Fostering social entrepreneurship.

Linklaters

Legal, regulatory and tax barriers: a comparative study
A summary of recommendations for governments, policymakers and social entrepreneurs in Brazil, Germany, India, Poland, the United Kingdom and the United States

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The report:

Linklaters with the assistance of the Schwab Foundation for Social Entrepreneurship ("Schwab") and various Schwab “fellows” around the world has prepared a Report which 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”).

The Report is the result of our objective to devise a project that could best use the firm’s legal resource on a global level. Our Community investment strategy is to work globally, nationally and individually with organizations whose aim is to foster and encourage social enterprise, and in particular social entrepreneurs, on promoting achievement, and offering access to justice.

Schwab exists to promote social entrepreneurialism in the belief that this is an ideal means through which to address social issues and encourage economic and social advance, and was an obvious partner with whom to work on our global project. Following the advice of Schwab, the research project was constructed to focus on the Selected Countries, where their fellows had experienced problems or barriers in setting up social enterprises, with the ultimate aim of the findings of the report being used to lobby government in each jurisdiction to change legislation and encourage the development of this crucial area of work.

Key findings:

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.

Copies of the full Report may be obtained from Linklaters Community Investment department, but a summary of some of the key issues we uncovered follow.
What is social entrepreneurship?

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). 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.

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

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.

How the report was compiled.

The process through which the 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.
Summary of findings and common issues.

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 makes 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.

Germany
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.

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 6.9 of the report presented. 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.

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.
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 could provide. In particular, 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.

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 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 funding 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.

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.