



# **SETTING UP A HYBRID SOCIAL ENTERPRISE**

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# INTRODUCTION

- Hybrid models (i.e. a mix of legal forms) are becoming increasingly popular amongst South African social enterprises.
- This trend is influenced by the failure of South Africa's legislation to adapt to the phenomena of social entrepreneurship. This has led to many social enterprises choosing to create both a for-profit and a non-profit legal entity in order to attract donations and earn an income from business activities.
- There are a range of reasons why social enterprises choose to establish hybrid models. While some of these reasons are informed (e.g. prevent business activities from dominating a social agenda), too many enterprises create hybrid models when they are in fact unnecessary.
- This e-book will discuss when you should think about establishing a hybrid social enterprise, as well as some of the pros and cons of doing so.

Note that I am not a tax lawyer or chartered accountant. This e-book reflects 14 years of experience advising organizations. Please contact a tax expert before filling out any legal forms.

# WHAT IS A HYBRID SOCIAL ENTERPRISE?

- Although there is some controversy on how best to define a “social enterprise”, Social Enterprise UK says a social enterprise will meet the following six criteria:
  - Have a clear social and/or environmental mission set out in their governing documents
  - Generate the majority of their income through trade
  - Reinvest the majority of their profits
  - Be autonomous of state
  - Be majority controlled in the interests of the social (or environmental) mission
  - Be accountable and transparent
- The legal form of a social enterprise is immaterial to this definition. Social enterprises can have assume the legal form of a non-profit entity (e.g. voluntary association) or the legal form of a for-profit entity (e.g. private company). A hybrid social enterprise assumes a combination of legal forms from across the spectrum.
- A single social enterprise can contain multiple legal entities. For example, in London I encountered [HCT Group](#) [a social enterprise bus service] and this enterprise includes 17 different for-profit and non-profit legal entities.

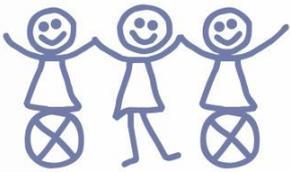
# Example: Shonaquip / Uhambo Foundation

Shonaquip is a well-known social enterprise that designs and manufactures mobility devices (e.g. wheel chairs and posture support) for the physically disabled. Shona McDonald designed her first wheel chair in 1992 for her daughter who had cerebral palsy. Soon thereafter Shonaquip was registered as a close corporation (for-profit entity) in 1992.

Shonaquip was always run as a social enterprise and profits were retained in the business to grow the enterprise, further its social purpose and fund its social activities (e.g. advocacy, training and community development).

By 2010, Shonaquip was faced with a number of problems. Shona was concerned that business pressures on Shonaquip were undermining its social agenda and believed it best to house these activities in another entity in order to protect them. The demand for its community development, training and advocacy work had also exceeded Shonaquip's resources and donations needed to be attracted.

Uhambo Foundation was then established in 2010 as a section-21 company with the NPO and PBO accreditations. Simultaneously, Shonaquip was converted from a close-corporation to a private company so it could give 27% of its shares to Uhambo Foundation. A further non-profit entity was established in the United States called Friends of Uhambo Foundation. Now there are three legal entities in the hybrid, working together to achieve Shona's original vision.



UHAMBO  
The Shonaquip Foundation



UHAMBO USA  
MAKING OPPORTUNITY ACCESSIBLE



SHONAQUIP  
disability equipment & training

# WHY START A HYBRID SOCIAL ENTERPRISE?

- If you already have a for-profit legal form and:
  - You need to attract donations to further your cause.
  - Your various stakeholders are reluctant to deal with a for-profit legal entity.
  - Your social activities require a distinctly different culture and skillset from your standard business activities.
  - You don't want the business focus to undermine your enterprise's social focus.
  - Your philanthropic activities needs to be housed under a different brand.
- If you already have a non-profit legal form and:
  - The business activities are not directly related to your core purpose and they are starting to dominate the agenda of your organization
  - Your staff and governing body don't have the skills or mindset required of a business
  - Your business activities are competing substantially with traditional businesses.
  - Your business activities need to be housed under a different brand.
- NB. The belief that a non-profit legal entity can lose its status as a Public Benefit Organization by earning more than a certain proportion of income is now outdated – this law was amended in 2006. This issue will be covered further on in this e-book.

# LEGAL FORMS USED IN HYBRID MODELS

- In order to discuss hybrid models, one must first understand the difference between the various legal forms and accreditations – a common source of confusion.
- The table below shows the non-profit and for-profit legal forms that are commonly used in hybrid models.

Non-Profit Legal Forms	For-Profit Legal Forms
Section-21 Company [No longer available. They have all been converted to Nonprofit Companies]	Close Corporation [No longer available, but many still exist.]
Voluntary Association	Business Trust
Nonprofit Company	Private Company
Nonprofit Trust	Personal Liability Company
	Public Company

# NPO ACCREDITATION

- The Department of Social Development hosts the Directorate of Nonprofit Organizations or 'NPO Directorate'.
- This directorate provides an accreditation called NPO Status, which is often confused with the legal form of Voluntary Association.
- The directorate was setup in 1997 when the Nonprofit Organizations Act came into being.
- It provides the NPO Status accreditation to nonprofit companies, trusts and voluntary associations.
- Accreditation requires a large number of conditions to be included in the founding documents, many of these around an organization's governance structures.
- NPO Status is a precondition for receiving funds from government.
- NPO Status used to be a precondition for receiving Public Benefit Status from SARS, but this is no longer required.

# PUBLIC BENEFIT ORGANIZATION [PBO] STATUS

- Accreditation by SARS as a Public Benefit Organization (PBO)
- Section 30 of the Income Tax Act
- Enables varying degrees of exemption from taxes such as transfer duty, estate duty, capital gains tax, donations tax, the skills development levy and dividends tax provided certain criteria are met.
- Requires the organization to be a nonprofit company, trust or voluntary association
- Requires the organization's core activity to be one of the approved Public Benefit Activities listed in Part 1 of the ninth schedule of the Income Tax Act (see page 61 of [Income Tax Guide](#)).
- Requires a number of clauses to be inserted into founding documents.
  - At least three persons who are not related to each other must accept the fiduciary responsibility of the PBO.
  - The funds of the PBO cannot be distributed to any person, except in the course of carrying on its public benefit activity.
  - The PBO must upon dissolution, transfer its assets to any similar approved PBO, a prescribed parastatal or a government department.
  - The PBO is not allowed to accept any donation which may be revoked by the donor for reasons other than a material failure to conform to the designated purposes and conditions of such donation, including any misrepresentation with regard to the tax deductibility thereof in terms of section 18A.

# DONOR DEDUCTIBLE STATUS [DDS]

- Accreditation by SARS to grant Donor Deductible Status (DDS)
- Section 18A of the Income Tax Act
- Enables the organization to provide its donors with a S18A receipt, which enables the giver to deduct their donations from their taxable income. Organization will struggle to get donations, particularly from businesses, unless they can issue this certificate.
- Requires the organization to be an accredited Public Benefit Organization
- Further conditions:
  - The donation must be made to an approved PBO that has donor status under section 18A (commonly referred to as donor deductible status).
  - The PBO must use the donation to carry out a public benefit activity listed under Part II of the Ninth Schedule of the Income Tax Act. Alternatively, the PBO must provide funds to a PBO carrying on such activities.
  - The donation must have been made bona fide and should not be a payment for services which the organisation has rendered to the taxpayer.
  - The donation can either be in cash or kind, but not in the form of a service, and the donation cannot exceed ten percent of the taxpayer's taxable income. If it exceeds ten percent the excess amount will not qualify for tax deduction.

# WHEN IS INCOME OF A PBO TAX EXEMPT?

- SARS has specified the criteria under which accredited Public Benefit Organizations can engage in business activities, earn an income and not pay tax on any surpluses:
  - The business activity is integral and directly related to the sole or principal object of the Public Benefit Organization
  - The business activity does not become the primary work of the organization.
  - The business activity is carried out or conducted on a basis substantially the whole of which is directed towards the recovery of cost
  - The business activity does not result in unfair competition in relation to taxable entities.
  - The organization's core purpose remains philanthropic and matches one of the approved Public Benefit Activities.
- The profits of business activities that meet the above criteria are not taxable. This is discussed in *section 10(1)(cN) of the Income Tax Act, 58 of 1962* and see page 42 of [Income Tax Guide](#) for more detail.

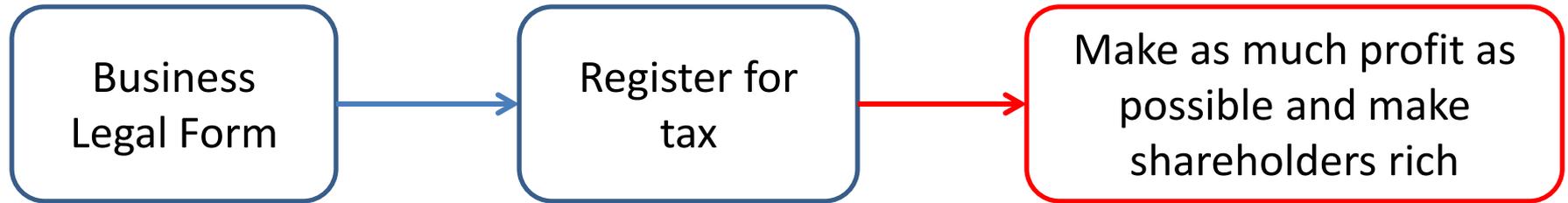
# WHEN ARE SURPLUSES OF A PBO TAXABLE?

- There are certain conditions under which an accredited Public Benefit Organization can engage in business activities but must pay tax on any net profits or surpluses.
  - Accredited Public Benefit Organizations must 'ring fence' the income and expenses of their business activities.
  - If the income of the business activity exceeds the greater of 5% of the organization's total revenue (of all funding and income combined) or R100,000 in a financial year then the profits then tax may be paid on any profits of the business activities
- Remember that the Public Benefit Legislation that was introduced in 2001 was amended on 1 April 2006, following the Minister's Budget Speech in 2005. Unfortunately too many organizations still believe the old laws are in force and that any income generation will result in the loss of PBO status.

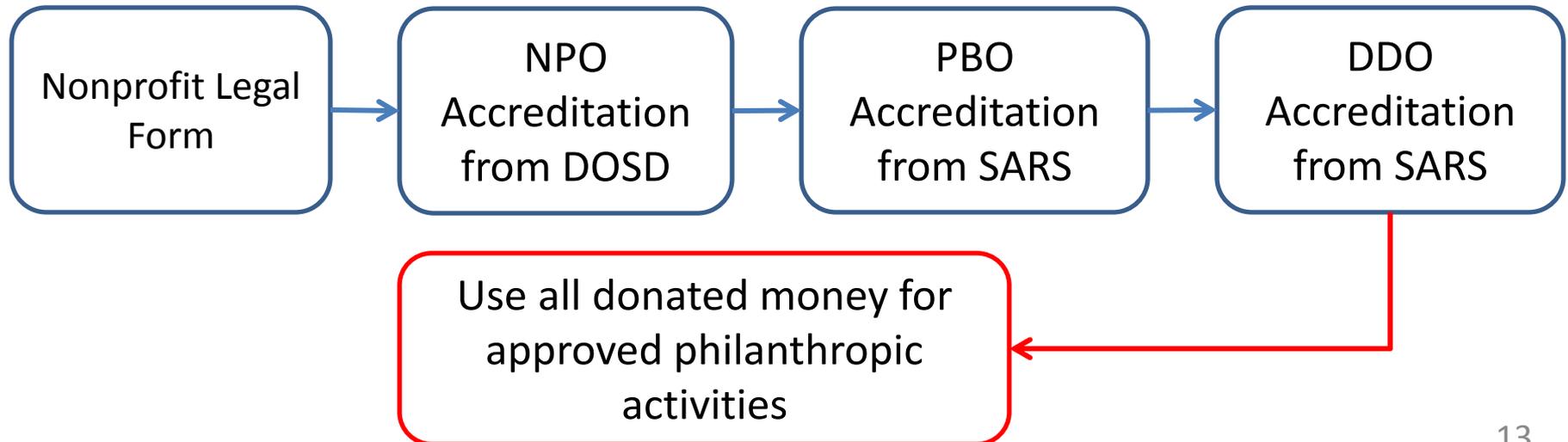
# WHEN CAN YOU LOSE YOUR PBO STATUS?

- Through the years, I've encountered a large number of accredited Public Benefit Organizations that are petrified of losing this accreditation. It also appears that some accounting firms are also misinformed and give unneeded recommendations in their audit reports.
- There are three primary conditions under which a Public Benefit Organization can lose its PBO status:
  - If the organization is no longer philanthropic
  - Dominant activities are no longer public benefit.
  - Business activities are unrelated to the core philanthropic purpose of the organization and start taking over the agenda of the organization.
  - The business activity generates a substantial income and competes with registered for-profit businesses thereby undermining South Africa's tax base.

# TRADITIONAL CHOICES: A DILEMMA



**OR**

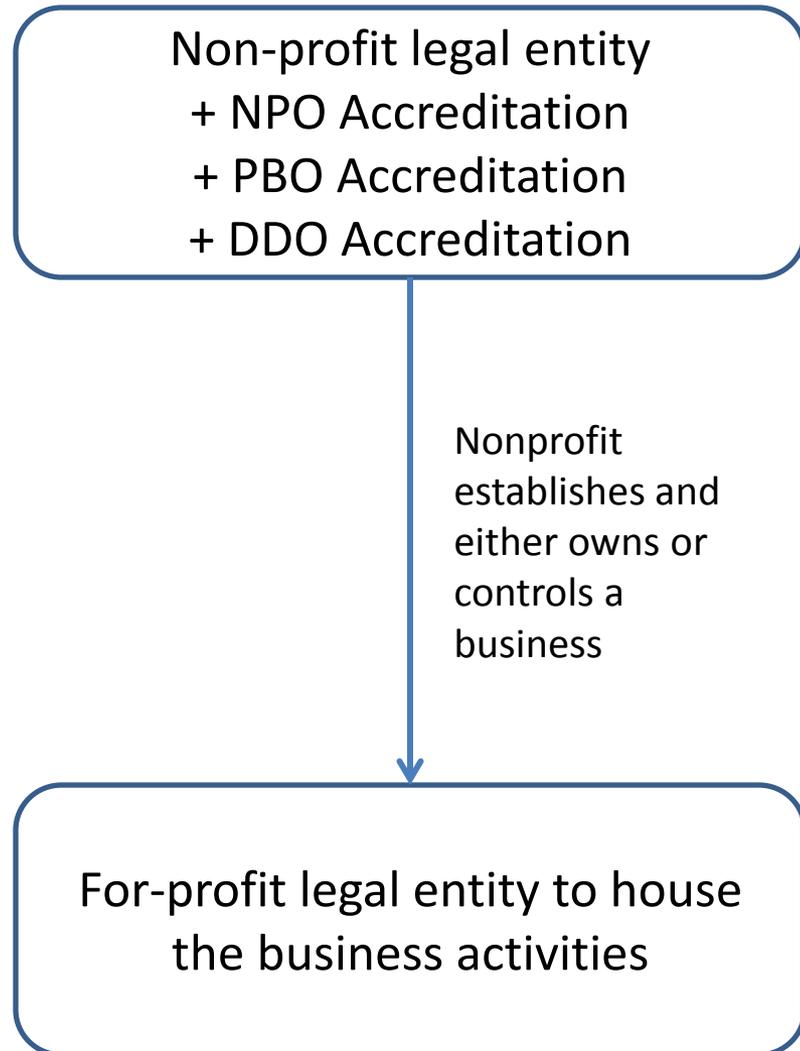


# HYBRID MODEL 1: NPO ESTABLISHES BUSINESS

A non-profit legal entity establishes a for-profit entity and either owns it or holds the license for the intellectual property or brands that are used in the for-profit entity.

Profits from the business entity are transferred to the non-profit entity:

- Donations up to 10% of profits
- Declaration of dividends (but there is a dividend tax)
- Subsidization of non-profits operating costs
- Payment of license fees for use of brand or intellectual property
- Nonprofit sells social services to the business and derives income therefrom



## Example: NPO establishes Business

NICRO specializes in the rehabilitation of offenders and their reintegration back into society. NICRO is an organization with a rich history. It was established in 1910 as a prisoners' aid organization, and has most probably had the more impact on the rehabilitation of offenders than any other organization in South Africa's history.

In 2007 when the recession hit, Soraya Solomons (the executive director) persuaded the board to act on two insights. The first was that NICRO wouldn't survive without learning how to generate much of its own income. Secondly, it is almost impossible to reintegrate former prisoners back into society unless they find employment, and this was an opportunity that NICRO should focus on.

NICRO then decided to setup a separate for-profit entity called NICRO Enterprise to house the business activities of NICRO and provide employment to former prisoners. Part of this decision was based on awareness that a different skill- and mind-set would be required in the for-profit entity than in the non-profit entity.

Since 2007, NICRO is in the process of commercializing a number of its products (e.g. probation assessments for lawyers) and is seeking to convert a number of its properties to commercial uses. It is also in the process of establishing a number of businesses that could employ ex offenders and is always looking for more opportunities.



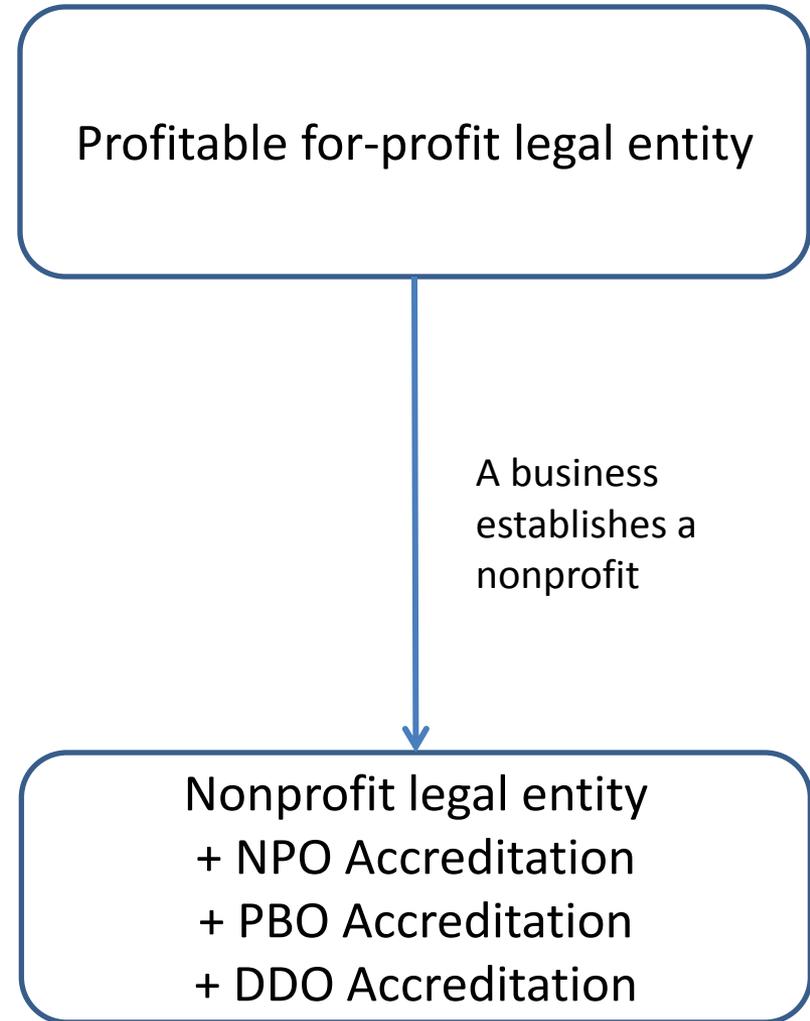
# HYBRID MODEL 2: BUSINESS ESTABLISHES NPO

A larger and profitable for-profit entity establishes a non-profit entity to help it achieve a shared social outcome.

The relationship between these two entities is more of an equal partnership, unlike the trend for big corporates to establish a charitable foundation.

The business may give the NPO:

- % shareholding
- CSI and enterprise development funding
- License to use parts of its intellectual property in its operations
- Products at cost price
- Free infrastructure
- A place in its value chain



## Example: Business establishes NPO

When Claire Reid was still at school she designed a method of preparing and packaging seeds for fruit and vegetable gardens that significantly increased the chances that gardens would grow and be fruitful.

She then set up a social enterprise [for-profit legal form] called Reel Gardening that sold these seeds and other food gardening supplies. Reel Gardening started working with poor communities and helped them to establish and maintain food gardens.

After a couple years, Reel Gardening encountered two challenges. Firstly, Claire wanted to attract donations from businesses and needed to be accredited as a PBO in order to do this. Secondly, a number of non-profit organizations were reluctant to cooperate with a 'business' and were only interested in dealing with other non-profit organizations. Claire then setup a Nonprofit Company called Reel Life and got it accredited as an NPO and PBO. This new legal entity enabled the social enterprise to attract more donor funding and gain more access to communities and partnerships.

This hybrid model works well and makes sense. Claire is a shareholder of the for-profit entity (Reel Gardening), and this entity sells its products at cost price to the non-profit entity (Reel Life) as well as subsidizing some of its costs. Meanwhile the non-profit entity works with communities to establish food gardens.



# WHY SOME DONORS DON'T LIKE HYBRIDS

- Some donors are reluctant to invest in social enterprises with hybrid models:
  - Donors may believe that their funding of a non-profit entity may inadvertently subsidize the costs of the for-profit entity, thereby increasing its profits and the income of its shareholders.
- What are some of the ways to overcome the fears of these donors?
  - Ensure that there is a distinct difference in the work of the non-profit entity from the for-profit entity
  - Design the hybrid in such a way that the for-profit entity is clearly serving the non-profit entity and not the other way around.
  - Have totally different boards of directors on the two entities, and let the donor place a trusted director[s] on the board of the non-profit entity.
  - The shareholders of the for-profit entity can consider selling their shareholding to the non-profit entity, and rather keeping ownership of the brands or intellectual property and potentially charging a license fee for their use.
- Overtime we will see more and more donors that understand how to work with hybrid social enterprises.

# RUNNING A HYBRID SOCIAL ENTERPRISE

- There are multiple challenges in running and governing hybrid enterprises, and here are some of the ones that are most common and challenging:
  - Hybrid models contain a mix of non-profit entities and for-profit legal entities. Each of these requires its own board of directors and accounting and legal admin.
  - The performance metrics and monitoring system used by the non-profit entity may be quite different from that which is required by the for-profit entity.
  - The organizational culture in a profitable business operation may be different from the mindset in a traditional nonprofit organization
  - Different skillsets are required in a for-profit operation when compared with a traditional non-profit operation.
  - The social enterprise paradigm and the blend of business thinking with a social agenda is very challenging for many people, particularly if they grew up with the traditional stereotypes of nonprofit organizations and businesses.
  - There are different techniques of costing products and determining profit margins in either entity.

# INVESTING IN HYBRIDS: THE OPPORTUNITY

- There are a number of good opportunities for philanthropists, CSI departments, ED departments and social investors:
  - Donate to the nonprofit entity and know that its overheads are being subsidized by the social enterprise's business activities. Also know that its future is more assured given its other sources of revenue and potential reserves.
  - Use enterprise development funds to help a social enterprise grow and expand its social impact, and possibly even include it in a supply chain.
  - Invest funds in the for-profit entity and derive a financial and a social return of investment.
- Do a mix of the above. Here is an example of a mixed investment from a business:
  - A corporate could use their ED funding to help establish the social enterprise in their supply chain and procure from it. This can give them B-BBEE points and a good source of supplies.
  - They could then use their CSI funds to assist with the social purpose of the enterprise thereby getting more value for money.
  - Finally they could top this up by getting their staff to volunteer in the enterprise thereby getting more B-BBEE points and increasing staff loyalty and morale.
- Elements of this type of opportunity are also available to social enterprises without hybrid models.

# THE BEST LEGAL FORM FOR SOCIAL ENTERPRISES

- There is much debate on what is the best legal form or combination of legal forms for a social enterprises.
  - Nonprofit legal form
  - For-profit legal form
  - Nonprofit legal form + for-profit legal form.
- Unfortunately, there is no single rule or formulae for which legal form or combination is best. You can read more about this is a study by the ILO in 2011 called [Guide to Legal Forms for Social Enterprises](#). This study found that “advantages and disadvantages [of each form] are largely based on the needs of the social enterprise and not necessarily as simple as one entity being better, or better suited to operate as a social enterprise”.
- A good general rule is don’t rush out and create multiple legal entities and a hybrid social enterprise. It is much better to stick with the legal entity you already have, and make that work for you. Then if you have tried everything and it still is not working out, then only consider creating a new entity.

# A HYBRID IS NOT ALWAYS NEEDED

- Although this e-book has been all about hybrids, remember that a hybrid is not always needed. You can do a lot with the legal form you already have.
- An organization with the legal form of a nonprofit can be a social enterprise:
  - Such an organization can rely heavily on revenue from business activities.
  - Provided this organization remains philanthropic in nature, sticks to an approved Public Benefit Activity and does not distort the tax base, it should be able to retain its PBO and DDS accreditations.
  - Greater Capital is a good example of this type of social enterprise.
- An organization with a legal form of a for-profit can also be a social enterprise:
  - A business can choose to have an explicit social purpose.
  - A business can recruit an external board of directors to ensure that it achieves its mandate.
  - A business can select to keep its profits in the business, and record this in its founding documents.
  - A business can ensure that value is created at each stage in its value chain.
  - A business can brand itself as a social enterprise.
  - A business can receive social investment for its social enterprise activities.

# REFERENCES

- [LAPD-Gen-G03 - Tax Exemption Guide for Public Benefit Organisations in South Africa - External Guide](#)
- [Introduction to Social Enterprises - Learners Guide – ILO](#)
- [Guide to Legal Forms for Social Enterprises – ILO](#)
- [Guide to Finance for Social Enterprises - Greater Capital](#)
- Cathy Masters Development Services [CMDS] gave valuable input, and is worth contacting to learn more about the technical details of law and taxation in this area. See [www.cmds.org.za](http://www.cmds.org.za) for more info.

**Thank you**

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