

## Incorporating as a legal entity and notes on charitable status

### Advice on incorporation

#### 1. Introduction

1.1 There are two stages for you in considering incorporation, namely:

1.1.1 is incorporating the right decision for your partnership; and

1.1.2 if you do wish to establish an incorporated entity, should that entity be a charity or not?

1.2 These notes consider both of those questions in turn, to help provide some guidance on working through these questions.

1.3 A glossary of key terms is set out in the first section and links to further information on both topics are included at the end of the note.

#### 2. Glossary

Below are short explanations of the key terms used in this note:

<b>Incorporating</b>	this often refers to an organisation that was unincorporated and which is setting up a new legal entity and moving its activities and assets to the new legal entity. It can also refer to setting up a legal entity for the first time.
<b>Legal entity</b>	<p>an organisation that has a separate legal identity to that of the people who run it – i.e. it is treated as a legal person that is different from the identity of the people who run the organisation. For example, a company has a legal entity that is separate to the identity of its directors or shareholders. This means if the company signs a contract it does so in its own name not the names of its directors or shareholders.</p> <p>The types of legal entity discussed today include companies, community interest companies, charitable incorporated organisations and community benefit societies.</p>
<b>Managing Committee</b>	the group of individuals who run an unincorporated association
<b>Unincorporated association</b>	an association that is run by a managing committee where it is not a legal entity, but it is a group of individuals who have come together to pursue a particular purpose

**3. Incorporating as a legal entity**

3.1 A key reason to set up a legal entity is to address the disadvantages associated with being unincorporated. Incorporation addresses:

- 3.1.1 the fact that a unincorporated association has no legal identity separate from its managing committee; and
- 3.1.2 the lack of limited liability protection for those running an unincorporated association.

No legal identity

3.2 Unincorporated associations have no separate legal entity. This means that everything an unincorporated association does is done by and in the names of the people on the managing committee, on behalf of the unincorporated association. This means the unincorporated association is not able to do any of the following in its own name:

- 3.2.1 enter into contracts;
- 3.2.2 sign documents in the name of the unincorporated association;
- 3.2.3 hold the Trust's assets; and
- 3.2.4 sue and be sued.

3.3 While the law has developed limited ways to overcome these issues, these can place an additional (and ongoing) administrative burden which incorporation largely removes. This means that when the managing committee does any of these things, they will sign documents as individuals. For example, if the unincorporated association wished to take out a loan that it would need to be in the names of the managing committee.

Unlimited liability

3.4 Another disadvantage of operating as an unincorporated association is not having limited liability protection for the managing committee. This means that as the managing committee of an unincorporated association will usually hold assets and contract in their own names, it is the managing committee who together will have personal responsibility for the debts and liabilities of the association.

3.5 Provided such liabilities are properly and reasonably incurred, the managing committee will be entitled to meet these costs if the unincorporated association has enough funds. The term 'reasonably and properly' has a technical meaning, but broadly speaking it means that if a liability is caused through the wrong doing of the management committee, for example, if there had been fraud or the management committee had been negligent, then the cost of that may not be able to be met from the funds of the unincorporated association.

3.6 However, being able to meet liabilities from the funds of the unincorporated association will not help if it has insufficient funds to reimburse the managing committee. In these circumstances, the managing committee may be obliged to meet any remaining liability personally. While insurance can cover liability in certain areas,

where the insurance fails or is insufficient, liability falls to the managing committee personally.

## What it means to be a corporate entity

- 3.7 A corporate entity has a separate legal identity to those of its managing committee and confers limited liability protection upon them. This means it is the entity in its own name (rather than the managing committee) which enters into contracts, executes documents, holds assets and may sue and be sued using that name.
- 3.8 This offers an important layer of protection which is not available to unincorporated associations, as well as helping to simplify the general administration in relation to holding assets and entering into contracts.
- 3.9 The members and company directors also enjoy the benefits of limited liability protection. It is generally only the assets that are the property of the legal entity (rather than the assets of the members or trustees personally) which are available to meet the liabilities of the corporate entity.
- 3.10 However, there are a number of exceptions to the principle of limited liability. Directors of a corporate entity may be personally liable to the same extent as the managing committee of an unincorporated association:
  - 3.10.1 for losses to the legal entity arising from a breach of their duties as company directors;
  - 3.10.2 for failing to comply with certain statutory obligations (such as failing to deduct PAYE and national insurance contributions);
  - 3.10.3 if the corporate entity goes into insolvent liquidation and it appears that, at some time before winding-up, they knew or ought to have known that there was no prospect of avoiding insolvent liquidation and they did not take the steps they ought to have taken to minimise the potential loss to the charity's creditors; and/or
  - 3.10.4 if they continue to act after being disqualified from acting as a company director.

## Types of corporate entity

- 3.11 There are different types of corporate entity. The ones that are likely to be most suitable are:
  - 3.11.1 A company limited by guarantee (a company limited by guarantee that is often used for not-for-profit companies and charities established as companies may also use this type of legal entity) (**CLG**)
  - 3.11.2 A company limited by shares (a company with shares that is the common type of company for commercial companies)
  - 3.11.3 A community interest company, which can be limited by guarantee or by shares (a company that is established for the benefit of the community but is not subject to the same restrictions as charities and has a lighter-touch regulatory regime than charitable organisations)

- 3.11.4 Charitable Incorporated Organisation (a legal entity only available to charities and established when the Charity Commission recognises the organisation as a charity) (**CIOs**)
- 3.11.5 Community benefit society (a legal entity that can be charitable or non-charitable, and which is regulated by the Financial Conduct Authority). If it is a charity it does not need to register with the Charity Commission at present, but this may change in the future (**ComBens**).
- 3.12 Each of these type of entity is an incorporated structure and offers limited liability. Further information on companies limited by guarantee and CIOs are below and a link to some further information is included in the appendix.

### The Company Limited by Guarantee (CLG)

- 3.13 CLGs can be charitable or non charitable.
- 3.14 CLGs are a widely recognised legal form and benefit from having broad powers and an established body of legal and practical knowledge relating to how they operate; there is also considerable flexibility regarding the provisions which can be incorporated into the governing document of a CLG, known as its Memorandum and Articles of Association.
- 3.15 CLGs have a two-tier governance structure comprising directors (and members, to whom certain rights are reserved by law. The directors of a CLG will be its charity trustees (if it is a charity), and have certain duties under company law. It is possible for the same individuals are directors and members of a CLG.
- 3.16 CLGs are regulated by Companies House (and the Charity Commission if it is a charity). CLGs must file with Companies House an annual "confirmation statement" and statutory accounts, and various other documents must also be filed within statutory time limits, including:
  - 3.16.1 the Articles of Association and any special resolutions to amend them;
  - 3.16.2 details of trustee/director appointments and resignations;
  - 3.16.3 details of any persons with significant control; and
  - 3.16.4 details of any loans and charges over assets.
- 3.17 An annual return (or annual update) will also need to be filed with the Charity Commission if it is a charity as well as complying with the requirement to inform the Charity Commission of any serious incidents within the charity.

### The Charitable Incorporated Organisation (CIO)

- 3.18 The CIO is a relatively new legal form and is designed specifically for charities and is only available for charitable organisations.
- 3.19 Similar to a company, a CIO has a two-tier governance structure comprising trustees and members; its governing document is referred to as a Constitution. The membership of a CIO can either be different from its trustees (known as the "Association Model"), or the same individuals as the trustees (known as the "Foundation Model").

- 3.20 Where the trustees and members are the same individuals (i.e the Foundation Model), those individuals are empowered to take all decisions relating to the charity's governance; however, certain decisions must be taken by those individuals acting in their capacity as members, and this will be stated in the Constitution.
- 3.21 CIOs are only registered with and regulated by the Charity Commission, so their administration and filing obligations are less onerous than those which apply to a charitable company; however, like a company they must hold and maintain certain registers, including registers of members and trustees. The legal and regulatory approach which has been taken to CIOs to date has broadly followed company law principles, and we would expect it to continue to do so.
- 3.22 Donors, funders and bankers may be less familiar with the CIO structure, though this is likely to change as the structure becomes more established (and most new charities are set up as CIOs). At present no central, searchable register of charges for CIOs equivalent to that which is maintained by Companies House in respect of companies (including charitable companies). The register of charges held at Companies House allow a bank to add an entry to the register to say that it has lent money to a company and taken security over its assets. While mortgages over land can be registered at the Land Registry, lenders may be reluctant to lend to a CIO where a charge is to be taken over the charity's undertaking or other non-land assets.

## **4. Being a charity**

- 4.1 Before becoming a charity it is important to consider whether this is right for your new organisation. This section looks at the advantages and disadvantages of being a charity, whether the charity is established as a CIO or a CLG.
- 4.2 The advantages of being a charity are that:
  - 4.2.1 charities are widely recognised by the public and funders (including local authorities, businesses and other charities that give out grants);
  - 4.2.2 charities are exempt from most direct taxes (such as corporation tax) although there is no general exemption from VAT;
  - 4.2.3 funders will, for the most part, be more willing to provide grant funding to charities than to other types of not-for-profit legal entity that do not hold charitable status;
  - 4.2.4 other charities may be more willing to work with you if you are a charity than another form of not-for-profit.
- 4.3 The disadvantages of being a charity are that:
  - 4.3.1 charities must comply with charity law (which restricts some of the activities that charities can carry out, particularly trading activities);
  - 4.3.2 charities are regulated by the Charity Commission and must ensure they are aware of the Charity Commission's regulatory guidance and the Charity Commission has extensive powers over charities; and
  - 4.3.3 charity trustees (or people connected to trustees) cannot usually be paid by the charity.

- 4.4 Before deciding whether charitable status may be right for your organisation, the following matters should be considered:
- 4.4.1 whether all the activities you wish to carry out are capable of being charitable (if not, some charities will have a trading subsidiary carrying out non-charitable work, but this adds to the complexity);
  - 4.4.2 what charitable purposes might be right for your organisation, which may include a purpose concerned with:
    - (a) community capacity building
    - (b) community centre
    - (c) recreational facilities
    - (d) relief of poverty
    - (e) advancement of education
    - (f) urban or rural regeneration

This is not a complete list of charitable purposes and the Charity Commission apply certain tests for different purposes so it is important to check whether your organisation will meet the criteria set by the Charity Commission for the purpose you choose. The Charity Commission also prefers purposes to be similar to their example objects. A link to the example objects is included in the appendix.
  - 4.4.3 whether you have a group of individuals willing to serve as charity trustees;
  - 4.4.4 whether you are more likely to receive the financial support you need (from individuals or organisations) if you are a charity than if you are another form of not-for-profit (if possible, it is helpful to have conversations with possible supporters to check this).
- 4.5 Registration as a charity can take a long time. Currently, it is not uncommon for registering as a charity to take 6 months or longer. This will need to be factored into your plans for incorporation. Once a charity is registered with the Charity Commission it also needs to register as a charity with HMRC.
- 4.6 A decision on whether charitable status is right for you should be considered before incorporation, as if you later decide you want to be a charity, you may have to set up a new legal entity or make changes to the constitution of your legal entity to become a charity.
- 4.7 If you decide not to be a charity but do wish to set up an incorporated entity it could be a community interest company or a company limited by guarantee or a community benefit society.
- 4.8 Links to further guidance are set out in the Appendix.

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## Appendix – Further information

### Information on legal structures for community and voluntary groups

<https://www.resourcecentre.org.uk/information/legal-structures-for-community-and-voluntary-groups/#society>

### Incorporation as a legal entity (except for a CIO)

Companies House

<https://www.gov.uk/topic/company-registration-filing/starting-company>

Community Interest Company Regulator

<https://www.gov.uk/government/organisations/office-of-the-regulator-of-community-interest-companies>

Financial conduct Authority (for community benefit societies)

<https://www.fca.org.uk/firms/registered-societies-introduction>

Incorporation agents or solicitors – may help with setting up a legal entity

### Setting up a charity

Charity Commission

<https://www.gov.uk/setting-up-charity>

<https://www.gov.uk/topic/running-charity/setting-up>

<https://charitycommission.blog.gov.uk/2016/03/22/want-to-set-up-a-charity-three-big-questions-to-consider/>

Choosing charitable purposes: <https://www.gov.uk/government/publications/charitable-purposes/charitable-purposes>

Example charitable objects: <https://www.gov.uk/government/publications/example-charitable-objects>