracts either on the economically most advantageous tender or the lowest price. A recent judgment of the European Court of Justice has, however, been interpreted as allowing social considerations also to be taken into account.

6 Case Studies and Responses to Questionnaires

Research was undertaken on a number of social enterprise entities in the UK including:

- a community development venture based in London that aims to encourage entrepreneurs in deprived areas, stimulate economic growth and create jobs in local communities;

- a weekly street paper sold by homeless people which features a mix of current affairs and art entertainment reviews and is particularly popular amongst the 15-24 age group; and
- an organisation that aims to be the world's leading academic institution for social entrepreneurship. As such, it is not a social entrepreneur in itself but aims to educate others to help advance change and add value to the social sector.

The accepted view tended to be that social entrepreneurship is a relatively new concept in the UK and, as such, there are a range of difficulties encountered by those involved in such ventures, most notably:

- the difficulty in accessing funding whether it be debt or equity-based;
- the lack of an appropriate legal framework for the establishment of social enterprise;
- the demand from the public sector being for high volume/low cost products that social entrepreneurs do not have the scale of operations to provide;
- social businesses being taxed exactly the same as other profit-making businesses;
- the burden of having to account to the large number of different private investors in social enterprises who have different views as to how they would like to see their money spent; and
- excessive regulatory and governmental bureaucracy.

7 Proposals for Improvement

7.1 Executive summary

There are substantial taxation concessions available in the UK for entities which achieve charitable status. However, the number of social enterprises that achieve this status is limited, not least because of the fact that the entities must be "exclusively charitable" within defined categories. Charities law is changing to allow the promotion of community development to be charitable, but for many social entrepreneurs charitable status will be inappropriate or, worse, unobtainable.

The government is hoping that CICs will offer benefits to a wider section of the business community by encouraging individuals and companies, through CITR, to invest in intermediary CDFI's which in turn invest in CICs.

However, there is a confusing array of choice of potential corporate vehicles open to social entrepreneurs in the UK, and many argue that this confusion has not been aided by the introduction of CICs. There are a number of restrictions, such as the asset lock and potentially heavy regulation in relation to CICs which may substantially limit their use.

We have set out a number of proposals which we hope would, if implemented, assist the development of the social enterprise sector in the UK.

7.2 Tax Concession/Credits

It is clear from discussion with those involved in social enterprise in the UK that funding is the key issue facing social entrepreneurs. While the new CITR rules do go some way to encouraging loan financing (although even these rules are unduly complex and limited in

their application), the preferred method of financing for the entrepreneurs themselves is, understandably, equity financing. However, social entrepreneurs often find it difficult to encourage equity finance.

We should therefore propose that tax concessions are granted to providers of equity finance.

An additional benefit to this proposal would be the increase in expertise that could be brought into the social enterprise market. Private equity funds, attracted by tax concessions as well as potential returns on their investment, could bring their significant experience in the private market to bear on social enterprises. Using streamlined business models and possibly even providing mentoring services to the entrepreneurs to aid the promotion of their ideas.

7.3 Capital gains tax concessions

Social enterprises are not charities. They should not be entitled to lead a fully tax-free existence. However, being run for the benefit of the community, social enterprises are also not 'normal' private businesses, and should therefore be granted some kind of tax concession. Whilst tax on income is to be expected and is relatively easy for social enterprises to manage, taxes on capital gains are much harder, and lead to hardship for many social enterprises.

We would therefore propose that all taxes on capital gains (as an aspect of any corporation tax payable) be waived for social enterprises.

As important, a capital gains tax ("**CGT**") concession should be offered to equity investors in social enterprises. It is clear that social enterprises find it difficult to encourage equity finance. However, once the equity is there, if it increases in value, the entrepreneur is 'penalised' for any increase in value on equity. We would propose CGT relief for the entrepreneur, in recognition of the benefits to the community he has provided.

7.4 Amendments to the CITR regime

Although the CITR regime is in its infancy, there has been very limited take-up so far and it has already been heavily criticised by several of those involved in social enterprise in the UK. There are several points to be made:

- (i) the current cap of £250,000 is too low to make a difference to any but the smallest social enterprises, which are more likely than not those which would not be aware of the existence of the organisations who can offer CITR funding, and are also likely to be too risk-averse to take out loans in the first place. This cap should therefore be removed, possibly with the caveat that loans above a certain amount would require the approval of the Regulator;
- (ii) the requirement for all CITR funding to be made through CDFIs has limited the availability of CITR funding to a few accepted organisations. We would propose that the need to fund through a CDFI be removed, and that anyone who funds through a loan (or shares, see proposal above) be entitled to a tax concession. This will allow high street banks to offer funding to social enterprises at less than market rates;
- (iii) the time limit of five years is also unduly restrictive, and should be extended. Most social enterprises are unable to pay off their loans that quickly; and

- (iv) some kind of rollover should be permitted to allow lenders to transfer tax concessions for one loan to another.

7.5 Procurement

One of the biggest issues facing social enterprises on a commercial level is the fact that they are often excluded from taking part in the activities they were set up to promote, due to the fact that they have insufficient financial reserves and quality assurance measures in place to be eligible for local council procurement processes. Sometimes this is merely an issue of perception, but more frequently councils feel tied by European procurement legislation to exclude social enterprises from their procurement processes. This is unacceptable and needs to change.

We therefore propose that the Government issue a paper clarifying how the European procurement legislation applies to social enterprises, making clear that such social enterprises are excluded from some of the harsher requirements of the regime (as is the case for several of the UK's European neighbours) and in doing so free local councils and governmental organisations from their fear of breaching the European procurement legislation.

7.6 State-aid exemption

State grants to social enterprises fall within the heavily regulated state aid arena. Originally created to ensure a level playing field for 'real' businesses, social enterprises are now often unable to benefit from state grants. We therefore propose that the European Commission is lobbied to create an exemption to the state aid rules for grants to social enterprises.

7.7 Think-tank

On a more pragmatic level, we propose that a social enterprise 'think-tank' (involving the public and private sector, universities and others) be created in the UK, much like the "Wall Street Without Walls" project in the USA, comprising legal and financial professionals, to help social enterprises with matters such as (i) understanding the legal, regulatory and tax environment, (ii) access to information, (iii) financing options, (iv) management issues, (v) succession planning and (vi) other issues which they face.

7.8 Standardised Model

Although the CIC has come a long way in standardising the choice of corporate vehicle open to social entrepreneurs in the UK, there is still an argument that the confusion regarding appropriate vehicles has not been aided by the introduction of CICs. There are still a number of restrictions, such as the asset lock and potentially heavy regulation in relation to CICs, which may substantially limit their use. Therefore there is still a need for the introduction of a standardised model in the UK.

UNITED STATES

Legal Framework

1 Forms of Establishment/Corporate Status

1.1 Overview

In the United States, state law serves as the primary source of regulation governing business entities. Initially social entrepreneurs face a choice regarding what legal form their organisation should take. The choice of corporate form involves a balancing of factors such as the goals of the social entrepreneur, the time frame for action, and the anticipated cost of achieving those goals. Considerations to take into account include:

- (i) the need to limit liability of the owners;
- (ii) management and control;
- (iii) likely sources of financing;
- (iv) issues of continuity of existence and transferability of ownership; and
- (v) tax consequences of organising, operating and winding up the social entrepreneurship organisation.

It is also important to note that determining where legal formation should occur is yet another consideration to take into account because governing laws vary from state to state. This section briefly summarises the defining characteristics of each of the typical organisational forms recognised under state law.

1.2 Sole proprietorships

A sole proprietorship is a company with only one owner that is not publicly registered. Sole proprietorships have the advantage of administrative simplicity and minimal transaction and start-up costs. No public filings are required either to establish their legal existence or to mark the winding down of operations. Existence is tied to the life of the sole proprietor. Management rests entirely in the control of the sole proprietor. Moreover, all of the assets of the sole proprietor are available to finance the business. There are typically no tax consequences with respect to the formation of a sole proprietorship other than that the sole proprietor should separate business and personal accounts for record-keeping purposes when filing his individual income taxes. A major disadvantage of the sole proprietorship is that, since the operator of the business and the business are inseparable, the operator is exposed to unlimited personal liability for the actions and obligations of the business. Another disadvantage is that transferring interests in sole proprietorships is difficult, and may only be accomplished upon a sale of the assets of the business.

1.3 Corporations

Unlike a sole proprietorship, a corporation is an entity that is separate and distinct from its owners. Corporations have the advantage of limiting the liability of their owners (typically referred to as shareholders), who are generally not held personally liable for the corporation's liabilities. Corporations have the further advantage of facilitating access to capital because they are able to offer a myriad equity interests to potential investors as well as to borrow money on the basis of their credit. Subject to market conditions, ownership interests in corporations can be relatively easy to transfer, with shareholders generally

permitted to freely transfer their shares. The corporate structure typically separates management and control from ownership, with a board of directors making business decisions pursuant to the corporation's articles of incorporation and by-laws. Corporations have perpetual existence unless their by-laws state otherwise.

There are, however, certain disadvantages to the corporate form. Forming and maintaining a corporation necessitates filings with the Secretary of State of individual states and complying with applicable regulations. Moreover, the standard corporate form can result in double taxation with tax imposed at the corporate level on the corporation's earnings and at the shareholder level upon their receipt of distributions of the corporation's earnings. Under the federal tax code, if a corporation meets certain criteria, it could elect to be treated as an 'S' corporation, which obtains pass-through status with respect to corporate earnings, thus avoiding the disadvantage of double taxation.

1.4 Partnerships

A partnership is an association of two or more persons who carry on, as co-owners, a business for profit. Partnerships are advantageous from a tax perspective because, unlike a corporation, partnership earnings are not taxed at the partnership level. Instead, partnership earnings are only taxed upon distribution to partners. In addition, because a partnership may be created upon entry of partners into a partnership agreement, formal filings with the Secretary of State are usually not required. The partnership agreement sets out the governing terms of the partnership, including the duration of the partnership and the manner in which it will be managed.

A general partnership arises when each of the partners manage the day-to-day operations of the partnership, and each partner may be held jointly and severally liable for the liabilities of the partnership. A limited partnership arises when a general partner manages the day-to-day operations of the partnership business and one or more limited partners contribute equity to the partnership but do not assume personal liability for the obligations of the partnership above the amount of their contribution. In exchange for limiting their liability to the amount of their investment, as a rule limited partners give up their involvement in making business decisions relating to the partnership.

1.5 Limited Liability Companies

Limited Liability Companies ("LLCs") are legal entities that attempt to combine the tax benefits of partnerships with the limited liability and financing benefits of corporations. For an LLC to be treated as a partnership for tax purposes, the LLC must lack at least two of the following characteristics: continuity of life, free transferability of ownership interests or centralised management. Unlike partnerships, where at least one member is personally liable for all of the liabilities of the partnership, each member of an LLC is liable for the debts of the LLC only up to the amount of its capital contribution. Moreover, unlike limited partnerships where partners give up managerial control in exchange for limited liability, members of an LLC may manage the LLC directly, or hire a third party to manage, without jeopardising limited liability.

Members typically serve as the primary source of financing for an LLC, but they may do so with a broader array of equity vehicles than available in partnerships. Ownership interests in LLCs are typically treated as securities and are governed by applicable federal law. LLC agreements typically provide for LLCs to dissolve upon the withdrawal of one of the members. Transferability of membership interest is another issue determined by agreement among the members. LLC members often sacrifice the free transferability of shares and the perpetual existence that are associated with the corporate form of

organisation in exchange for receiving partnership pass-through treatment with respect to revenue generated by the LLC. Like corporations, LLCs register with the state and file periodic updating documentation.

1.6 For-Profit /Not-for-profit

Most corporate statutes assume that organisations are being created for profit. Many states, however, have additional laws governing the formation and operation of not-for-profit entities as well. Not-for-profit entities are not forbidden from making a profit on business activities, but they are forbidden from distributing profits to owners. Instead, not-for-profit entities must use their profits to promote approved public purposes. The decision regarding whether to organise as a for-profit or a not-for-profit entity, like the decision regarding what legal form of organisation to take, has a strong bearing upon the kind of funding that a corporation can raise, and the regulatory hurdles it will have to overcome.

2 Tax Regime and Benefits

2.1 Overview

The applicable tax regime and the availability of certain tax incentives provide another important consideration for social entrepreneurs in determining whether to organise as a for-profit or not-for-profit entity. For many social entrepreneurs, the tax code has a direct bearing on their ability to raise financing from both government and private sources. This section will first highlight several tax incentives available to for-profit social entrepreneurs and, second, describe certain tax considerations relevant to not-for-profit organizations.

2.2 For-Profit organisations

For-profit social enterprises are taxed as any for-profit institutions would be. Thus, for-profit corporations are taxed at the applicable corporate rate on revenues, less deductions. There are certain tax credits, however, for which social enterprises are potentially eligible, depending on their social purpose. These tax provisions serve to lighten the tax load that would otherwise apply to conventional for-profit businesses. Two such examples are described below.

2.2.1 Low-Income Housing Tax Credits

The Low-Income Housing Tax Credit Program (“**LIHTC**”) incentivises private investors to provide funds for the development of affordable housing projects. LIHTCs allow Community Development Entities (“**CDEs**”) to syndicate and sell tax credits to investors to raise money for the funding of the construction of affordable housing units. The amount of tax credits that a CDE may sell depends on (i) the number of tax credits that are made available to the state in which it operates; and (ii) considerations such as the cost of the project, the sources of funding for the project and the proportion of the project that will be devoted to affordable housing. Once a CDE receives an allocation of tax credits, it must hire a syndicator to securitise the tax credits for purchase by investors. In addition to purchasing tax credits, private investors also may acquire an ownership interest in the affordable housing project. If, over time, the housing project fails to meet qualifications required for LIHTC eligibility, the tax credits may be recaptured by the Government.

2.2.2 New Markets Tax Credit

The New Markets Tax Credit (“**NMTC**”) is an attempt to incentivise private investment in CDEs that promote entrepreneurship and business development in low-income areas. The NMTC attempts to induce investors to invest in traditionally under-capitalised areas by mitigating the risks typically associated with such investments in several ways:

- (i) in exchange for investing in approved CDEs, the NMTC provides private investors with tax credits in addition to equity interests in the businesses that the CDEs support. Regardless of whether the business ventures succeed or fail, investors receive approximately 30% of their investment in the form of tax credits over 10 years.
- (ii) by requiring investors to go through CDEs, the NMTC ensures that investment decisions will be made by the people who are experts in the needs of the communities they serve. This increases the chances that investment decisions will be made on an informed basis by the people who are familiar with low-income communities.
- (iii) by becoming equity investors in CDEs, private investors benefit from reduced risk because CDEs will be able to spread their investment out over a relatively broad array of businesses located within low-income communities. As a further incentive for CDEs to invest carefully, if CDEs fail to invest in qualified active businesses in low-income communities, their tax credit allocation may be recaptured.

2.3 Not-for-profit organisations

Tax benefits are crucial to the operation and continued survival of not-for-profit entities. For the purposes of the tax code, not-for-profit organisations generally are organisations organised and operated exclusively for a proper public purpose (such as religious, charitable, scientific or educational) of which no part of the net earnings inures to the benefit of any private shareholder or individual.

2.3.1 Tax exempt status for not-for-profits

Section 501(c)(3) of the Internal Revenue Code allows not-for-profit organisations to be exempt from taxes on any revenue generated by their business activities to the extent that any such income is related to a not-for-profit’s public purpose. If, however, a not-for-profit generates income that is unrelated to its not for profit/public purpose, such income will be taxed at the applicable corporate rate. The distinction between unrelated and related business income can be difficult. Whether income is unrelated to a not-for-profit corporations’ public purpose turns on considerations such as whether the income was derived from a trade or business regularly carried out or an activity that typically generates a profit and whether the activity was conducted in the same manner as a for-profit business that provides a similar service or goods.

2.3.2 Public charity vs. private foundation

Perhaps even more important to not-for-profit organisations than their tax exempt status under section 501(c)(3) is their status as a public charity under sections 509(a)(1) to 509(a)(4) of the Internal Revenue Code. Status as a public charity is

crucial because it allows qualifying not-for-profits to raise money from contributors with the understanding that contributors may deduct their contributions on their tax returns. To qualify as public charities, not-for-profit entities must demonstrate, among other things, that their mission embodies a permissible public purpose and their contributors represent a fairly broad segment of the population. In addition, the proportion of the public charity's budget from a single donor cannot exceed a specified amount.

A private foundation, sometimes called a non-operating foundation, receives most of its income from investments and endowments. This income is used to make grants to other organisations, rather than being disbursed directly for charitable activities. Private foundations do not receive status as public charities under sections 509(a)(1) to 509(a)(4) of the Internal Revenue Code. While a private foundation has tax-exempt status, donations to the private foundation cannot be deducted by donors on their tax returns.

The distinction between donations being tax deductible (in the case of a public charity) or not being tax-deductible (in the case of a private foundation) can be central to an organisation's capital raising. Falling outside the eligibility of the relevant Internal Revenue Code and, instead, becoming a private foundation, can seriously impair a not-for-profit entity's ability to raise money. Private foundation status means an increased reporting burden on the not-for-profit and an increased likelihood that donors may be audited by the IRS. Moreover, if the proper provisions are not included within a not-for-profit organisation's governing instrument, private foundation status can jeopardise the organisation's tax exemption as well as the ability of its contributors to deduct their contributions from their tax returns. Because of the numerous rules, to obtain or maintain public charity status under sections 509(a)(1) to 509(a)(4) of the Internal Revenue Code, it is essential that not-for-profit entities obtain sophisticated tax advice when raising money from contributors, designing their internal governing framework and creating their organisational structure.

3 Regulatory Regime

Perhaps the biggest obstacle to social entrepreneurship involves sorting and complying with the tangled web of laws that regulate business operations at the federal, state and local levels. While federal, state and local laws are replete with incentives for social entrepreneurs, there are also a number of pitfalls, particularly at the local level, that can ensnare social entrepreneurs with unforeseen expenses.

For example, state licensing requirements can impose a layer of requirements and added costs that hinder the start-up of entrepreneurial activity. In addition to complying with state licensing requirements, social entrepreneurs must also comply with all other applicable local ordinances, including zoning ordinances, business tax licenses or other locally required permits. Another potentially complicating aspect of local zoning and code regulation is the personal manner in which the rules are enforced. Code enforcement offices are often understaffed, making enforcement haphazard and unpredictable. Whatever their idiosyncrasies, code inspectors possess sufficient discretion under authorising ordinances to make, for example, establishing a home-based business exceedingly cumbersome and potentially prohibitively difficult for low-income individuals.

4 Access to Finance

4.1 Overview

Having sufficient money on hand to pay obligations as they become due is the central challenge of any business. Social entrepreneurship is no exception. The financing decisions that social entrepreneurs make are directly related to their ability to make payments as they become due, and, equally important, to fulfil the social purposes for which they were created.

Financing is crucial at all stages of the business, from seed money at infancy, to working capital facilities for businesses as they mature, to additional funds for new projects or acquisitions. Moreover, financing is an area where federal, state and local laws have been designed to provide incentives to certain entrepreneurship activity in the form of direct grants, matching funds and below-market-rate loans, just to name a few. Some of these incentives are place-based, meaning that they are available to the extent that social entrepreneurs undertake activities in particular geographic regions; some are means-tested, meaning that they are available only to the extent that the activity of social entrepreneurs is directed to help individuals who satisfy thresholds of need; and some are unrestricted grants.

It is therefore critically important for social entrepreneurs to maximise the effect of available subsidies by structuring their business and activities accordingly. This section will first provide an overview of the financing options available to for-profit entities. Second, it will detail financing options available to not-for-profit entities. Finally, it will provide examples of potential government financing assistance available to social entrepreneurs.

4.2 For-profit entities

Conventional for-profit entities have numerous financing tools at their disposal. Although rights and labels differ depending on the choice of corporate form, for-profit entities generally can raise money by selling equity stakes in their business to investors. Equity entitles an equity holder to a pro rata share of the value of the business in excess of its liabilities, which may be realised, for example, by receiving a distribution from the company (a dividend with respect to corporations), or by selling all or part of its equity share to another willing buyer.

For-profit entities can also obtain capital by issuing debt, allowing such entity to receive cash in exchange for a promise to repay principal plus interest at a later date. Unlike equity financing, which entails little in the way of commitment from the company, debt financing, by its nature, obligates a company to perform in accordance with an agreed repayment schedule. Depending on its enterprise value and available assets, for-profit entities may decrease the cost of obtaining debt financing by offering lenders a security interest in personal property, including the right to future revenue, and a mortgage over real property. It is worth noting that for-profit entities seeking to raise money by selling equity or issuing debt may fall within the federal regulatory remit of the Securities and Exchange Commission, as well as regulations with respect to financing passed by the individual states. These regulations are designed to ensure that all equity and debt offerings are accompanied by a level of disclosure appropriate to fully inform offerees of the risks of the particular investment. Securities regulations apply equally to conventional for-profit businesses, and to for-profit social entrepreneurs alike. As the cost of regulatory compliance can be significant, it is important that social entrepreneurs are adequately

apprised of the potential risks and advised accordingly so as to minimise front-end transaction costs and the risk of incurring back-end liabilities in connection with the issuance of securities.

4.3 Not-for-profit entities

Not-for-profit entities have fewer options than for-profit entities in terms of raising financing. There are two significant reasons for this limitation. First, unlike for-profit entities, which can sell equity entitling investors to a share of the value of the enterprise, not-for-profit entities are expressly prohibited from selling equity. Indeed, traditional notions of equity do not translate well into the not-for-profit environment because not for profits cannot earn and distribute the cash flows they generate to owners, but instead must invest any earnings into the social purpose served by the entity. Second, the cost of obtaining debt financing for not-for-profits can be higher than the cost of obtaining debt financing for-profit corporations because of the perception that not-for-profits lack steady cash flows and hard assets over which to grant security.

Nonetheless, traditional sources of capital for not-for-profits include private individual donors, family foundations, community foundations such as community development corporations which disburse contributions to worthy organisations in the community, national philanthropic foundations, corporate foundations, banks and governmental funders. The tax mechanisms that provide incentives to encourage private contributions to not-for-profit organisations are discussed in greater detail below.

Common methods of funding not-for-profit entities include (i) direct grants, which amount to conditional or unconditional gifts of liquid resources for use in the short term; (ii) below-market rate loans; (iii) market rate loans; and (iv) the use of equity equivalents. Equity equivalents are essentially loans that do not have to be repaid to investors if the not-for-profit can demonstrate that it has attained specified threshold levels of social return. Equity equivalents are a new phenomenon in not-for-profit finance that are designed to fill the gap encountered by many not-for-profits that are unable to borrow all of the money that they require to operate through conventional means.

4.4 Selected public sources of funding potentially available to social entrepreneurs

4.4.1 Empowerment zones

The Empowerment Zone and Enterprise Cities Demonstration Program ("**Empowerment Zone Program**"), passed by Congress in 1993, created geographic zones within certain selected cities that would be eligible for special federal attention to alleviate economic distress. Empowerment zones attract private commercial investment by providing businesses located within Empowerment zones access to low-interest loans and tax credits based on the number of zone residents they employ. In particular, Empowerment zones make available wage tax credits to employers for each employee who resides within the zone and performs services in a trade or business of an employer located within the zone. The Empowerment zone Program also provides accelerated depreciation for certain business property, which allows the entity to minimise its taxable income by accruing depreciation expenses more quickly, and tax-exempt facility bonds for lower-cost financing to induce commercial investment. Interestingly, incentives offered in empowerment zones are available only to start-up companies or to existing businesses that have expanded to create a new branch or office within the

empowerment zone. empowerment zones are precluded by statute from providing incentives to businesses that relocate to an empowerment zone. This relocation disincentive was included to quell fears that empowerment zones would be used to lure businesses away from suburban locations.

4.4.2 Community Development Financial Institutions

The Community Development Financial Institutions Act of 1994 created a new entity, the Community Development Financial Institution (“**CDFI**”), specifically to address the problem of diminished credit availability to residents in many distressed communities. According to their statutory definition, CDFIs must (i) have as their primary purpose the promotion of community development; (ii) serve an investment area or targeted population; (iii) provide development services in conjunction with financial services; (iv) maintain accountability to their service area through community representation on their board; and (v) not be an agency of any government. Upon application to the federal government, selected CDFIs receive government funds for use in supporting commercial endeavours that promote community revitalisation, job creation, the provision of basic financial services and affordable housing, to name just a few. By virtue of being closely tied to particular communities, CDFIs are designed to enhance the decision-making process with respect to the disbursement of federal funds to the most worthy social entrepreneurs.

4.4.3 Community Development Block Grants

Established in 1974, the Community Development Block Grant (“**CDBG**”) is one of the oldest programmes in the Department of Housing and Urban Development (“**HUD**”). The CDBG programme provides annual grants on a formula basis to many different types of grantees through programmes such as Entitlement Communities and State Administered CDBG. This programme, for example, provides annual grants by formula to eligible cities and counties to develop viable urban communities by providing decent housing and a suitable living environment and by expanding economic opportunities, principally for low and moderate-income persons. Furthermore, in 1981, the Housing and Community Development Act of 1974 (“**HCD Act**”) was amended to give each state the opportunity to administer CDBG funds for non-entitlement areas, such as units of general local government that carry out development activities, not otherwise eligible to receive funds from the HUD directly. Annually, each state develops funding priorities and criteria for selecting projects, and distributes CDBGs accordingly. CDBGs provide a common means by which federal, state and local governments can make available funds to social entrepreneurs, among others, in accordance with locally determined needs.

4.4.4 Small Business Administration Development Grants

Small business development grants are extended by the Small Business Administration (“**SBA**”) to fund the SBA’s Small Business Development Center (“**SBDC**”). The SBDC, which started in 1977, provides counselling, training and specialised support assistance to the small business community. Although national in scope, the programme is implemented at the state and local level through more than 50 SBDCs and 900 sub-centres. The objective of the SBDC programme is to leverage funds with state, academic and private sector resources to strengthen the small business community, contribute to the economic growth of the communities

served, create a broader-based delivery system to the small business community, and make local assistance available to many small businesses. The availability of these Small Business Development Grants is limited to for-profit organisations.

4.4.5 Small Business Administration Micro-loan Demonstration Program

Introduced and passed in 1991, the SBA's Micro-loan Demonstration Program ("MDP") was the first legislation to specifically target funding to minority entrepreneurs, not-for-profit entities, business owners, women and low-income individuals possessing the capability to operate successful small businesses. The programme makes a combination of grants and loans to not-for-profit agencies for technical assistance and loans to entrepreneurs. Since its inception, the SBA has made 254 such awards totalling over \$100 million. In 1997, the programme received permanent status as the SBA MDP and is one of the largest federal sources of financial support for the field.

5 Case Studies and Responses to Questionnaires

Research was undertaken by interviewing social entrepreneurs who had experience of founding socially-minded organisations in United States. Amongst those organisations interviewed were the following:

- an organisation providing gardening services and running a bakery employing individuals with disabilities and those from economically disadvantaged backgrounds;
- an organisation that works to establish fair trade practices as an industry standard for agricultural products grown in developing countries and sold in the United States;
- a not-for-profit membership organisation that aims to promote the interests of workers in the United States by providing discounted health insurance, legal services and retirement planning advice, amongst other things;
- an organisation based on a not-for-profit venture capital model that aims to foster and finance the development of technological initiatives that would not otherwise be taken on by for-profit software developers due to their low market returns;
- a not-for-profit pharmaceutical company that aims to complete the development of new drugs for diseases affecting people in the world's poorest countries; and
- an agency providing home health care owned mainly by workers who come from disadvantaged backgrounds.

These organisations are at various stages of development but have all been reliant on the drive, commitment and connections of their educated founders. However, all agree that the following have been and continue to be a hindrance to efforts to develop their respective organisations further:

- the difficulty of obtaining funding for expansion - while donations and tax credits are available, access to funding through the capital markets is not;
- the expense and time spent on fulfilling reporting requirements to donors and to government agencies;

- government regulation, especially concerning registering patents and trade marks;
- the expense of implementing suitable IT systems;
- the difficulty of recruiting employees of sufficient calibre or experience;
- the expense of sourcing professionals from countries where taxes related to employment are high and have to be borne by the not-for-profit organisation;
- insufficient resources to implement concerted marketing campaigns; and
- the difficulty of negotiating with people at a senior management level when trying to sell products or services to large corporations.

6 Proposals for Improvement

6.1 Executive summary

Social entrepreneurship in the United States encompasses a broad array of sectors and disciplines – from for-profit micro-lending institutions created to finance small businesses to not-for-profit pharmaceutical companies dedicated to improving public health. The diversity of social entrepreneurship activities in the USA is an indication of the overall strength of the climate for social entrepreneurship here. Across the USA, the government, private donors and local communities provide a wealth of potential resources and opportunities for entrepreneurs.

At the same time, properly accessing these resources too frequently necessitates the incurrance of significant transaction costs. In addition to the legal impediments to creating a sustainable, effective organisation that confront every business owner, social entrepreneurs face the special challenge of complying with well-meaning regulations that simply were not drafted with social entrepreneurs in mind. Attempting to shoehorn often dynamic social entrepreneurship organisations into regulatory systems designed for traditional philanthropies presents problems that require sophisticated political and legal solutions.

6.2 Proposal details

The diversity of social entrepreneurship makes it difficult to provide general legal recommendations that will be appropriate to each circumstance; however, certain legal obstacles are encountered by nearly every social entrepreneur in the USA. As discussed above, these legal obstacles include:

- deciding on the appropriate corporate form;
- establishing and maintaining access to financing;
- paying tax (or complying with requirements to maintain tax-exempt status); and
- complying with regulations regarding the day-to-day operations of the business.

As a matter of practical policy, it would be useful to provide social entrepreneurs with as comprehensive a guide as possible to the US laws that are relevant for the establishment and running of social enterprises. The development of a resource that cuts through the confusion created by so many overlapping laws and the multitude of governmental and quasi-governmental administrators would provide a helpful tool for current and would-be social entrepreneurs.

Another recommendation is to normalise certain benefits available to for-profit and not-for-profit social entrepreneurs. Certain SBA grants, for example, exclude not-for-profit organisations from their eligible grantees. Expanding their scope to not-for-profits could benefit not-for-profit organisations seeking to fill the gap created by the lack of equity as means of raising financing.

A related recommendation is to work towards an accepted and general definition of social entrepreneurship so that future regulation can be targeted to the entire community of entrepreneurs rather than to subsets determined by virtue of not-for-profit status or corporate form, to name two examples. Agreeing on an accepted definition of the phenomenon of social entrepreneurship could allow regulators to confer social entrepreneurship status upon eligible organisations, or entrepreneurs, themselves, to “elect” social entrepreneurship status. Qualifying social entrepreneurs should be permitted to avail themselves of the benefit of a defined subset of laws and regulations. This normalisation of the legal and regulatory benefits available to social entrepreneurs could diminish transaction costs associated with one-off legal inquiries as well as encourage additional targeted regulation in the future.

In crafting an agreed definition of social entrepreneurship, careful consideration should be given to the question of whether and to what extent social entrepreneurship should be rooted in the act of entrepreneurship for the social good. Reaching a common understanding on this issue would go a long way to resolving whether social entrepreneurship in the USA represents an organic trend arising in local communities, a corporate-driven phenomenon to invest in communities in need, or a workable combination of both.

Appendix A

Types of Social Entrepreneur

Around the turn of the century, the term “social entrepreneurship” was familiar to only a few people around the world. However, over the past few years, people have become more broadly aware of the true meaning of the concept. Entrepreneurs possess a combination of common traits: creativity, single-mindedness, drive and perseverance. But usually these qualities are channelled in the pursuit of personal profit; so it takes a special type of individual who chooses to use his talents not just to benefit himself, but to work for the good of disadvantaged communities and to empower and encourage people in those communities to work together to improve their social predicament. It is those societies which foster innovation, individual achievement, empathy and make allowance for failure that will benefit enormously from the entrepreneurial spirit of the people who live there.

Social entrepreneurship is most frequently associated with the not-for-profit sector, and for that reason there are many social enterprises that have chosen to assume charitable status. But it is questionable whether this existing legal framework is the one which will be the most suitable, in the longer term, to encourage the growth of existing social enterprises and to encourage the proliferation of new ones. Some social entrepreneurs believe that using the existing legislation designed to cater for for-profit entities in various jurisdictions provides greater flexibility.

It is difficult to generalise about social entrepreneurship owing to the difference in the area, scope and aims of the social enterprises currently in operation. However, for the purposes of this report, we have classified social enterprises into two groups.

1 Not-for-profit hybrid social entrepreneur

Not-for-profit hybrids may recover some of their costs, as in, for example, health service provision, education, and/or technology. But to be able to sustain their activities and respond to their clients effectively, they must mobilize other sources of funds from the public sector and/or the philanthropic community.

Example 1:

Rubicon was set up in 1973 in Richmond, California by a group of concerned volunteers. The three core issues Rubicon is engaged in are:

- the multi-generational poverty in the African-American community and the problems faced by immigrant communities;
- the problem of homelessness; and
- the disenfranchisement and marginalisation of the severely mentally disabled.

Rubicon has incorporated business principles into its practice, building three highly successful social enterprises: Rubicon Landscape, Rubicon Bakery and Rubicon Home Care for low income senior citizens.

All Rubicon employees are recruited among the consumers it services namely, the poor, the homeless and the mentally disabled.

Rubicon’s success is based on the primary strategy of creating a successful business that can create jobs and sustain a training component.

Example 2:

Jim Fruchterman who founded Benetech in 1989 in Silicon Valley, likes to joke that Benetech is a “high-tech not-for-profit on purpose” – as opposed to all those high-tech for-profits that died with the collapse of the dot.com bubble and became not-for-for-profits by accident. Benetech is a not-for-profit venture-capital model that fosters and finances the development of technological initiatives which would not otherwise be taken on by for-profit software developers due to their low market returns – mainly because the population Jim serves through Benetech is socially disadvantaged.

Jim came up with the idea when he was an undergraduate studying engineering at the California Institute of Technology, one of the best engineering universities in the USA. One of his professors was explaining the use of pattern recognition to guide “smart bombs” to destroy enemy airfields. Why not use the pattern recognition for social good instead? Jim thought. He came up with the idea of applying this technology to recognise characters and read aloud to the blind. The first of Jim’s initiatives was the Arkenstone reading machine for the blind. The Arkenstone talking/reading systems are considered pioneers in their field. To date, they have delivered reading tools in a dozen languages to over 75,000 disabled people living in 60 countries.

Martus, another Benetech technology, is used by human rights groups as a way of capturing sensitive information about human rights abuses. It was developed through research conducted in Sri Lanka, Cambodia, Guatemala, Russia and Eastern Europe. Benetech is also launching a project to develop a Landmine Detector that will adapt existing technologies to aid in humanitarian landmine removal. This device has the potential to significantly reduce the 1,000 year timeframe projected as necessary for clearing the world’s villages and farmlands of mines. Similar to many social entrepreneurs, Benetech works with a wide variety of global and local companies including IBM, Intel, Sony, Hewlett Packard, Fujitsu, and Sun Microsystems.

2 For-profit hybrid social entrepreneurs

For-profit hybrids are able to fully recover their costs and also generate a profit margin with the main aim being to expand their social venture and reach more people in need effectively. Personal wealth accumulation is not a priority – but reinvested in the enterprise in order to fund expansion.

Example 1:

Rory Stear, a South African, founded the Freeplay Energy Group to address two fundamental impediments to socio-economic development in poor rural regions:

- widespread illiteracy which impedes the effective use of written communication for information dissemination; and
- poor access to electricity that has kept television and radio diffusion at low levels.

Freeplay began by developing cost-effective, robust, wind-up radios, opening up the world of information to isolated and impoverished communities in the Middle East and Africa. These radios do not require electricity or batteries. Rory has patented this wind-up technology which is now applied to torches, water purifiers, cell phone chargers and foetal monitoring instruments.

Freeplay could initially not afford to produce and distribute these radios to the poor, rural populations. However, the success of Freeplay products in the developed world, especially amongst outdoor enthusiasts, environmentalists and emergency workers, has generated sufficient profit for the company to develop and improve its products and to establish the Freeplay Foundation, which buys the radios at a subsidised rate for humanitarian and development efforts. The company has sold more than 4 million products worldwide, and the Freeplay Foundation has distributed more than half a million of those products to isolated rural populations through aid agencies.

Social entrepreneurs undertake both public and private sector functions simultaneously. On one hand, they work with those populations that governments have been unable to reach effectively or have ignored. On the other, they address market failures by providing access to private goods and services where business does not operate - because the risks are too great and the financial rewards insufficient to justify that risk.

Many of the world's largest and most profitable companies attempt to harness the spirit of entrepreneurship as they endeavour to access new markets and build their brand as responsible companies. Governments also have much to gain from supporting social entrepreneurs, but the state should view them as agents for social change and not merely as acting as an outsource agent for public sector functions. In practice, this means that social entrepreneurs should obtain state funding but should also be given a relatively free rein to innovate, outside the straitjacket of government bureaucracy.

Example 2:

Ismael Ferreira established APAEB (Association of Small Farmers of Bahia) to improve the lives of poor sisal growers in one of the most arid states in Brazil. Many of those farmers, Ferreira included, lived in shacks without running water and electricity and could not afford to educate their children. APAEB began by helping farmers to collectively market their sisal crop. As it grew, APAEB fought for export rights, forged links with foreign markets, built processing plants and a factory and now sells millions of dollars of quality finished products abroad. Since the construction of a multi-million dollar carpet factory in 1997 in the middle of the semi-arid region, APAEB's revenues have increased 400 percent. Prices for sisal have increased dramatically. With more than 800 employees and a revenue of \$10 million, APAEB has brought a powerful economic multiplier effect to an impoverished region where half a million people are estimated to derive part of their livelihood from sisal.

APAEB invests its profits in building the infrastructure needed to build the social fabric of Valente, the town where it is located. It has established agricultural schools, health centers, a cooperative bank and a grocery store for the benefit of the area as a whole.

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