

# WHAT IS A GUARANTEE COMPANY ?

## Introduction

The technical name of a Guarantee Company is 'a company limited by guarantee but without a share capital'. It is one of the types of company, affording limited liability, which can be set up under the Companies Acts.

Where voluntary and community organisations enter into contracts, as they are likely to do with any active project work, a guarantee company can provide important protection to its Board of Trustees and its members, who are otherwise involved on a voluntary basis. Such contracts might include contracts of employment, the purchase of property, building contracts, contracts with fund-raisers, contracts with service providers, etc.

In addition, a guarantee company provides a clear legal identity, the ability to own property in its own name and a democratic structure where its participants are required to adhere to the strict laws and regulations governing limited companies generally.

A guarantee company is often referred to as a 'not-for-profit organisation', meaning that its profits are not distributed to its members but are retained to be used for the purposes of the guarantee company. Of course this does not mean that the guarantee company cannot make a profit, as indeed it is almost paramount that it can and does so. It would therefore be better called a 'non-profit-distributing organisation'. As such it is ideally-suited to many charitable and community initiatives where its purpose and assets remain in the charitable or community domain, rather than in the hands and ownership of individuals.

The main differences between a guarantee company and a company with shares are:

- its members do not receive share certificates and whilst they control the guarantee company, through decisions taken by them at General Meetings, they do each not "own" a proportionate part of the guarantee company.
- its members cannot receive any dividend, profit or other income from the guarantee company, nor can they share in its assets if the guarantee company comes to an end.
- its members enjoy limited liability, but usually have to pay an annual subscription (at a rate set annually by themselves at General Meeting) and, if the guarantee company comes to an end through a liquidation, they are obliged to pay a final sum of £1 each to the Liquidator.
- the members elect the Board of Directors (usually called Trustees or Governors to avoid connotations of salaries and bonuses) which is responsible for setting and overseeing the policy of the guarantee company.
- the Directors also enjoy limited liability, provided that they have not acted negligently, or fraudulently, or have not permitted the guarantee

company to continue trading when it was insolvent (this is known as "wrongful trading").

## **Constitution of a Guarantee Company**

The constitution document is known as 'the Memorandum and Articles of Association'. It is in two parts - the Memorandum of Association and the Articles of Association.

The **Memorandum of Association** explains:

- the type of company
- its main Objects (all of which must be charitable if the guarantee company is to be recognised as a charity), which describe the maximum extent of the guarantee company's ambit
- its Powers (to enable the Objects to be carried out)
- restrictions on money being paid out by the guarantee company to its members and Trustees
- the personal guarantee given by each member (usually £1) upon liquidation
- what is to happen to the surplus assets if the guarantee company comes to an end (which, if the guarantee company has been a charity, must be transferred to one or more other charities).

The **Articles of Association** explain:

- how membership can be applied and ended
- the rules relating to members' meetings (known as Annual General Meetings or Extraordinary General Meetings)
- how Trustees are elected or appointed, their term of office and how they retire
- the rules relating to Board meetings and meetings of any Committees
- any provisions relating to Conflicts of Interest
- the appointment of the Company Secretary
- provisions relating to the finances and the annual accounts
- provisions relating to notices

## **Advantages**

- members' liability is restricted (usually to £1)
- the guarantee company can hold property and borrow money in its own name
- the guarantee company is subject to the democratic control of members - both in relation to fundamental decisions (e.g. a change in the constitution) and in relation to election/re-election of the Board.
- it is relatively easy to set up a wholly-owned subsidiary company, with a share capital owned by the guarantee company, which is particularly useful where the guarantee company is a charity and the subsidiary company is to be used for non-charitable trading (often called "a trading subsidiary").

## **Disadvantages**

- the guarantee company is bound by the terms of the Companies Acts and thus subject to more controls than any other legal structure. These controls are really designed to protect the shareholders of commercial trading companies and, however inappropriate these may sometimes seem to a community-run guarantee company, they have to be adhered to
- costs of setting up including legal advice may be substantial (although in some cases, particularly for charities, there may be grant aid available to assist in meeting these start-up costs)
- annual expenses are incurred - the audit or independent financial examination of the annual accounts and the company secretarial work (intimating to the Registrar of Companies changes in the composition of the Board, lodging an Annual Return, lodging the annual accounts, arranging the AGM, etc.).

## **Constitution / Memorandum & Articles of Association**

A number of issues will require to be considered by the promoters of the new organisation, which include:

- **Determining the Objects** which the new organisation intends to carry out. Particular care with the Objects requires to be taken where charitable status is to be sought as all of the Objects must be charitable, not just some. If only some are charitable, consideration should be given to setting up a separate but wholly-owned subsidiary company to carry out the non-charitable trading - this is most appropriate where a guarantee company which is a charity owns all the shares in a trading subsidiary company.
- **Determining the membership**, and its composition; whether the membership will be "open" to all-comers, or "closed" to a specific group of organisations or individuals, or "hybrid" as a mixture of the two; whether there will be more than one class of member; and whether and how new members are to be recruited.
- **Determining the membership subscription** (if any).
- **Determining the Board of Directors** (although not usually called 'Directors'); their minimum and maximum number; how they are to be elected, nominated and/or appointed; the length of a term of office; and the maximum time they can serve.
- **Considering any issues which will require a 75% vote.**
- **Considering the terms upon which the organisation would be wound up** and a mechanism to determine to which other charity or charities the surplus assets would be transferred.
- **Consider an appropriate name.** If it is a charity, it may wish to exclude the word "company" or "limited" in its name and to include, for example, the word "trust" or "partnership" (even though it is a company rather than an actual trust or partnership). It is possible to obtain preliminary approval to a name from the Registrar of Companies and essential to do so if the name contains a sensitive word such as "Scotland", "Scottish". "Institute", "Authority", etc.

These criteria are to some extent less relevant where a Deed of Trust is drawn up.

### **Formation of a Guarantee Company**

- prepare draft Memorandum & Articles of Association
- if the guarantee company is to be a charity, send draft to HM Inland Revenue (IR Charities) for their informal opinion on its potential charitable status
- seek approval from the Registrar of Companies to the proposed company name
- finalise Memorandum & Articles
- appoint the Company Secretary and choose the Registered Office
- hold the Subscribers' meeting and sign the incorporation papers
- proceed to incorporate the guarantee company
- if to be a charity, write again to HM Inland Revenue to obtain its Charity Recognition Letter
- hold the first meeting of the interim Board.
- hold the first General Meeting of members.

### **Publicity about a Guarantee Company**

The name of the guarantee company must be displayed outside its Registered Office and any other business office at which it carries on its operation.

All notepaper of the guarantee company must show its full name as stated on its Certificate of Incorporation, its Registered Office address, its business address (if different), its registered company number and the fact that it is registered in Scotland. One can decide whether to show the names of the directors on the notepaper but, if so, all of the directors should be shown, not just some. If the guarantee company is a charity, this must be stated on the notepaper and it is advisable to include the Scottish charity number.

## **SETTING UP A CHARITY**

### **Introduction**

Every year, hundreds of groups set up as charities in Scotland. They encompass all sorts of interests and activities - environmental issues, training for employment, working with the young, the elderly ethnic minorities and so on. However; gaining charitable status is a formal process with implications to be consider carefully.

The following notes are intended for initial guidance only to those considering setting up formally a new non-profit-distributing organisation, which may or may not also be recognised as a Scottish charity. Detailed advice and

assistance should be sought at the earliest stage as, increasingly, an 'off-the-shelf' solution is not usually appropriate.

## **Legal Structure**

The new organisation can be:

- an unincorporated association or club; or
- a trust formed by a Deed of Trust (usually granted by one or more individuals); or
- a company limited by guarantee, but without a share capital.

There are other models, but these three are the most common. Most non-profit-distributing organisations nowadays opt to become guarantee companies.

Two new model for charities - the Charitable Incorporated Organisation and the Community Interest Company - are being contemplated under an updating of the Companies Acts and modernisation of the Industrial & Provident Acts, but neither is yet in force. When they are, they are likely to sit alongside guarantee companies rather than replace them, at least initially.

## **What is a Charity?**

A charity is an organisation which has been established exclusively for charitable purposes. Its income must be applied to its charitable purposes only. The people involved in making policy decisions (the members of the management committee, the trustees or the directors - depending on the type of legal structure) must not be paid employees of the charity. If the legal structure involves a membership, there must be a clause in the constitution prohibiting the payment of dividends and profits to members. The funds and other property of a charity have to be used for charitable purposes and, if it comes to an end, its surplus assets have to be given to another charity or charities.

In essence, there are now six different categories of Charity recognised in Scotland (although the McFadden Commission has suggested a complete overhaul of these, which is currently being considered by the Scottish Executive). To be recognised as a Scottish charity its aims (i.e. the Objects set out in the constitution) must fall within one or more of these categories, which are:

1. **The relief of poverty** (and relief from need in relation to disabilities, etc.) - this includes activities such as relieving the needs of people with disabilities providing special housing for the elderly etc.
2. **The advancement of education** - this means education in the broadest sense - e.g. research (providing the findings are made public),

- the arts, museums and galleries, training and (providing there is a strong educational element) child care projects.
3. **The advancement of religion** - this refers to any form of religion and includes the support of the clergy as well as the repair and maintenance of churches.
  4. **Other purposes beneficial to the community in a way recognised as charitable** - for example, conservation of the environment, preservation and protection of health, rehabilitation of ex-offenders, relieving the distress of the homeless, victims of violence and so on. Unfortunately, the category of "purposes beneficial to the community" is not quite as wide as it might seem - there are certain activities (e.g. community radio) which the law courts will not recognise as falling within the charitable field.
  5. **"The provision in the interests of social welfare of facilities for recreation and other leisure time activity** available to the public at large with a view to improving their conditions of life"; this category was introduced by the Recreational Charities Act 1958 and includes community halls and leisure centres.
  6. **Community Amateur Sports Clubs**, which must (a) be of an amateur nature; (b) be open to all members of the public; (c) be non-profit distributing; and (d) provide facilities for one or more sports; but (e) provide only the normal facilities of an amateur sports club to its members; this category was introduced by the Finance Act 2002.

There is a general "public benefit" test - that is, the charity's work must be intended to benefit the general public or a reasonably large section of the general public. This test would exclude for example clubs which are run for the benefit of their members, or a project involving the renovation of a listed building if the public was to be denied access. It also has implications in relation to training (a training course will not be considered as charitable if it is open only to employees of a specific organisation) and research (research will not be charitable unless the results are to be made public).

### **Charitable Status - or not ?**

If a body is unlikely to benefit financially from the tax privileges available to charities and if there is no intention to seek funding from sources which can only give to charities, it may not be worthwhile applying for recognition as a charity. Also, if proposed activities are mainly intended to benefit a specific membership or if all the decision-making is to be carried out by people who draw a wage from the project, then this would be incompatible with charitable status. The Steering Group should discuss with its legal adviser how important the benefits would be in particular circumstances and whether the proposed aims would be compromised unacceptably by the restraints of being a charity.

### **Advantages**

1. Donations can be received from individuals and companies through annual covenants, deposited covenants, Gift Aid or payroll giving, with relative Income Tax and Inheritance Tax advantages.
2. Donations can be received from other charities.

3. Exemption is given from Income Tax (s. 505 of the Income and Corporation Taxes Act 1988), Capital Gains Tax (s.256 and 257 of the Taxation of Capital Gains Act 1992), some Value Added Tax (especially on the sale of donated goods in charity shops), Corporation Tax and (where public trusts would otherwise be subject to tax as being discretionary) Inheritance Tax.
4. Relief is available from local authority Rates. 80% relief is standard, on application. In the past, this was usually brought up to 100% by discretionary relief, but this is now less likely because of Local Authority funding constraints. Whatever, the sewerage rate is still charged.
5. Public image.

### **Disadvantages**

1. Adherence to accounting requirements in terms of the Regulations and Statements of Recommended Practice. More Regulations and Statements are in the pipeline.
2. Adherence exclusively to the stated and approved charitable objects.
3. No return is permitted to members (they cannot be "investors" and cannot partake in profits or dividends ).
4. A duty to provide information on request to HM Inland Revenue, the Lord Advocate, the Scottish Charities Office and also the public generally (in supplying a copy of the charity's "explanatory document" and its last statement of accounts).
5. Supervision and potential investigation by HM Inland Revenue and/or the Scottish Charities Office.
6. The need to create a separate trading subsidiary, if there is to be any non-charitable work, with additional costs involved.

If it is considered preferable to seek charitable status, the constitution of the association, trust deed of the trust or Memorandum & Articles of Association of the guarantee company would require to be approved by HM Inland Revenue (IR Charities) before being given recognition as a Scottish charity.

### **Non-Charitable Trading**

It is essential that all of a charity's funds are used for its stated charitable purposes only: - this is an absolute rule. In this connection it is helpful to ask three essential questions:

1. what are the charity's main Objects?
2. is the proposed course of action going to further the charity's Objects?
3. is the proposed course of action in the best interests of the charity and its Objects?

To avoid the charity's profits being taxed by virtue of s.832 of the Income & Corporation Taxes Act 1988, it will be necessary to create and run a trading subsidiary to carry out all of its non-charitable work. The trading subsidiary will be a company limited by shares (with perhaps two or three shares in all).

The charity will be the sole shareholder, owning all of those shares. The charity will appoint all of the trading subsidiary's Directors, who will run the subsidiary and report, as a Committee, at all Board meetings. Any surplus profit which the trading subsidiary makes in any year, not required for its own business development, can be covenanted by it to the charity. The question of trading needs to be considered more and more carefully, as charities are forced to look at other ways to boost their income. If a charity trades non-charitably, it not only risks taxation of its profits but also losing its charitable status.

It is essential to work out the process carefully because there funds go up a One Way Street - the trading subsidiary can send funds to the charity, but the charity cannot send funds to the trading subsidiary. careful planning is therefore required.

An example of this system in operation is in relation to a theatre. The theatre will be a charity and its arts programme is charitable. But its restaurant is not because, although linked to the arts experience, feeding people is not a charitable activity. So each theatre will have a separate trading subsidiary to run its catering facility.