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ABSTRACT

A social enterprise is a revenue-generating business with primarily social objectives whose surpluses are reinvested for that purpose in the business or in the community, rather than being driven by the need to deliver profit to shareholders and owners (BC Centre for Social Enterprise 2012). These entities are currently not recognised in the South African legislation but instead may adopt any of the legal structures within the Companies Act of South Africa, 2008.

Social enterprises have been identified for their potential to solve society’s critical issues of poverty, unemployment and inequality, to name but a few. Many countries around the world are recognising the contribution these entities have to make and governments are taking steps to support social enterprise including through regulatory changes. South Africa in comparison to many other countries is lagging behind, however, the South African government is considering the development of a policy framework for social enterprise.

This dissertation firstly, analyses the current tax implications of a social enterprise operating in South Africa. This is demonstrated by using the case study of the UnEarth Group.

Secondly, after analysing the current tax environment for social enterprises, an assessment is carried out on the types of changes needed in the South African Income Tax Legislation to support social enterprises. This assessment includes an analysis on social enterprises operating in other countries and more specifically the policies in the United Kingdom which are ahead in embracing the social sector and demonstrating their support of social enterprise through a favourable policy framework. This dissertation proposes amendments to the current tax legislation which include tax incentives in order to assist Government in developing a framework to support social enterprise and create a more enabling environment in which to operate.
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CHAPTER 1

INTRODUCTION

1.1 Background

“Poverty is unnecessary”
Muhammad Yunus
(Founder of Grameen Bank, the first micro-credit Bank)

South Africa currently faces challenges of high unemployment, poverty and inequality. Statistics show the employment rate at 24.7%¹ and population below the poverty line at 31.3%.² Research shows that approximately 8 million South Africans are unemployed while 5 million have never worked (NICOR South Africa 2012).

Government announced its ambitious goals to eliminate poverty and reduce inequality by 2030 in the National Development Plan (NDP) whilst in the framework to guide government’s programme in the electoral mandate period 2009 to 2014, some of the objectives identified were halving poverty and unemployment by 2014 and ensuring a more equitable distribution of the benefits of economic growth and reduce inequality.

The priority areas to give effect to the above strategic objectives identified were:

- more inclusive economic growth, decent work and sustainable livelihoods
- economic and social infrastructure
- rural development, food security and land reform
- cohesive and sustainable communities
- creation of a better Africa and a better world
- sustainable resource management and use

¹ Source: http://www.tradingeconomics.com/south-africa/unemployment-rate
Priorities identified in the Minister of Finance, Pravin Gordhan’s 2012 Budget Speech were:

- An expansion in infrastructure investment.
- Special emphasis to improving competitiveness in industry, investment in technology, encouragement of enterprise development and support for agriculture.
- Education, health and social assistance.
- Job creation, with a particular focus on unemployed youth (Gordhan 2012).

In terms of environmental issues, South Africa faces problems of water shortages, overfishing and destruction of natural habitats. However, the most disturbing issue, which has been widely publicised, has been the horrific increase in poaching of rhinos in South Africa. During 2013, in South Africa alone a staggering 1,004 Rhinos were killed by poachers (Department of Environmental Affairs 2014). The South African government has made it a priority to address these issues.

Historically, government and non-profit organisations, assisted by government through grants, have been jointly responsible for tackling society’s problems. Research suggests that government and humanitarian efforts have not lived up to citizens’ expectations resulting in a lack of confidence in their ability to address South Africa’s most crucial issues. Many governmental and philanthropic efforts have fallen far short of citizens’ expectations (Dees, The meaning of "Social Entrepreneurship" 2001).

At present, non-profit organisations are facing critical financial challenges. These entities operate in a highly competitive environment with many organisations competing for government and donor funding (Mort 2006). The current economic climate and global economic downturn have resulted in many international donors withdrawing from South Africa adding to the drastic decrease in grants and donations to non-profit organisations (NPOs). Research suggests that many NPOs are expected to close in the short to medium term (NICOR South Africa 2012).

The solutions to South Africa’s growing social and environmental issues cannot be solved independently by either Government or the charity sector. Experts have identified the social enterprise model as having the potential to answer South Africa’s problems. Jacqui Kew, a member of the UCT Centre for Innovation and Entrepreneurship and GEM researcher stated that
social entrepreneurship will become more important as social needs increase while government and civil society resources decrease (Notten 2010).

It is widely acknowledged that social enterprises have a significant role in creating employment (OECD/ European Commission 2013). International analysis shows that the number of jobs in the social economy sector was approximately 14 million in 2010, corresponding respectively to 6% and 6.5% of the total paid workforce in the European Union. Furthermore, data shows that the jobs created by this sector are targeted in areas suffering from environmental, economical and social distress (Teasdale 2013). Social enterprise has the ability to assist government in achieving its goals of alleviating poverty and reducing unemployment and inequality more efficiently and effectively rather than relying solely on the public sector (OECD/ European Commission 2013).

The social economy is a growing sector in South Africa and has been identified by government as a ‘key jobs driver’ (Patel 2009). Steinman (2010) stated that the South African Government has initiated plans for the development of social enterprise through its policy documents such as the Medium Term Strategic Framework (MTSF) and the Framework for South Africa’s Response to the International Crisis (2008).

No law or policy on social enterprise currently exists in South Africa. Steinman (2010) has identified the lack of a definition as being one of the factors hindering the growth of social enterprises and the expression ‘social enterprise’ is referred to as a generic term. A literature review on the topic of social enterprise reveals that there has been limited research conducted on the subject in the context of South Africa. This however should change as the concept attracts interest as demonstrated in the establishment of centres for social enterprise and inclusion of the topic in a number of prestigious South African universities (Steinman 2010). Governments’ policies have the ability to support or hinder the development of social enterprise however through its legal, regulatory and taxation environment (Linklaters 2006). If the Government of South Africa is considering developing a policy framework for social enterprise (Fonteneau 2011) then consideration should be creating one that supports these entities. Current literature on social enterprise is predominantly focused on defining these unique organisations as well as tax incentives for the investment in social enterprise. No comprehensive study has been done on incentivising social enterprises themselves. The purpose of this dissertation is to contribute to the general body of tax knowledge by analysing current income tax legislation and recommend
amendments to the tax legislation that will create a more enabling environment for social enterprise to grow and achieve their goals of addressing society’s critical issues.

1.2 Objectives and value of research

This dissertation has two main objectives:

1. To identify and discuss the current income tax consequences in relation to social enterprises operating in South Africa; and
2. To propose tax incentives to be used to encourage growth and development in social enterprises, creating a more enabling environment in which the social enterprise may operate.

Both York (2011) and Steinman (2010) have suggested that there is a need to professionalise the social enterprise sector and more academic contributions on the subject need to be explored. This dissertation hopes to add to the body of knowledge on social enterprises.

This dissertation sets to answer a number of sub questions:

1. What is a social enterprise and how is it different to Corporate Social Responsibility (CSR)?
2. What are the different legal structures a social enterprise can currently adopt?
3. What is the best structure for a social enterprise to adopt?
4. Why would a social enterprise choose to forgo tax relief by not operating as a non-profit company?
5. How are other countries supporting the growth of social enterprises?
6. Can social impact be measured and converted to monetary terms?
7. What are the characteristics of a successful tax incentive?

Social enterprise is currently not recognised in South African legislation. Social enterprises can be carried out under any of the available legal structures in the legislation. The specific legal form adopted by a social enterprise determines how the entity will be taxed. The South African government is considering the development of a policy framework on the social economy and social enterprise (Fonteneau 2011). This dissertation aims to recommend tax incentives that could be implemented to provide a more enabling tax environment to assist social enterprise in reaching their social goals and ultimately contributing to government’s goals of eliminating poverty and reducing unemployment and inequality.
1.3 Limitations of study

This study will examine the South African Income Tax effects on social enterprises and does not cover tax policies applicable to small businesses as defined by the South African tax law. Small and medium size enterprises (SME’s) are defined in the Income Tax Act 58 of 1962 (the ITA). To qualify as an SME and receive tax relief, an entity must meet the following criteria (Section 12E of the ITA):

- The entity must be a close corporation, co-operative or a private company;
- The gross income of the entity should not amount to more than R14m for the current year;
- All the shareholders or members of the entity must be natural persons. Thus it follows that a group of companies cannot qualify as a SBC due to this requirement;
- The shareholders or members of the entity must not hold shares or have interest in the equity of another company.

The last two requirements thus exclude social enterprises that have turnover less than R14m but have shareholders or members other than natural persons or those that have shareholders or members with other interests. These social enterprises do not enjoy the tax relief for SMEs. With this in mind, this dissertation seeks to separate incentives for social enterprises and excludes those awarded to SMEs.

Furthermore, this dissertation recognises that incentives to encourage the investment into social enterprises also requires the attention of policy makers and such policies may have similarities to the discussion points of this dissertation. For the purpose of this dissertation, the focus is not on the investors in social enterprise but rather the tax environment in which social enterprises operate and therefore incentives around investment into social enterprises will only be included for the completeness of this dissertation. Other studies have considered such incentives in detail, for example Big Society Capital’s research on the role of tax incentives in encouraging social investment (Worthstone 2013).

1.4 Research method
The author, Zora Neale Hurston said that “Research is formalized curiosity. It is poking and prying with a purpose.”

The method used in approaching this dissertation was:

- Defining social enterprise and identifying the different vehicles in which these entities operate;
- Identifying the most strategic business model for social enterprises to adopt in order to drive economic and social value;
- Using a case study to demonstrate the current tax environment for a social enterprise adopting a hybrid model;
- Establishing the guidelines around which social value could be measured and tax incentives could be developed in South Africa.

The objective of the dissertation was firstly achieved through an analysis of literature related to social enterprise and the various legal structures with in which they can operate. A clear definition of social enterprise was made which differentiated these entities from charity and corporate social responsibility. The analysis then went on to discover the most favourable business model to be adopted by social enterprises to maximise both economic and social value.

A single-case study was conducted with the UnEarth Group, presenting a proposed social enterprise adopting a hybrid business model to use as an example to demonstrate the current cash flows and their related tax implication in terms of the South African Income Tax Legislation. The findings were used to assess the current tax environment in which social enterprises operate and whether this supports social enterprise. Researcher Robert K. Yin defines the case study research method as an “empirical inquiry that investigates a contemporary phenomenon within its real-life context; when the boundaries between phenomenon and context are not clearly evident; and in which multiple sources of evidence are used.” A review of the policies of countries which have embraced the concept of social enterprise was performed in order to use as a guide to ultimately propose amendments to South African Income Tax Legislation.
The second part of the dissertation analysed literature around the measurement of social impact created by social enterprises. The different methods of measurement commonly used by international professional bodies supporting social enterprise were discussed and the most favourable tool selected for its ability in converting social impact into monetary terms.

The final part of the dissertation analysed literature on the design of tax incentives and includes guidelines for a successful incentive. Using this as a base, proposed tax incentives were developed alongside other studies and papers on the subject of creating an enabling environment for social enterprises through regulatory and policy changes.

1.5 Outline of the study

This dissertation is structured as follows:

Firstly, chapter 1 serves as a general introduction and states the background to the study, the research justification, the primary and secondary research objectives and the study methodology and the study outline.

Chapter 2 is a literature review exploring the broad definition of a social enterprise in a global context as well as for South Africa. To further understand the nature of social enterprises in the South African context, the legal framework is analysed and the different vehicles in which social enterprises can operate is explored. In this regard, the Companies Act 71 of 2008 (the Companies Act), the Nonprofit Organisations Act 71 of 1997 (the NPO Act) and the Co-operatives Act No 14 of 2005 are particularly relevant and the more critical provisions of each of these Acts are discussed. The chapter concludes with statistical data on social enterprise’s contribution to the economy, used as evidence that social enterprise is deserving of specific policies created to support its growth.

In Chapter 3, the hybrid business model, a model that incorporates the public, private and non-profit sector, is introduced and the reasons as to why an entity would choose to operate under such a structure are explored.

Chapter 4 introduces the case study on the UnEarth Group with a company profile and explanation on the proposed group structure using a hybrid model. The South African Income Tax Legislation relating to the proposed structure is examined and the current tax consequences
of social enterprise structured with a hybrid business model are analysed. Chapter 4 then goes on to examine some recent international developments in government policies regarding social enterprise in order to provide possible suggestions for the development of tax incentives for social enterprise in South Africa.

Chapter 5 comprises the definition of social impact and conducts an analysis of the different methodologies used for social impact measurement. The dissertation explores the idea that if the social impact of a social enterprise is measured in Rand value, a calculated tax benefit could be offered in lieu of the governmental save from having the social enterprise providing services that fall under the responsibility of the state.

Chapter 6 provides proposals of tax incentives to be included in South African Income Tax Legislation in order to promote social enterprises and create a more enabling environment for them to operate in.

Chapter 7 provides the overall conclusions and recommendations derived from the dissertation.
CHAPTER 2

WHAT ARE SOCIAL ENTERPRISES

2.1 Introduction

Before an analysis of the current tax consequences of a social enterprise can be undertaken, it is
first necessary to perform a literature review on the definitions of a social enterprise. Chapter 2.2
discusses the various definitions of a social enterprise and establishes a working definition for
the purpose of this dissertation. Furthermore chapter 2.3 differentiates between social enterprise
and Corporate Social Responsibility (CSR).

Chapter 2.4 analyses the various legal forms that can be adopted by a social enterprise in the
context of the South African legislation.

Finally, chapter 2.5 discusses whether social enterprises are worthy of tax relief by analysing
current data on the status of the sector in relation to the economy.

2.2 A broad definition

The concept of social enterprise can be traced back to the 1970s, however, to date, consensus on
a definition of a social enterprise and what qualifies as such has still not been reached. A
literature review on social enterprise reveals a multitude of definitions which vary from country
to country as well as amongst the different organisations that support the sector. On review of the
literature on the topic, the attempts to distinguish social entrepreneurship from normal
entrepreneurship are seen and the prevalent distinguishing characteristic in all of the definitions
is the adoption of a mission to create and sustain social value. This social mission is fundamental
in differentiating social enterprise from normal business. The late Greg Dees, a pioneer in social
entrepreneurship, said “making a profit, creating wealth, or serving the desires of customers may
be part of the model, but these are means to a social end, not the end in itself. Profit is not the
gauge of value creation; nor is customer satisfaction; social impact is the gauge. Social
entrepreneurs look for a long-term social return on investment. Social entrepreneurs want more
than a quick hit; they want to create lasting improvements. They think about sustaining the impact” (Dees, The meaning of "Social Entrepreneurship" 2001).

In the USA, a social enterprise is defined as “any organisation, in any sector, that uses earned income strategies to pursue a double bottom line or a triple bottom line, either alone (as a social sector business) or as part of a mixed revenue stream that includes charitable contributions and public sector subsidies” (Boschee 2001).

Similarly, Australia has adopted the definition that social enterprises are organisations that:

- “are led by an economic, social, cultural, or environmental mission consistent with a public or community benefit;
- trade to fulfil their mission;
- derive a substantial portion of their income from trade; and
- reinvest the majority of their profit/surplus in the fulfilment of their mission” (Jo Barraket 2010).

More recently, the European Commission has defined a social enterprise as being “an operator in the social economy whose main objective is to have a social impact rather than make a profit for their owners or shareholders. It operates by providing goods and services for the market in an entrepreneurial and innovative fashion and uses its profits primarily to achieve social objectives. It is managed in an open and responsible manner and, in particular, involves employees, consumers and stakeholders affected by its commercial activities” (OECD/ European Commission 2013).

In the UK, new regulations, which included a legal definition of social enterprise, were recently laid before Parliament. It defines a social enterprise as a charity or community interest company; or an organisation which “has provisions in its constitution which ensure that it distributes less than 50 per cent of its profit to shareholders, states that it is a body carrying out activities for the benefit of the community and has clauses that require it to pass on its assets to another social enterprise if it dissolves or winds up” (Mair 2013).

In South Africa there is no generally accepted definition for social enterprise. Research commissioned by the International Labour Office (“ILO”) which explored the development of an
enabling environment for social enterprises in South Africa, sought to define a working
definition of what constitutes a social enterprise for South Africans. This research felt that a local
definition should be adopted instead of using a European or American version. The concluding
definition was that a “social enterprise’s primary objective is to ameliorate social problems
through a financially sustainable business model, where surpluses (if any) are principally
reinvested for that purpose” (Steinman 2010). This definition was again used at the national
conference on social enterprise in South Africa, held in October 2009 (Fonteneau 2011). On
further examination on the definition of a social problem, Steinman found that this was

- “an existing and socially undesirable condition or phenomenon in society (three general areas
  of social problems are: deviant behaviour, social inequality and conflict, and problems
  relating to human progress and social change);
- it compromises certain basic and generally accepted values in society;
- a significant number of people are affected by this condition/phenomenon; and
- there is a strong feeling that something should be done about it by means of some form of
  collective action” (Steinman 2010).

Based on a literature review of the various definitions of a social enterprise, commonality is
found in the characteristics a qualifying social enterprise should have. These are:

- having a primary social objective which is clearly stated as its core purpose;
- adopting a financially sustainable business model which has the ability to generate sufficient
  income to exceed costs.
- earning a significant proportion of its income through trading activities as opposed to
  receiving grants and donations;
- being accountable to its stakeholders, with an appropriate mechanism to ensure
  accountability to beneficiaries and to measure and demonstrate its social impact (Fonteneau
  2011).

To summarise, Steinman (2010) said that “it is the social purpose, aimed at ameliorating a social
problem, and the manner in which the enterprises choose to deal with the surplus, which
determines its status as a ‘social enterprise’”.
2.3 The difference between social enterprise and Corporate Social Responsibility

CSR has been defined by the World Business Council for Sustainability Development as “the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large”.

There is an expectation created by government and the general public that companies become accountable for their actions and build activities which uplift their local communities into their operations and core strategy. In South Africa, the requirements of Black Economic Empowerment policies increase a company’s social responsibility by allocating points for corporate companies who assist previously disadvantaged groups. To meet these demands for social impact, many companies contribute to community and environmental development through various programmes. This has resulted in the creation of opportunities for partnerships between companies and not-for-profit organisations, governmental agencies and other social enterprises. The CSR programmes carried out do not increase company profits or shareholder value but rather carry out activities separate from the company’s operations such as charitable donations, or staff volunteering projects.
In South Africa, it is estimated that approximately 45% of the R9bn a year spent on CSR goes to the non-profit sector (Championing the nonprofit sector n.d.). Of this, over a third is spent on education, approximately 10% on social development whilst less than 5% is spent on the environment (2012). The significant amount invested in education by CSR can be related to providing education and training to potentially increase the workforce in the future, offering a mutual benefit to the recipient and the company. “Businesses cannot operate in societies which are failing, owing to social problems, there is a need for them to partner with communities to uplift and improve conditions” (Theron 2010). Companies are compelled to carry out CSR initiatives by the expectation of consumers for them ‘to do good’. Their moral obligation encourages corporations to make decisions that will benefit society

Conversely, social enterprise separates itself from charity by having its core strategy as one of positive social impact. It incorporates a holistic approach in carrying out their operations whilst delivering social or environmental value. Social enterprises create direct social impact through their business operations thus achieving a “shared value”. Michael Porter, a leading authority on company strategy, defines shared value as the “policies and operating practices that enhance the competitiveness of a company while simultaneously advancing the social conditions in the community in which it operates”. He states that this shared value creation is the definitive difference between social enterprise and CSR (Porter 2011). This is in contrast to the CSR initiatives carried out by companies which while they invest profits into the community, their core purpose remains to generate wealth for their shareholders.

2.4 Current vehicles used by social enterprises and their tax status

In South Africa, social enterprises can be carried out under any of the available legal structures in the South African legislation, that is for-profit entities including public companies, private companies, close corporations and co-operatives and not-for-profit companies (Linklaters 2006). The structure adopted by a social enterprise has significant implications in terms of its corporate governance structure, distribution of profits, reputation and image, market access and reporting requirements. The choice of a particular structure also plays a crucial role in determining how the enterprise attracts finance which ultimately affects their revenue generating strategy. Furthermore, the specific legal form adopted by a social enterprise is crucial to its ability to benefit from different tax incentive schemes.
2.4.1 Non-profit companies

Non-profit companies are defined as “organisations incorporated for a public benefit or other objective relating to one or more cultural or social activities, or communal or group interests” per (Schedule 1 of the Companies Act 71 of 2008). These companies have the following characteristics:

- “all property and income, whether obtained by donations or profit by means of income generating activities, must be used to further its objectives;
  - no part of the non-profit company income may be paid to a member, or director unless the payment is reasonable reimbursements for expenses;
  - the payment is an amount due and payable under a bona fide agreement between the non-profit company and the incorporator, member, or director;
  - the payment is a fulfilment of any right arising from the advancement of the objective(s) of the non-profit company; or
  - the non-profit company is obliged by law to do so”

- a non-profit company may acquire and hold securities issued by a profit company; directly or indirectly, alone or with any other person, carry on any business, trade or undertaking consistent with or ancillary to its stated objectives;

- upon dissolution the entire net value of non-profit company must be distributed to another non-profit company with objectives similar to its own. Directors or members of the non-profit company are not entitled to any part of the net value of the non-profit company after its obligations and liabilities have been settled;

- non-profit companies may not amalgamate or merge with profit companies. The disposal of any part of a non-profit company's assets or business to a profit company is limited to the extent that it must be for fair value and within the non-profit company's regular course of business. Where a non-profit company has voting members, their approval must be sought for an amalgamation or merger with another non-profit company, or the disposal of all or a greater part of the assets or undertakings of the non-profit company; and
non-profit companies are permitted to conduct trading activity and make profits but are prohibited from distributing these profits to directors or shareholders. Instead, profits must be entirely re-invested into the organisation to ensure sustainability over the long-term by building up reserves. The intention of earning a profit must not be the sole or principal object or activity” (Hendricks 2009).

A non-profit company can apply for Public Benefit Organisation (PBO) status which will then allow them to qualify for a tax exemption in terms of section 10(1)(cN) of the Income Tax Act on the basis of its ‘public benefit activities’ (PBAs) (Legal Resources Centre 2011). Part II of the Ninth Schedule to the Income Tax Act sets out a number of PBAs for which earned income will be exempted from taxes. These activities include:

- Welfare and Humanitarian
- Health Care
- Land and Housing
- Education and Development Religion, Belief and Philosophy
- Culture, Conservation, Environment and Animal Welfare

2.4.1.1 Shortcomings of social enterprises operating as non-profit companies

Non-profit companies are dependent on government grants or charitable contributions due to the nature of the entities and the regulations imposed on them. Research shows that their income is earned predominantly from government subsidies (40%), donations (20%), fund raising collections (17%) and membership fees (15%). Only 0.4% of income is sourced from foreign donors whilst only 3.5% of income is generated from non-profit companies trading (Lehohla 2013). Without this funding, these organisations are unable to provide services to society which government have failed to provide. Research suggests that non-profit companies are experiencing significant financial constraints due to many organisations competing for the same government and donor funding (Mort 2006). The current economic climate and global recession has resulted in many international government donors exiting Africa as countries become more interested in their own domestic issues resulting in a drastic decrease in grants and donations to non-profit companies (OECD 2012). Furthermore, the ranking of South Africa by the World
Bank as a middle income economy has resulted in previous foreign aid to South Africa being reassigned to low income economies. This current climate means that many non-profit companies are expected to close in the short to medium term. The decrease in funding is demonstrated in the case study of NICRO which stated a 66% reduction on the 2010 grant from The National Lottery Distribution Trust Fund and amounted to only 11% of the grant awarded to the organisation in 2008 (NICOR South Africa 2012).

Social enterprises do not fall under the provisions of the NPO Act unless their income is invested entirely to a public social purpose, thus excluding social enterprises that do so principally but not exclusively. Social enterprises with equity financing on which members can expect some form of return cannot operate as non-profit companies. In addition, no taxable benefit is received by either of these entities without the PBO status and with trade activity. CSR spend is usually directed at registered PBO’s in order for the company to receive a tax benefit. This further limits the available funding options for non-profit companies which do not have PBO status and may be a motivation for a non-profit company to adopt a for-profit model and strategy to achieve sustainability.

2.4.2 Co-operatives

Co-operatives are defined in the (The Co-operatives Act 2005) as:

“An autonomous association of persons united voluntarily to meet their common economic and social needs and aspirations through a jointly owned, democratically controlled enterprise organized and operated on cooperative principles.” In simple terms, a co-operative is an organisation owned and operated by a group of individuals for their mutual benefit.

Co-operatives registered with the Registrar of Co-operatives have similar legal rights and powers to that of companies which include:

- limited liability for members
- personal assets of members which are distinct from company finances and assets.
- perpetual succession: it continues to exist even if its members and office-bearers change.
- the co-operative can sue, be sued and enter into contracts in its own name.
Section 38(2)(d) provides that a co-operative should be classified as a public company. As a result, co-operatives are treated as public companies for tax purposes and are taxed as such, unless a specific section provides otherwise.

2.4.3 Private company social enterprises

Social enterprises may operate as for-profit private or public companies governed by the Companies Act (n.d.). In order for a for-profit company to qualify as a social enterprise within the locally generally accepted definition, the company must have the following features:

- restriction on dividends or distributions to stakeholders;
- company assets will be transferred to similar organisations when liquidated or dissolved
- objectives restricted to social pursuits rather than predominantly profit driven (Fonteneau 2011).

It is critical that a social enterprise adopting a for-profit company structure ensures that its social mission is the primary objective of the business and this should be documented in its Memorandum of Incorporation.

2.5 The current status of social enterprise activity and whether social enterprises are worthy of tax relief

“Social entrepreneurship operates in areas where traditional market mechanisms and government-based support structures for allocating resources and power have failed. Social entrepreneurs use innovative tools and market-driven mechanisms to solve key and urgent social problems, making a positive impact on society as a whole” (R. Harding 2004). These entities contribute to the economy using an alternative sustainable business model whilst providing an alternative delivery system for public services such as health, education, housing and community support. Social enterprises have been proven to be successful in job creation and social impact (York 2011), but are these organisations deserving of a tax relief? It was asked in Worthstone’s (2013) report whether social enterprises were viable and sustainable or whether a tax relief should be providing an ‘artificial prop’ to their sector.
The findings of the State of Social Enterprise Survey 2013 (Chung 2013), the largest survey of social enterprises in the UK, showed that the social enterprise sector is growing. Recent government estimates suggest there are 70,000 social enterprises in the UK, employing around a million people. The sector’s contribution to the UK economy has been valued at over £24 billion. According to Worthstone (2013), social enterprises account for approximately 7% of the Small and Medium-sized Enterprise (SME) population and provide over 5% of all jobs in the UK. A survey conducted in 2011 in the UK found that the social sector employs more people relative to turnover than mainstream small business. The average annual turnover for the social enterprises was £240 000. This sector is continuing to grow rapidly due to the demand for organisations that can provide effective social impact and it is predicted that over £1bn of social investment will be needed by 2016 (Social Enterprise UK 2011).

On comparison (Chung 2013) between FTSE 100 companies, SMEs and the social enterprise sector in the UK, it was found that 38% of social enterprises are led by women, compared with just 3% of FTSE 100 companies and 19% of SMEs. Furthermore, 91% of social enterprises have at least one woman on the leadership team compared to 51% of SMEs and 28% have at least one member of the leadership team from a Black and Minority Ethnic background compared to 12% of SMEs. The survey went on to reveal that the majority (52%) of social enterprises actively employ people who are disadvantaged in the labour market (for example: long-term unemployed, ex-offenders, disabled people). These statistics are interesting in a South African context. If there is a similar pattern in terms of creating employment amongst traditionally under-represented groups, then the role of social enterprise may prove to play an even more crucial role in addressing society’s need while assisting Government with achieving its priority of inequality though policies regarding Broad Based Black Economic Empowerment.

The 2013 survey (Chung 2013) found that social enterprises are very heavily concentrated in the UK’s most deprived communities with 38% of all social enterprises working in the most deprived 20% of communities in the UK, compared with 12% of traditional SMEs. That is three times the proportion of SMEs, creating jobs and contributing to the economy where it is needed the most.

The survey (Chung 2013) also revealed that 72% of the respondents earned between 76% and 100% of their income through revenue from their trade opposed to grants, donations or other
income sources. This is an indication that social enterprises are not charities and are different from most traditional voluntary and community organisations even if they do share similar values and objectives. Furthermore, the survey found that 55% of social enterprises made a profit, 22% reported a loss and 18% broke even.

In the USA, the actual number of social enterprises is unknown however preliminary results from sampled entities in The Great Social Enterprise Census conducted in 2012 account for over $375 million in revenue and 15 000 jobs in 28 states. National estimates speak of a sector employing over 10 million people, with revenues of $500 billion; about 3.5 percent of total US GDP (Thornley 2012).

The social sector has become a major provider of jobs in Europe, where job creation, firstly, results directly from the aim of work-integration many social enterprises pursue and, secondly, from social enterprises providing personal services with a high labour intensity (Heckl 2007).

In South Africa, the social economy is in its infant stage of development and there is currently little national data available on the social economy. Social entrepreneurial activity has been measured at approximately 1.8% per the Global Entrepreneurship Monitor (“GEM”) 2009 survey (Visser 2011). The sector is expected to grow due to an increased interest in social entrepreneurship in South Africa as demonstrated by the launch of South Africa’s first online social investment stock exchange, SASIX, and the establishment of organisations which assist social enterprises such as Impact Trust, Greater Good and Greater Capital. Further evidence of this interest is in the increasing number of recognised social entrepreneurs as members of Ashoka Fellows, the increasing number of courses on social entrepreneurship, the increasing number of centres on social entrepreneurship and the increasing number of academic outputs on social entrepreneurship (Shumba n.d.)

South Africa was severely impacted by the economic recession with up to one million jobs lost in 2009 of which about 600,000 have been recovered since, however, the local unemployment rate in 2013 is still high at 25.6% (Maswanganyi 2013). The South African government has labelled unemployment as being South Africa’s greatest challenge and sets forth an ambitious vision of reducing the current unemployment rate from the conservative estimate of twenty-five per cent in the country to six per cent by 2030 (Moss 2012). Government has publicly
acknowledged that the social economy has a key role in addressing poverty, inequality and unemployment. In 2011, the Minister of Economic Development, Ebrahim Patel, stated that “South Africa’s new growth path would be led by the social economy”. He went further to acknowledge the potential of social enterprises to contribute to the job creation goals of government which are set at 5 million new jobs by 2020. He estimated that social enterprise could create 260 000 jobs in this period (Moss 2012). Growth in this social sector would also relieve government of its social assistance burden as sustainable social enterprises do not require public funding like that of the traditional non-profit companies who rely on grants to achieve their social and environmental purpose.

The survey conducted on the UK social enterprise environment (Chung 2013) found that close to a third of all social enterprises are three years old or younger, with three times the proportion of start-ups than the SME sector. It is assumed that these statistics would be similar for South African social enterprises. From all of this analysis it would seem that social enterprises may play a key role for job creation and a proposed tax framework should targets these entities at their most vulnerable phase by offering tax relief, creating a more enabling environment for them to establish.

**Social entrepreneurship prevalence rate as a percentage of the working age population by enterprise maturity in selected countries in 2009**
2.6 Conclusion

There is a range of different definitions used by different countries, organisations and studies however the elements that are common to the majority of definitions of a social enterprise are that it will:

- generate income through trading activities, it may also receive funding, but it’s core activity is selling goods or services
- have its social or environmental purpose at the centre of what it does, its social or environmental purpose is not an add-on such as a CSR project undertaken by a corporate organisation
- use innovative approaches to achieve its social or environmental impact
- re-invest its surplus back into achieving its social and environmental purpose – the more surplus it makes, the more impact it can have, some structures allow for a capped dividend for investors or co-operative members in order to attract investment or commitment from members
- be transparent and engage its stakeholders at every level (African Social Entrepreneurs Network n.d.).

Social enterprises differ from other organisations in the civil society sector as they use a business-like approach to achieve their social purpose. They often earn a substantial proportion of their income and are not structurally dependent on grants and donations. There is currently no legal definition of a social enterprise. The range of legal structures that social enterprises can choose each comes with their own unique characteristics, advantages and disadvantages. This chapter discussed the different legal forms a social enterprise may adopt. Chapter 3 examines the most favourable structure for a social enterprise to operate.

Historically, non-profit organisations and government have been jointly responsible to assist society with their basic needs. In the light of the current economic environment and related increase of social issues, NGOs and government are unable to meet the demands of society. Traditional non-profit business models are proving to be unsustainable providing only short-term relief, due to the shrinking of resources and increased competition for limited resources.
Organisations that create shared value are needed in order to meet society’s basic needs, sustain communities and the economy and social enterprise may be the solution. Social entrepreneurs are implementing and developing innovative solutions to meet the country’s domestic challenges as their ability to innovate allows them to achieve greater results with fewer resources (Wolk, 2008).
CHAPTER 3

FOR-PROFIT SOCIAL ENTERPRISES AND HYBRID MODELS

3.1. Introduction

The main objective of this chapter is to identify the most favourable business model for social enterprises to adopt. Furthermore, this chapter explores reasons as to why a social enterprise would choose to adopt a hybrid structure, potentially forfeiting any tax exemptions granted to traditional non-profit companies. Theron (2010) has suggested that a business model that integrates public, private and non-profit sectors with social entrepreneurship is the most strategic, resulting in social and economic value creation. The hybrid business model has therefore been identified as the most successful and preferred model to be used in the South African context, as it delivers both social and economic value. “This model employs business processes to solve social problems whilst focussing on measurable results and has the potential to generate real transformative, cost-effective solutions to the most challenging social problems” (Theron 2010).

3.2 The hybrid structure

A single entity cannot simultaneously be a non-profit and a for-profit operation. Social enterprises must choose between obtaining tax benefits by operating as not-profit companies or accessing funding though capital. The hybrid model allows for an organisation to have a non-profit and a for-profit component, however guidelines are in place as to how these two entities must interact to ensure that the structure does not exploit grant funding or tax advantages.

A typical hybrid structure consists of a non-profit company which sources grant funding and carries out the social enterprise’s social objectives, and a for-profit company which earns income and seeks profit through carrying out its trading activities (GreaterCapital 2011).

The set-up of a hybrid structure may be that the for-profit company generates income and passes surpluses on to the non-profit company to enable it to fulfil its social objective. The shareholders and the investors of the for-profit company benefit from their investment, but at the same time
further their social objective through the non-profit company. Alternatively, a hybrid structure may be set-up so that the for-profit company earns income from trading which may be supplemented by the non-profit entity through other sources such as grants and donations. Another common set-up of a hybrid model involves the non-profit company owning equity in the for-profit company allowing the non-profit company to control the activities of the joint venture, protecting its social mission.

The symbiotic relationship of a hybrid model benefits the for-profit company by allowing:

- flexibility regarding distribution of profits for the for-profit company;
- access to conventional business finance, including equity if required and some forms of debt that non-profits would find it hard to access;
- access to enterprise development funding through B-BBEE (where the enterprise has the required status); and
- a favourable public image

whilst simultaneously enabling the non-profit company to:

- access grants and donations that are only available to non-profit organisations, including funding through CSR initiatives and government grants allocated specifically to registered NPOs;
- take advantage of the tax exemptions for non-profit companies with PBO status); and
- have a favourable public image as a social purpose enterprise (Legal Resources Centre 2011).
An example of a South African social enterprise successfully adopting a hybrid model is Shonaquip. “Shonaquip builds innovative, sustainable service delivery systems and mobility devices to improve physical access and quality of life for people living with disabilities in under-resourced and rural regions in Africa” (Shwab Foundation for social entrepreneurship n.d.). The entity uses a hybrid model consisting of a private company and a non-profit company. This model was set up in order to separate out the non-profitable activities into Uhambo, the Shonaquip Foundation whilst ensuring sustainability through Shonaquip, the for-profit company. The Foundation’s mission is to provide more advocacy and research and to source funding for activities which include providing wheelchairs and support services to the poor. The Foundation owns 25% of Shonaquip’s equity in order to ensure that the company and its staff remain true to its original social vision. All Shonaquip’s income is generated from the sale of wheelchairs, posture support devices, mobility products, clinical and training services (International Labour Organization 2011).

### 3.3 Why a social enterprise would elect a hybrid structure

The tax benefits of a social enterprise operating as a non-profit company are most advantageous, further increasing if operating with PBO status, however the sustainability of these organisations
has been questioned (NICOR South Africa 2012). The sustainability of non-profit companies is under threat due to government’s extensive spending cuts and decreasing donor funding during the global recession. Research estimates social entrepreneurial activity in the non-profit sector of South Africa to be only 15%, considerably lower than the average activity of countries in South Africa’s economic peer group (Moss 2012). A reason given for this by Richie (2013) was that non-profit companies are established to deliver services that do not generate income. Restrictions placed on them by their governing regulations means they are unable to pursue profits, limiting their sustainability.

Non-profit companies with the ability to engage in sustainable activities may still prove to be unsuccessful. In his book, Dan Pallotta, a writer and well known speaker on social innovation, identified the following five segments in which the non-profit sector fails to compete with the for-profit sector:

1. Compensation
2. Advertising
3. Ability to take risk
4. Ability to think in the long term
5. Access to capital

Pallotta (2013) suggests that for-profit businesses are able to compete for talent due to their ability to pay competitive wages for value adding employees. In addition, the for-profit sector is allowed the freedom to advertise in order to sell their product while donors in the non-profit sector are inclined to feel that the organisation is not addressing the cause when money is spent on marketing.

There are a number of motivations for why social enterprises may choose to forgo the tax beneficial vehicle of a non-profit company and rather elect to adopt a for-profit or hybrid structure in order to pursue its social goals. These include the following:

3.3.1 Financing

Social enterprises operating as non-profit companies are prohibited from having share equity and therefore cannot obtain finance through investors subscribing for shares. A social enterprise
operating a for-profit company has the opportunity to raise capital for the company through the offer of shares. This financing method is a favourable choice for social enterprises as the cost of equity is cheaper than the cost of debt (York 2011). Access to finance through share equity could assist social enterprises in achieving sustainability and growth.

Research has estimated the demand for investment in social enterprises to be £165m in 2011. The demand is expected to be £1billion by 2016 (Swersky 2012). With this potential increasing demand for investment in social enterprise, a hybrid model would seem a more favourable conduit to carry out a social enterprise organisations mission. The for-profit arm would have greater access to capital markets, enabling them to scale up quickly in response to changing economic conditions, and changing government policies (Berhnolz 2013), whilst the non-profit offshoot focuses on achieving its social objectives.

3.3.2 Flexibility

The requirements for an organisation to qualify as a non-profit company were dealt with in chapter 2.4.1 and those of a co-operative in chapter 2.4.2. These requirements are very specific and are even more onerous if a non-profit company were to apply for PBO status. Organisations have to adhere to the following principles:

- public purpose,
- not allowed share equity
- non-distribution of assets and profits among members
- on dissolution, assets must be transferred to a similar organisation
- devote their income exclusively to the social purpose

A social enterprise may therefore choose to operate as a for-profit company or include a for-profit arm in their structure as even though the primary aim of the business is social, not all its activities have to meet the criteria of a non-profit company.

Furthermore, non-profit companies are predominantly funded by grants and bequests from donors. Often these donations carry certain instructions on how or for what the donation may be used. The restrictions of being funded by organisations may be limiting due to funding criteria laid down by the sponsors. These restrictions may interfere with the social purpose of the
enterprise. As a for-profit company, shareholders are able to make their own decisions on how to spend money and how to fulfil their social purpose.

3.3.3 Challenges regarding the registration process

A non-profit company may have to register three times at different government institutions (Registrar of Companies, NPO Directorate and Tax Exemption Unit of SARS) and adhere to the regulations of three separate governing bodies that require different kinds of information and different reporting requirements. Multiple registrations are time-consuming and costly and this increased administration may lead social enterprises to register as for-profit companies (Steinman 2010).

3.3.4 Hiring and retaining of quality staff

Due to financial constraints of non-profit companies it is difficult for these organisations to hire and retain quality staff and their workforce is primarily made up of volunteers. Staff often lack the required skills and motivation and there is a lack of professional employees due to uncompetitive salaries in the sector (Heckl 2007). In contrast, for-profit companies are able to pay market-related salaries, attracting skilled professionals, contributing to the success of the company.

3.3.5 Sustainability

The non-profit sector in South Africa faces the challenge of decreasing availability of funding (NICOR South Africa 2012). South Africa is now viewed as a middle-income economy, resulting in decreased international funding opportunities. Furthermore, the economic recession has resulted in international grant cuts from the USA and the UK (Kabane 2011). Non-profit companies are facing challenges of raising funds through accessing donations and grants. The lack of funding has raised the issue of financial sustainability in the non-profit sector with many organisations looking for alternative models to adopt in the future. Consideration must now be given by non-profit companies to include trading activities in their model in order to support their social objectives. It is projected that by 2020 the majority of charities and non-profit organisations will be generating some if not all of their income through trading activities (British Council 2014).
3.4 Conclusion

In order to exploit the benefits of both for-profit and non-profit legal structures, a social enterprise can adopt a hybrid model. This structure was found to be the most effective vehicle for social enterprises to operate. A hybrid model typically entails the creation of two separate legal entities, one a for-profit entity and the other a non-profit entity. The partnership of these two traditionally separate models, a non-profit structure and a trading operation allows the group to pursue sustainable profits and achieve its social mission.

Adopting a hybrid structure may mean forgoing the tax benefit received operating as a traditional non-profit company. A social enterprise may choose to sacrifice this benefit in order to achieve greater financing opportunities, better flexibility, the ability to attract skilled staff and a greater opportunity to guarantee sustainability.

Traditional non-profit business models that rely on grant and donor funding are proving to be unsustainable\(^3\) in an environment of shrinking resources and increased competition (Theron 2010). Adopting a hybrid structure allows social enterprises to use other methods of financing as the for-profit side can take on debt and raise equity making the company less dependent on grants and donations. Government and non-profit companies are failing to meet the demands of growing social issues and a new solution is required. Social enterprise’s innovative public service model may be key in providing a solution to society’s pressing issues using existing resources more efficiently.

\(^3\) The Charities Aid Foundation survey on UK charities in 2012 found that one in six charities believed they could face closure within a year. More than eight out of 10 said the charity sector was in crisis. London Voluntary Service Council's "Big Squeeze" report found that 27% of its members closed services during 2013; 51% reported a reduction in overall funding and 82% saw an increased demand for services, declining resources, increased demand and reduced donations (Smedley 2014)
CHAPTER 4

CASE STUDY: UNEARTH AND THE CURRENT TAX TREATMENT OF HYBRID SOCIAL ENTERPRISE MODELS

4.1 Introduction

The main objective of this Chapter is the analysis of the South African tax implications for social enterprises adopting a hybrid business model. This is examined by using a case study example of the dynamic and exciting group of companies called UnEarth Group. This chapter applies the concept of a hybrid social enterprise to the UnEarth Group which has both profit making and social objectives. The case was selected in order to propose a structure which minimizes tax leakage whilst still achieving the group’s objectives and to demonstrate the tax consequences of a social enterprise operating with this business model under the current tax legislation in South Africa. The chapter then goes on to examine other countries’ acceptance of the concept of social enterprise and analyses their tax-specific legislation which is contributing to an enabling environment for social enterprises.

4.2 Case study: The UnEarth Group

4.2.1 Company background

“UnEarth International is a group of companies focussed on conservation with the objective of creating an enduring and extensive conservation footprint by developing self-sufficient, bio-region, rural ecotourism businesses built on efficient land reform, job creation and empowerment of local entrepreneurs. This objective is to be achieved by harnessing the global marketing power of television and online media to direct spending towards targeted conservation regions and initiatives. The business model is such that funds will be directed into seven business units which will then use these profits to achieve UnEarth’s conservation model of directing spending into conservation initiatives” (UnEarth Productions 2012).
“UnEarth uses TV and online media to popularise conservation. By harnessing the global marketing power of television and online media, they aim to market travelling to lesser-known eco hotspots which will help to seed ecotourism operations which will boost local business and employment- all of which will be facilitated by UnEarth. The hotspots will be showcased through the Ranger Africa series, a reality TV show, and as such will be marketed to a mass audience. The resultant interest, with support from UnEarth Direct, will boost travel to hotspots providing a strong economic base from which to operate. UnEarth will use its extensive network and collective skills to support these ecotourism hubs. Where appropriate, UnEarth Developers will facilitate effective land reform using its buying power and by leveraging government support. UnEarth Consulting will manage ecotourism businesses with a strong emphasis on skills and expertise transfer to ensure the effective transfer of operations to local people. This will ensure effective land reform”.

“Through the establishment of the core ecotourism business, UnEarth seeks not only to boost job creation but also to empower rural entrepreneurs in the establishment of spin-off businesses such as food suppliers, construction, land management, anti-poaching, hospitality, guiding and tracking. Ultimately, wilderness assets will be handed over to empowered local people and UnEarth will be able to step away completely, leaving a self-sustaining, bio-regional, rural economy based on ecotourism” (UnEarth International n.d.).
UNEARTH PRODUCTIONS
Ranger Series:
Africa, USA, India, China, Russia, Canada, Australia

MASS AUDIENCE

TAPPING INTO GLOBAL SPEND

UNEARTH DIRECT
Online Travel Co.

UNEARTH LAND
Development Co.

UNEARTH CONSULT
Development Co.

UNEARTH MERCHANDISE
Brand Awareness Co.

UNEARTH FOUNDATION
Non Profit Org.

UNEARTH KNOWLEDGE
Online Info Co.

BUSINESS MODEL

CONSERVATION MODEL

UNEARTH’S COLLECTIVE CONSERVATION
DIRECTING GLOBAL SPEND
A collective network of strategic alliances, established to align
conservation initiatives. UnEarth’s alliances that will capacitate
existing conservation movements and expertise.

BOOSTED ECOTOURISM

EFFECTIVE LAND REFORM

JOB CREATION & SMALL
BUSINESS DEVELOPMENT

TRANSFER OF SKILL & EXPERTISE

BRAND AWARENESS

OPTIMISING SPEND

COLLECTIVE BUY IN

WILDERNESS

LOCAL PEOPLE

WEALTH CREATION DEPENDENT ON CONSERVATION
There are seven business units in the UnEarth group:

1. **UnEarth Productions**

   “UnEarth Productions will initially create a global TV brand— the Ranger Series. The premise of the Ranger TV series is to get a bunch of people who feel trapped in their jobs, desk-jockeys, people tired of their daily grind, guys and girls who just want to change their lives and make a real difference to the world, and put them through their paces on a four month journey to become a game ranger in a documentary adventure. In four months the contestants will be pushed to their emotional, physical and mental limits, learning everything there is to know about being a game-ranger and conservation. They will learn to shoot, drive, walk and track. They will have to overcome their deepest fears while alone in the wilderness. They will discover the importance of the wilderness to human survival and how ecotourism can benefit rural people, how to dig deep within themselves to determine if they could kill an animal to save a life, mostly they will learn the place of humankind on planet earth.” (UnEarth International n.d.)

   Each Ranger season will showcase a globally important conservation hotspot and direct interest and spend towards it.

2. **UnEarth Direct (Online Travel Agency):**

   “UnEarth Direct is an online travel operator that will direct travellers to the hotspots showcased by the Ranger Series”.

3. **UnEarth Developers:**

   “UnEarth Developers aims to identify areas that have the potential to become self-sufficient economies based on ecotourism. UnEarth Developers will utilise the buying power of the UnEarth group and leverage NGO and donor support to secure land assets and developments”.

4. **UnEarth Consult:**

   “Unearth Consult is an ecotourism management company. It will run lodge operations in targeted hotspots. UnEarth Consult will ensure the effective transfer of skills and expertise to the local community”.
5. **UnEarth Merchandising:**

“UnEarth Merchandising aims to capitalise on the global “Ranger” brand by globally distributing branded Ranger products”.

6. **UnEarth Knowledge:**

“UnEarth Knowledge is an online information portal designed to provide a meeting place for collective conservation ideas”.

7. **UnEarth Foundation:**

“A non-profit business aimed to facilitate the transparent and effective use of donations. Donors will have the ability to choose and monitor how and where their donations are spent”.
4.2.2 The Business Model- proposed group structure

This dissertation experimented with regard to UnEarth Group’s business model, beyond the traditional non-profit and charity vehicles and favoured a hybrid business model. Based on the group and individual companies’ objectives, and the findings that hybrid structures are ultimately the most efficient structure for social enterprises to operate as, the following structure has been proposed:
i) Profit driven entities:

UnEarth Productions, UnEarth Direct and the for-profit arm of UnEarth Consult are the primary trading companies of the UnEarth Group whilst UnEarth Merchandising operates as a secondary trading company. These entities (the “for-profit companies”) have the objective of maximizing profits which will be channelled to the non-profit investor to be used to fulfil the group’s social objectives.

ii) Socially-driven entities

UnEarth Developers, UnEarth Consult (non-profit arm) and UnEarth Foundation have primary social objectives which include conservation and community development. These entities (the “non-profit companies”) will operate as non-profit companies allowing them to source donor and grant funding. It is proposed that these entities apply for PBO status under the following provisions of the Ninth Schedule to the Income Tax Act of South Africa:

A. UnEarth Developers

Part I Ninth Schedule

3. Land and Housing

(e) “The promotion, facilitation and support of access to land and use of land, housing and infrastructural development for promoting official land reform programmes.”

Part III Ninth Schedule

7. Conservation, Environment and Animal Welfare

(a) “Engaging in the conservation, rehabilitation or protection of the natural environment, including flora, fauna or the biosphere.”
B. UnEarth Consult

Part I Ninth Schedule

1. Welfare and Humanitarian

(p) “Community development for poor and needy persons and anti-poverty initiatives, including—

(i) the promotion of community-based projects relating to self-help, empowerment, capacity building, skills development or anti-poverty;

(ii) the provision of training, support or assistance to community-based projects contemplated in item (i); or

(iii) the provision of training, support or assistance to emerging micro enterprises to improve capacity to start and manage businesses, which may include the granting of loans on such conditions as may be prescribed by the Minister by way of regulation.”

The decision to establish more than one non-profit company allows each entity to focus on the various aspects of what the enterprise as a whole aims to achieve. The individual entities are able to fundraise or engage in income generation activities as separate legal entities, spreading any risk.

iii) Co-operative

UnEarth Co-op is owned and operated by members of the local community together with a representative of UnEarth Group and operates for their mutual benefit. The entity is profit driven and distributions from profits will be made to members accordingly.

iv) Benefits of the structure

The UnEarth group of companies share a common mission of creating an enduring and extensive conservation footprint by developing self-sufficient, bio-region, rural ecotourism businesses built on efficient land reform, job creation and empowerment of local entrepreneurs. The above hybrid structure separates the for-profit and non-profit operations allowing the for-profit entities
freedom to pursue profit and use access to market capital, whilst the non-profit entities are able to raise funds through grants and donations as well as receive funding from profits re-invested into the group in order to carry out their social mission and fulfil the group’s social goals. The structure also allows each company to operate independently with each legal entity having its own board of directors. The entities mutually support each other, sharing markets and infrastructure as visitors brought to the ‘Hot spots’ via UnEarth Direct provide the business for UnEarth Consult and potentially donate to UnEarth Foundation. Conversely, potential donors of the UnEarth Foundation may visit the ‘Hot spot’ and require the services of UnEarth Direct as well as provide business for UnEarth Consult. The synergies between the entities in the above hybrid model allow for both social and economic value to be created simultaneously. The symbiotic relationship of the hybrid structure should result in a maximization of profits which in turn will maximise the group’s social impact.

The diagram below, adapted from (Kannegiesser 2007) demonstrates the synergies of the hybrid structure adopted by UnEarth Group:
4.2.3 Cash flows of the hybrid structure

The non-profit companies may receive funds from the for-profit companies by:

- Hiring out services, staff time or intellectual property to the for-profit company at market rates. In addition, the for-profit companies may pay the non-profit companies for research, designs or software that allows it to produce the product or services that it sells to the market;
- Donations to the non-profit companies;
- Distributions made to the non-profit company by way of dividends; and
- The sale of shares held by the non-profit companies in the for-profit companies.

4.3 The current tax implications of the structure

In South Africa, the tax regulatory framework does not recognise a social enterprise by its definition and there are no established tax incentives in the current tax legislation that are specific to social enterprises. Consequently, social enterprises are treated as per their legal form adopted in terms of the Companies Act. The following cash flows and consequential tax implications for the group have been identified:

4.3.1 Profits generated from the for-profit companies

The for-profit companies as well as UnEarth Co-op are defined under section 1 of the Income Tax Act as a company. For-profit social enterprises do not qualify for any tax exemptions on their income like that of registered PBOs. This is because they cannot qualify for the PBO status due to the ability to distribute profits to shareholders (Steinman 2010). Companies registered in terms of the Companies Act pay corporate tax at a rate of 28% calculated on taxable profits.

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4 “company” includes -

(a) any association, corporation or company (other than a close corporation) incorporated or deemed to be incorporated by or under any law in force or previously in force in the Republic or in any part thereof, or any body corporate formed or established or deemed to be formed or established by or under any such law; or

(c) any co-operative;
Section 12E(4) of the Income Tax Act defines a small business corporation\(^5\) (SBC). SBCs benefit from special tax rates and accelerated allowances in the Income Tax Act. In the UnEarth group structure, none of the companies are able to qualify as an SBC even if their gross income is within the constraints of R14 million as all members are not natural persons and do not enjoy the reduced tax rates offered to SBCs but are taxed at the standard company tax rate of 28%.

The UnEarth Group qualifies as a group of companies\(^6\) under section 1 of the Income Tax Act. This means that the UnEarth Group is able to benefit from the roll over relief provided in terms of the special rules relating to asset-for-share transactions (section 42), amalgamation transactions (section 44), intra-group transactions (section 45), unbundling transactions and liquidation (section 47). UnEarth co-op is not included in the group of companies as co-ops do not qualify under the definition and any corporate roll over provisions conditional on the entity being part of a group of companies do not apply. The inclusion of co-ops into the definition of group of companies under section 41 was recommended by Wheeler (2012).

\(^5\) A small business corporation is defined as a company that meets the following requirements:

- All the members must be natural persons.
- The gross income for the year does not exceed R14 million.
- The members cannot hold any shares or any interest in the equity of any other company except for those companies excluded in section 12E(4)(a)(ii)(aa) to 12E(4)(a)(ii)(ii).
- These excluded companies include listed companies, any portfolio in a collective investment scheme and a venture capital company, amongst others.
- The receipts and accruals from investment income as defined in section 12E(4)(c) and the total receipts and accruals from rendering a personal service as defined in section 12E(4)(d) may not exceed 20 percent of the co-operatives gross income and capital gains for the year.
- The company must not be a personal service provider as defined in the Fourth Schedule to the Income Tax Act.

\(^6\) “group of companies” means “two or more companies in which one company (hereinafter referred to as the ‘controlling group company’) directly or indirectly holds shares in at least one other company (hereinafter referred to as the ‘controlled group company’), to the extent that -

(a) at least 70 per cent of the equity shares of each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof”
The transfer of assets and funds from a non-profit company to any for-profit company is prohibited except under restricted circumstances such as fair payment for services delivered. This means that the for-profit can never benefit financially through donations and transfers from the non-profit company.

The only tax relief these entities may benefit from is the tax deductibility of donations made to PBOs. The Income Tax Act allows for bona fide donations in cash or of property made to PBOs to be deducted from the taxable income of a company under section 18A of the Income Tax Act. The deduction is limited to 10% of the taxable income of the company before allowing any deduction under section 18A. In order to deduct the donation from taxable income, it must be supported by the necessary receipt issued by the organisation. Minister Pravin Gordhan announced that the SARS will allow donations in excess of 10% to be rolled over to the next year as allowable deductions. In addition, these donations are exempt from Donations tax.

A social enterprise that adopts the for-profit legal structure is therefore at a tax disadvantage compared to non-profit companies that trade within the acceptable limits and qualify for tax exemptions under the non-profit company legal form. The high rate of tax has many adverse consequences for a social enterprise including reduced levels of re-investment in the business and difficulties created for cash-flow by having to meet the required tax assessment.

### 4.3.2 Profits from non-profit companies

The non-profit companies are exempt from income tax in terms of section 10(1)(cN) of the Income Tax Act if they are registered PBOs. PBOs are permitted to carry on limited business or trading activities on a tax-free basis within certain specific parameters in terms of section 10(1)(cN). Receipts and accruals derived from any business undertaking or trading activity that falls outside the parameters of these permissible trading rules are subject to tax, after deducting the basic exemption. Permissible trading activities which are exempt from tax include:

- the undertaking or activity is integral and directly related to the sole or principal object of the PBO where substantially the whole (not less than 85%) of the trading activity is conducted on a cost recovery basis and the trading activity is not seen as being in unfair competition with other taxable entities. This means that the PBO should not be in a more favourable
position or have an unfair advantage over a taxable entity conducting the same trading activity;

- the undertaking or activity is of an occasional nature and undertaken substantially with assistance on a voluntary basis without compensation. To qualify under this item the trading activity must take place on an occasional or infrequent basis;

- the undertaking or activity is approved by the Minister (SARS 2007).

Where a PBO carries on trading activities which do not fall within the ambit of the above exemptions, the PBO will be taxable on the taxable income derived from all such other business or trading activities. An exclusion, calculated as the greater of 5% of the total receipts and accruals of the organisation or R150,000, will not be subject to tax. Taxable income from all non-permissible trading activities after this deduction is taxed at a single rate of 28% irrespective of the type of legal entity.

The non-profit company of UnEarth Consult may generate profits through the hiring out of staff and other services. The non-profit company’s social objective is that of community development for poor and needy persons through empowerment, skills development, training and support. The profits generated from hiring out of staff may therefore be exempt from tax as they are integral and directly related to the company’s objectives.

### 4.3.2 Donations tax

A donation is defined under Part V of the Income Tax Act as “any gratuitous disposal of property including any gratuitous waiver or renunciation of a right”. Donations made by a company attract tax at a flat rate of 20% on the value of the property donated, payable by the donor. No donations tax is payable on donations to PBOs where a valid section 18A certificate has been obtained by the donee. Donations between companies in the same group are exempt from donations tax. Donations made from the for-profit companies to the non-profit companies of UnEarth group will therefore be exempt from donations tax if they are granted PBO status.

Steinman (2010) has assessed that in terms of taxation, the thresholds for individual and business donations and trading by PBOs are restrictive and do not contribute to an enabling environment.
4.3.3 Dividends tax

Profits from the for-profit companies will be distributed to the non-profit companies by way of dividends\(^7\).

Dividends are exempt under section 64F of the Income Tax Act if paid to

(a) “group companies” as defined in section 41;
(b) a public benefit organisation approved by the Commissioner in terms of section 30(3).

4.3.3 Interest free loans

The for-profit companies (lender) may advance interest-free loans to the non-profit companies (borrower). This type of loan may be preferred over an interest-bearing loan due to the non-deductibility of interest. Charging interest on a loan may result in the lender receiving interest that would be taxed, while the borrower cannot claim a deduction for the interest paid, creating a situation where tax leakage occurs between the related parties.

SARS has given clarification on interest-free loans in Interpretation Note 58 where the interest-free nature of a loan may give rise to an amount being received by the borrower, as the fact that a loan is interest-free is something that has money’s worth in the commercial world. It was clarified that the receipt of such an amount will only be included in gross income if it is not of a capital nature. The risk of an inclusion in gross income therefore exists in cases where the borrower has to do something to earn the benefit of an interest-free loan.

The question of donations tax also often arises when dealing with interest-free loans. An argument in the case of an interest-free loan is that if no right to receive interest has been established, it cannot be said that the lender waived or renounced such a right. If this view is followed the granting of an interest-free loan should not trigger donations tax.

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7 ‘dividend’ means any dividend as defined in section 1 that is-

(a) paid by a company that is a resident
4.3.4 Profits of the co-op

UnEarth Co-operative ("the Co-op") is defined as a closed co-operative company\(^8\) in terms of section 97(2) of the Co-operative Societies Act No 29 of 1939.

Profits derived from the Co-op are distributed to members based on the value of the business transactions between the Co-op and the member. These distributions are called bonuses and may be deducted for tax purposes from the Co-op’s profits, subject to a limitation. The limitation is that the bonus should not exceed one tenth of the value of the business transactions between the Co-op and its members. Furthermore, bonuses must be distributed during a “specified period” which is defined in section 1 and is generally the period starting six months before the end of the fiscal year and ending six months after the end of the fiscal year. Thus the Co-op will have the opportunity to claim a deduction in the current year of assessment, for bonuses which may only be distributed six months after the year end (Wheeler 2012).

The Co-op can qualify as a SBC if its revenues do not exceed R14million and may then receive preferential tax treatment, particularly with regard to capital allowances. Where plant and machinery owned by the co-op or acquired in terms of an instalment credit agreement and used in a process of manufacture or similar process for the purpose of the co-op’s trade, the Co-op may deduct 100% of the cost of the asset in the year first brought into use. Furthermore, if the Co-op acquires any asset which would qualify for a wear and tear allowance in terms of section 11(e), the Co-op may elect to claim the allowance in terms of section 11(e), or to claim an accelerated allowance of 50% of the cost of the asset in the year first brought into use, 30% in the subsequent year and 20% in the year thereafter.

If the Co-op qualifies as an SBC, it will be taxed at a rate less than the 28% company tax rate on a progressive scale. According to this scale, the first R67,111 of taxable income is taxed at zero percent. The amount between R67,111 and R365,000 is taxed at 10 percent. The amount between R365,000 and R550,000 is taxed at 21%. Taxable income above R550,000 is taxed at 28%

\[8\] “...any co-operative trading society with limited liability, in respect of which the [Registrar of Cooperative Societies] is satisfied that it does not deal with persons who are not members to a greater extent than, in his opinion, is in the particular circumstances of the case essential to the proper carrying out of the objects for which it has been established.”
percent. Alternatively, if the Co-op does not qualify as an SBC, the standard company tax rate of 28% will apply.

### 4.3.5 Tax leakage and deficiencies of the hybrid structure

The UnEarth group was used as a case study to demonstrate the cash flows and tax consequences of operating a hybrid structured social enterprise. The tax leakage of the structure is significant if the non-profit companies are unable to obtain PBO status.

The hybrid model was found to be the most effective structure for the UnEarth group to adopt as it allows it to pursue sustainable profits and achieve its social mission. The structure takes advantages of the tax benefits granted to the not-profit companies with PBO status whilst the for-profit companies strive to achieve profit without jeopardising the non-profit companies’ status. The hybrid structure was adopted in order to minimize the tax leakage of social enterprise however this approach is onerous. The social enterprise will have to establish and register more than one legal entity, with cost implications, and will also be required to manage and operate more than one legal entity in line with the reporting and compliance requirements for each. Steinman (2010) has said that the South African Revenue Service (SARS) has a large contribution to make in terms of adjusting the currently restricting legislation to encourage social enterprises to flourish. Studies have shown that existing policies are preventing social entrepreneurs from reaching full potential, scale and innovation related to solving social problems (Theron 2010). Government has the ability to create conditions that enable social enterprises to thrive. Incentives such as tax breaks or policy changes could assist in creating a more enabling environment in which social enterprises operate.

### 4.4 Tax status of social enterprises in other countries

The concept of social enterprise is growing and a number of countries around the world have embraced this model evidenced through support organisations being established, policy frameworks being written and research conducted by governments. The European Union (EU) has demonstrated their views on social enterprise as a model with high potential to respond to society’s challenges with the implementation of the Social Business Initiative (SBI) with the objective of creating an ecosystem conducive to developing social businesses and to facilitating their access to funding (OECD/ European Commission 2013).
Social enterprises take various legal forms in different countries across Europe. A number of European countries have adopted specific laws regulating social enterprises. These laws have commonality in that they address issues including the definition of social enterprise, asset allocation, stakeholder and governance systems and accountability and responsibility towards internal and external stakeholders. In this regard, Belgium, Finland, France, Italy, Poland, Portugal and the United Kingdom are ahead in recognising social enterprise into their legislation. In Europe, social enterprises are active in a wide spectrum of activities and in many different sectors including social services, education, housing, the environment, culture and the arts and tourism (OECD/ European Commission 2013).

The social enterprise sector in the UK is advanced and has been catalysed by relatively strong government policy (Comoll 2013). David Gauke, secretary to the Treasury in the UK has said that the UK government “wants to make the UK one of the easiest places to invest in social enterprises in the world” and is in the process of further enhancing the environment for social enterprises in the UK in order to create the right conditions for the sector to thrive.

The social enterprise sector in the USA is also relatively advanced. In addition to regulations designed to promote social enterprise, there are numerous social enterprises and social enterprise support organisations dedicated to assist in their growth (Comoll 2013).

South Africa is lagging behind international efforts in creating an enabling environment for social enterprise and introducing strategy to promote these entities. Internationally, the infrastructure that facilitates the social economy is more developed, and legal structures are in place to capacitate social economy organisations. A brief study of the UK and USA policies which support social enterprise has been carried out in order to develop possible amendments to the current South African legislation.

4.4.1 United Kingdom (UK)

UK legislation includes a form of entity specifically for social enterprises called Community Interest Companies (“CICs”). These entities are designed for business with a primary purpose of providing benefits to the community and who use their assets and profits for public benefit.
CICs are incorporated under the Companies Act 1985 in the same way as ordinary companies. However, CICs are governed by an independent regulator to ensure they are providing their intended benefit to the community and have to pass a “Community Interest Test”. In addition, CICs must state in their “Community Investment Statement” that their operations are carried out for the purpose of benefitting a community in the UK or elsewhere. These organisations are different to charities and are able to pay dividends to shareholders however dividends are subject to a cap. Similarly, interest payable on debts or debentures where the rate is linked to the performance of the CIC is also capped.

CICs are not considered as charities and do not receive tax exemptions. These entities do, however, receive indirect tax incentives through the 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 businesses and other enterprises in disadvantaged communities. The tax incentive offers individuals and companies 25 per cent tax relief spread over a five year period. 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, research suggests that the restrictions on CICs (such as the asset lock) and the restrictions on CITR are complex in order to protect this tax relief from abuse and many social enterprises prefer to adopt other legal forms (Linklaters 2006).

In the UK’s Budget 2013 it was announced that the Government will introduce a new tax relief to encourage private investment in social enterprise. The relief is expected to be released in April 2014 and will grant investors an income tax reduction for investing in enterprise that trade for a social good or purpose. Tax relief granted on investments in social enterprise is limited to the calculated maximum amount of tax which may be foregone by the Fiscus, taking into account the various tax reliefs which will be available, and also taking into account any other de minimis aid received by the organisation. The exact amount will depend on the rate of relief which will be announced at Budget 2014 but the UK government has estimated the figure to be greater than £150,000 over three years. In addition, to encourage individuals with significant capital gains to invest in social enterprises, the Government proposes a capital gains tax reinvestment relief which will operate in a similar way to the current Enterprise Investment Scheme relief.
payment of tax on a capital gain can be deferred where the proceeds from that disposal are reinvested into a qualifying social enterprise. Further capital gains tax relief is granted in the form of an exemption from tax of gains on the disposal or repayment (redemption) of social investments after a minimum investment period, being three years. No tax relief has been granted on dividends or similar returns (HM Treasury and the Department for Business Innovation and Skills 2013). The intention of the tax relief is to help social enterprises grow and innovate in order for them to continue to tackle social issues such as homelessness and high rates of re-offending. Research predicts that the incentive could unlock up to £500m of extra investment over the next five years. The UK Government has shown a long-standing commitment to support social enterprise, and the new tax relief is set to complement Government’s other initiative which helps social enterprises access capital though Big Society Capital. Launched in 2012, Big Society Capital is the world’s first social investment bank. The social investment tax relief aims to encourage more investment in social enterprises, to enable it to become a self sustaining industry in the long term (HM Treasury and Department for Business Innovation and Skill 2013).

The social investment tax relief differs from CITR as it allows direct investment from the individual straight into the organisation.

Recently, the UK government passed two pieces of legislation which involve the measuring of social impact. The first being the Charities Act 2006\(^9\) which is based on two principles: that there must be an identifiable benefit or benefits, and that it must be a benefit to the public or section of the public. The second, The Public Services (Social Value) Act 2012, requires that procuring public authorities take into account wider social and environmental value when they select suppliers. This means that a charity or social enterprise that proves that it can deliver efficiency as well as a social impact may be favoured in tenders over a rival with a lower-cost bid (Social Enterprise UK 2012).

\(^9\) The Charities Act 2006 requires all organisations wishing to be recognised as charities to prove, unequivocally, that their objectives are for public benefit (House of Commons Public Administration Select Committee 2013). Prior to this, there was a presumption in case law that charities who pursued objectives for the relief of poverty, the advancement of religion or the advancement of education were for the public benefit.
4.4.2 United States of America (USA)

The low-profit, limited liability company (L3C) is a legal form of business entity in the USA which has an explicit primary charitable mission and only a secondary profit concern. Unlike charities, they are free to distribute profits to members or owners. The L3C is designed to attract private investments and philanthropic capital in ventures designed to provide a social benefit (Takagi 2008). Despite its socially-conscious mission, an L3C is not a tax-exempt organisation under USA tax legislation, and donations and investments in L3Cs are not tax deductible. In short, L3C’s are taxed like traditional for-profit companies.

A Benefit Corporation (B Corp) is another form of for-profit charity legally recognised in the USA. B Corp laws have been passed in 7 states across the USA and in 2012 there were over 500 Certified B Corporations with $2.3 Billion in revenues operating across 60 industries (B Lab 2012). B Corps are required by law to create social impact and consider how their decisions affect their employees, community, and the environment and are certified by B Lab.\(^\text{10}\) Reporting the social impact measurement is required using established third-party standards. Tax rebates for B Corps have been introduced in Philadelphia where an annual tax credit of $4,000 for the tax years 2012 to 2017 to 25 local B Corps has been offered.

4.5 Conclusion

The dissertation sought to identify the current tax implications of a social enterprise adopting a hybrid model. The UnEarth Group case study was used to propose a group structure and examined the use of a hybrid model and demonstrated the different cash flows of the group with the consequential taxes. The proposed group model was structured in this dissertation in order to minimise tax leakage however, in order to do this, a number of entities would need to be established, which may prove onerous and costly. The case study demonstrates that there are no specific provisions for social enterprises in South African tax legislation. Current tax legislation on non-profit companies only relates to social enterprises that devote their income exclusively to their social purpose, excluding entities which make any distributions to their members or investors. Carrying out trading activities is discouraged by the implementation of tax on any profits exceeding R150,000 or 5% of total receipts. Research suggests that Government should

\(^{10}\) B Lab, a non-profit organization, certifies B Corps in the same way Fair Trade USA certifies Fair Trade coffee.
make increased efforts to specifically incentivise and support businesses that seek to deliver a social or public good and the investors who are seeking positive social impact alongside financial returns by investing in them. Regulatory and legal changes should be made to accommodate and support the growth of social enterprises and encourage the flow of investment capital to them.

An examination of policies in other countries illustrates their embrace of the social economy sector. In the UK, government has carried out extensive research in policy changes that can be implemented in order to encourage growth in the sector. Both the USA and UK have specific legislation for social enterprises and the UK is currently implementing tax incentives for the investment in social enterprise. In comparison, research has shown that current South African policies do not support the growth of this sector. The challenge is to create an enabling environment to encourage the growth of social enterprise in South Africa. Steinman (2010) recommended that SARS adjust their tax legislation in order for social enterprise to flourish. An enabling environment requires a legal and regulatory framework that supports social enterprise. Government has the ability to introduce policies, which encourage social entrepreneurs to grow and ultimately increase their social impact.
CHAPTER 5

SOCIAL IMPACT MEASUREMENT

5.1 Introduction

Social impact refers to how an organisation's actions affect its surrounding community. The definition used for this dissertation describes social impact as “the measurement of the impact of changes (outcomes) intentionally achieved in the lives of beneficiaries as a result of services and products, delivered by an organisation, for which the beneficiary does not give full economic value” (Clifford 2013).

The purpose of this chapter is to discuss whether the social impact of a social enterprise can be measured, why measuring social impact is important for a social enterprise, whether the impact can be reported in monetary terms and what the best tool for such measurement may be.

If a policy framework for social enterprises is to be introduced, formal recognition criteria would need to be in place to identify those entities that deliver social value. This would require a reliable means of measuring social outcomes (Pettus 2013). This chapter discusses the different mechanisms to measure social impact and guarantee the social purpose of social enterprises in South Africa. If the government of South Africa is considering developing a policy framework for social enterprise, a consistent methodology of accounting for the measuring of social impact will be required and will ensure better credibility of the reporting of social value (Fonteneau 2011).

It is estimated that by 2020 social impact measurement will be standard practice in the social economy. Social impact measurement and reporting will become increasingly sophisticated with the result that all organisations will be judged on a ‘Social Impact Spectrum”, affecting the way buying, giving and investing decisions are made. A large driver for improved social impact
measurement is the growth and development of the social finance sector evidenced by the increasing demand for social investment\(^{11}\) (British Council 2014).

### 5.2 Measuring the social impact of social enterprises

Social impact measurement involves identifying, analysing and evaluating the impacts a social enterprise’s activities may have on society and the environment and in particular, the group they are targeting. Reporting the social impact measurement results provides evidence that the social enterprise is delivering tangible benefits to its targeted beneficiaries. Measuring the impact may be difficult as the benefit is normally intangible, difficult to quantify and it is hard to attribute causation to a specific activity (Anderson 2003).

Perceived challenges to social impact measurement include:

- lack of data and a substantial administration burden for data collection
- challenge of attributing social value to specific inputs
- high costs
- lack of skills to carry out procedures
- lack of time
- challenges in identifying intangible impacts
- lack of commitment to real impact (GreaterCapital 2013).

A number of global initiatives are attempting to provide a common set of tools for social impact measurement. Research\(^{12}\) has identified 5 commonly used tools used to measure social impact. There are linkages among these and other tools and methods of measurement however, at present, there is no one widely accepted and utilized approach. For the purpose of this dissertation, the Social Return on Investment (SROI) method was selected due to its ability to translate social impact into economic terms. Furthermore, this method was found to be the most quantitative approach with a higher credibility than most other approaches as it is based on the actual data of a social enterprise’s outputs and outcomes (Fonteneau 2011). For these reasons, SROI has been promoted by third sector organisations, as well as public and private bodies and

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\(^{11}\) Refer 3.3.1

\(^{12}\) Analysis carried out by (Fonteneau 2011) on established methodologies used to measure the social impact of social enterprises in South Africa which documented 5 tools commonly used and their respective benefits and limitations.
has been suggested as a possible standardised evaluation tool for the purposes of measuring outcomes of Social Impact Bonds.

5.2.1 SROI

SROI is defined as ‘a form of adjusted cost–benefit analysis that takes into account, in a more holistic way, the various types of impact that programs have’ (Dr Malin Arvidson 2010). The tool is an outcome-based measurement tool that enables an organisation to measure and monetise its social, environmental and economic value compared with the level of investment it has received. The tool is used to translate social benefits created by a social enterprise, such as increased employability, providing education and training to disadvantaged communities and conservation of endangered animals, into a monetary value. It aims to calculate a financial rate of return for money invested in services by calculating a monetary value for the social impact (social, environmental and economic outcomes). In placing a monetary value on outcomes a comparison can be made with the investment in the company. This results in a ratio of total benefits (a sum of all the outcomes) to total investments. For example, an organisation might have a ratio of R40 of social value created for every R10 spent on its activities (Nicky Stevenson 2010). SROI’s framework is based on social generally accepted accounting principles (SGAAP) that can be used to help manage and understand the social, economic and environmental outcomes created by organisations. The seven principles on which SROI is based are:

1. “Involve stakeholders

Understand the way in which the organisation creates change through a dialogue with stakeholders.

2. Understand what changes

Acknowledge and articulate all the values, objectives and stakeholders of the organization before agreeing which aspects of the organisation are to be included in the scope; and determine what must be included in the account in order that stakeholders can make reasonable decisions.
3. Value the things that matter

Use financial proxies for indicators in order to include the values of those excluded from markets in same terms as used in markets.

4. Only include what is material

Articulate clearly how activities create change and evaluate this through the evidence gathered.

5. Do not over-claim

Make comparisons of performance and impact using appropriate benchmarks, targets and external standards.

6. Be transparent

Demonstrate the basis on which the findings may be considered accurate and honest; and showing that they will be reported to and discussed with stakeholders.

7. Verify the result”

(SROI Network and Cabinet Office of the Third Sector 2009).

Carrying out an SROI analysis involves six stages:

1. “Establishing scope and identifying key stakeholders. It is important to have clear boundaries about what your SROI analysis will cover, who will be involved in the process and how. Often service users, funders and other agencies working with the client group are included in an SROI.

2. Mapping outcomes. Through engaging with your stakeholders you will develop an impact map (also called a theory of change or logic model) which shows the relationship between inputs, outputs and outcomes.

3. Evidencing outcomes and giving them a value. This stage involves finding data to show whether outcomes have happened and then giving them a monetary value.

4. Establishing impact. Those aspects of change that would have happened anyway or are a result of other factors are taken out of the analysis.
5. Calculating the SROI. This stage involves adding up all the benefits, subtracting any negatives and comparing the result with the investment. This is also where the sensitivity of the results can be tested.

There are four steps to calculating the ratio, with an optional fifth:

5.1 Projecting into the future
5.2 Calculating the net present value
5.3 Calculating the ratio
5.4 Sensitivity analysis
5.5 Payback period

6. Reporting, using and embedding”

This last step involves an appropriate independent verification of the report, and informing stakeholders of the outcomes and obtaining their responses (SROI Network and Cabinet Office of the Third Sector 2009).

The SROI method provides a standardised approach for the evaluation of a social enterprise’s effectiveness of use of funds and the rigour and transparency of the SROI method allows for more credible assessment reporting (Marden 2011). To ensure further credibility, SROI reports can be audited to ensure the information in the report is accurate. This involves having the SROI analysis independently checked by qualified assessors and assured by a panel to have been prepared in line with the principles of SROI and is therefore to a consistent standard.

5.3 Examples of social enterprises and their measured social impact

The stories of successes among social enterprises delivering public services and positively impacting individuals and their families are plenty and powerful. Two examples of these entities operating in South Africa have been selected to demonstrate their impact and how it can be translated into monetary terms, proving their social value.
Kuzuko Game Reserve in the Eastern Cape, South Africa (Roberts n.d.)

An investment of $10 million was used to fund wildlife and land conservation, job creation and social transformation in a region of 70% adult unemployment.

The game reserves social impact was measured as follows:

- 80 permanent jobs with benefits created at Kuzuko Game Reserve ($842,400 value)\textsuperscript{13}
- 80 people received life skills education ($40,000 value)
- 80 people received HIV/AIDS prevention education ($8,000 value)
- 80 people were aided in wealth savings ($50,000 value)
- 70 people were given job skills – fence building ($35,000 value)
- 69 temporary jobs (full-time equivalent) created ($48,370 value)\textsuperscript{14}
- 420 jobs indirectly through the local eco-tourist industry ($1,470,000 value)
- 75 endangered animals released onto the game reserve ($11550 value)\textsuperscript{15}
- 39,000 acres rehabilitated and incorporated into the reserve ($14,742,000 value)\textsuperscript{16}

With a quantified social impact value and a known initial philanthropic investment, SROI can be calculated as:

\[
\frac{\text{Social Impact Value - Initial Investment Amount}}{\text{Initial Investment Amount}}
\]

The SROI of Kuzuko Game Reserve was calculated to be 72\%, providing evidence that the investment in the entity has been a catalyst for economic growth in the region resulting from eco-tourism.

**Food and Trees for Africa**

Food & Trees for Africa is a section 21 not-for-profit company based in Johannesburg addressing the issues of climate change and food security. To ensure its financial sustainability, the social enterprise sells energy certificates and the service of carbon offsetting to corporate companies, government and other non-profit organisations. It also implements government

\textsuperscript{13} All values are calculated over a 5 year period.  
\textsuperscript{14} Value for one year only.  
\textsuperscript{15} Wildlife and land conservation values created with Analytical Hierarchy Process (AHP)  
\textsuperscript{16} Value is over ten years
contracts on urban greening. The company’s reported turnover was R15m in 2010 with 40-50% of this from earned income.

Social impact

- 3.6 million trees planted and distributed to schools, clinics, old age homes, hospices, orphanages, community centres, police stations and other community groups.

- 72 workshops have been held all over the country for educators and learners through the EduPlant programme.

- over 680 000 trees planted at thousands of settlements across South Africa through the Trees for Homes programme.

- over 6500 residents received training and short term employment.

(INTERNATIONAL LABOUR ORGANIZATION 2011).

5.4 Tax incentives for measured social impact

The social impact of social enterprises relieves the financial burden of government for services traditionally provided by it to society. This relief decreases government spending (e.g. on providing health services, housing and environmental grants) allowing funds to be directed elsewhere. In addition, social value created by social enterprises may also increase fiscal revenue for example; more people are employed resulting in additional taxable income earned or VAT on increased consumer spending. If this social value created can be monetised to reflect actual impact, consideration should be given for social enterprises to receive recognition for their contribution to society by way of tax benefits which will allow them to maximise the use of their financial resources towards achieving their social and environmental objectives. Policies could be developed around providing tax incentives for social enterprises which provide measurable, positive social impact without relying on government funding. Studies have demonstrated that public money spent to support job creation or the provision of goods and services by social enterprises represented a more efficient way of utilising resources than alternative methods. Estimates of the return from government’s public resources committed to social entrepreneurship
projects based on both direct savings stemming from reduced social benefits and direct spending and future revenues generated by social enterprises (e.g. taxes and direct revenues) reveal that the support of social entrepreneurs is systematically a cost-effective policy as well as a policy that meets demands unanswered by traditional market methods (OECD/ European Commission 2013).

This dissertation submits that government can support social enterprises through tax relief. The tax relief may be granted by way of a credit/ tax saving. If the social impact of a social enterprise is measured in Rand value, a calculated tax benefit could be offered in lieu of the governmental save from having the social enterprise providing services that fall under the responsibility of the state. A proposed formula for the calculation of a tax credit equivalent to the value of government savings for services provided by a social enterprise is explored in chapter 6.4.7.

5.5 Conclusion

The measurement of social impact involves understanding the effects on various people, either directly or indirectly, that happen as a result of a social enterprise carrying out its objectives. Social enterprises report their impact data to show transparency and attract and retain donors and investors by proving that the capital or grants received are being used to carry out their social objectives.

The government of South Africa is considering developing a policy framework on the social economy and social enterprise. The implementation of this policy demands recognition criteria for entities delivering social value. An established instrument that measures the social impact of social enterprises is required in order for these entities to assess and report their social impact against set-standards and prove their social purpose. The SROI method converts social impact into a monetary value. This allows social enterprises to prove they are delivering on their social objectives and report on their return on investment. If social enterprises have the ability to prove and measure their actual social impact, in monetary terms, it is proposed that tax relief is granted in the equivalent of the impact which can be funded by government’s savings for services it no longer needs to supply.
CHAPTER 6

TAX INCENTIVES FOR SOCIAL ENTERPRISES AND PROPOSED CHANGES TO THE CURRENT TAX LEGISLATION

6.1 Introduction

This dissertation examined the current tax environment in which social enterprises operate. Research has shown that South Africa’s current policies are not conducive to the sector’s growth. Government has identified social economy in South Africa’s new growth path and has expressed their intention to develop a framework to encourage and directly promote social enterprise. Research suggests that social enterprise has the potential to solve society’s ills and that South Africa could benefit from increased government and public support for social enterprises (York 2011).

The final chapter of this dissertation includes a literature review on the design of effective tax incentives to use as a starting point for developing a tax framework for social enterprises. Using these guidelines, this chapter submits proposed tax incentives in order to assist Government with developing a policy framework on the social economy and social enterprise. Furthermore, the practical application of the tax incentives is discussed. The tax incentives are suggested without intending to propose express provisions to be incorporated into the tax legislation. This section has been prepared by building on the body of previous work on creating an enabling environment for social enterprises, notably by Impact Trust (2012) and Dr Susan Steinman (2010).

6.2 The design of tax incentives

A tax incentive is a deduction, exclusion, or exemption from a tax liability, offered by the fiscus as an enticement to engage in a specified activity for a certain period (WebFinance 2013). Tax incentives are often used by countries to attract investment in order to encourage economic activity to stimulate growth and development. Tax incentives typically utilized in Sub-Saharan
African economies include tax holidays, investment allowances, tax credits, reduced corporate taxes, VAT and duty exemptions, subsidies, special regulatory exemption and investment zones, and accelerated investment write-offs (Bolnick 2004).

Tax incentives reduce the growth of the tax base of a country as they decrease governmental revenues. It is therefore necessary, when designing a tax incentive policy, to consider what the goals of the incentive are, whether it is effective, what the cost-benefit associated with the incentive’s use is and how the effectiveness can be evaluated. A well-designed incentive should enhance revenue by stimulating investments that generate other taxable income linkage effects. Understanding the costs and benefits of tax incentives are critical in determining policies. This involves analysing the cost efficiency of the tax incentive and examining the effectiveness of the incentive in achieving its objectives and the impact on government revenue, tax administration, economic efficiency, social equity and the country’s economic growth. In designing a policy, the primary question should be whether the tax incentive stimulates the intended behaviour and whether the overall impact is beneficial or detrimental to the ultimate policy objectives (Bolnick 2004). An effective incentive is one that’s benefit to the economy from an increase in the incentive-favoured activities outweighs the total costs of the tax incentives granted (H Zee 2002).

A tax incentive should be designed to achieve the objective of the fiscus at minimum cost. Bolnick (2004) has identified four criteria for an effective tax incentive, namely:

1. Effectiveness in stimulating investment
2. Impact on revenue
3. Economic efficiency
4. Impact on tax administration.

In providing guidelines for the structure of incentives, research suggests that in states with severe revenue constraints, tax breaks should focus on activities that are likely to deliver a high return in terms of policy objectives and which would not be undertaken without special incentives. Zero tax rates should be avoided as a minimum tax rate can ensure that every company contributes at least minimally to the cost of basic public services (Bolnick 2004).

Research on the effectiveness of tax incentives found that:
• companies benefiting from tax incentives generate more employment opportunities than those in highly taxed regions;
• tax incentives promote economic growth; and
• tax incentives improve living standards and per capita income and expand the variety of goods available to consumers (A. U. Akpan 2012).

6.3 Tax incentives in the context of social enterprise in South Africa

The South African government is considering the development of a policy framework on the social economy and social enterprise (Fonteneau 2011). Minister Pravin Gordhan has stated that South Africa’s new growth path will be led by the social economy and that specific measures would be taken to encourage and directly promote social entrepreneurs and the building of social enterprises (Moss 2012). However, at present, there is no policy in place which is designed to address social enterprises which deliver a social impact in South Africa. While some countries, such as the UK, have been proactive in drafting favourable legislation, South Africa is lagging behind in providing fiscal support through legislative framework on organisational forms and taxation. Currently social enterprises may be taxed at the same rate as normal business, which could ultimately hinder their sustainability as research suggests that tax incentives are an important element in creating an enabling regulatory environment for social enterprises.

A tax incentive has an opportunity cost as it is foregone revenue. This cost may be easy to bear if the revenue loss is small. In South Africa, large companies with taxable earnings in excess of R200 million accounted for 50% of fiscal income in 2012. Companies with taxable income greater than R100 million (0.1% of total number of companies) contributed 57.5% of fiscal income (2012 Tax statistics). It is calculated that revenue from SMEs accounted for approximately 1% of fiscal income. There is currently no data on social enterprise’s contribution to total fiscal income however, from these figures it appears that their contribution is insignificant in the context of total fiscal income and the loss in revenue due to any proposed tax incentives on social enterprises would have little effect on fiscal revenue. Instead, the potential benefit in savings on government spending would far outweigh this loss. If social enterprises are contributing insignificant amounts to government revenue collection then incentives or tax breaks based on revenues or profits could assist the growth of these entities while having
negligible effects for government. On the contrary, the success of social enterprises and growth in the sector could contribute to a reduction in government expenditure. To encourage the establishment of social enterprises and in recognition of the social benefit nature of the legal form, these companies should be granted tax relief which provides an incentive for entrepreneurs to start-up social enterprises.

6.4 Proposed changes to incentivise social enterprises and the implementation thereof

Social enterprises not adopting a traditional non-profit model are excluded from the tax relief enjoyed by conventional charities even though they also provide social value. A hybrid structure may be adopted by a social enterprise in order to operate with minimum tax leakage. However, this structure may not be ideal as the structure is costly due to number of entities needing to be registered. This dissertation submits that a tax framework be developed to recognise social enterprises, as a single entity, for their contribution to society with tax incentives designed to reward these entities for their positive social impact. This is a trend in countries where tax incentives for social enterprise have been implemented, for example, Poland has introduced a tax relief as compensation for the loss of productivity as a result of the choice of hiring less productive individuals who are in a re-integration process inside the enterprise. Tax relief offered in Belgium includes a reduced VAT rate of 6% for some social economy initiatives and a tax exemption up to certain limits for integration enterprises (Linklaters 2006).

It is submitted that Government’s use tax incentives to encourage activities that are in line with their priority areas and strategic growth objectives. The objectives identified in the Medium Term Strategic Framework (2009) could be used as a basis to incentivise activities that allow for:

- more inclusive economic growth, decent work and sustainable livelihoods
- economic and social infrastructure
- rural development, food security and land reform
- cohesive and sustainable communities
- creation of a better Africa and a better world
- sustainable resource management and use.
In this way social enterprises are rewarded for their social impact, incentivising the creation of social enterprises which will ultimately assist Government in addressing South Africa’s social issues.

6.4.1 Recognise social enterprise in legislation

The European Commission has stated that the establishment of clear legal definitions should be a priority (OECD/ European Commission 2013). Social enterprise as a legal form is currently not recognised in South African legislation. The first step towards creating tax policies around social enterprise would be recognising social enterprises for legal and regulatory purposes in order to create a distinctive social enterprise tax relief. The Social Business initiative was adopted by the European Commission with the aim of creating an eco-system conducive to developing social businesses and to facilitating access to funding. This initiative recognised the establishment of clear legal definitions of social enterprises as a priority in order to govern issues such as their tax treatment, access to markets and access to public business development support (OECD/ European Commission 2013). Steinman (2010) found that one of the greatest obstacles for social enterprises in achieving financial sustainability was there being no definition in South African legislation. For the purposes of Steinman’s (2010) research the definition adopted was ‘a social enterprise’s primary objective is to ameliorate social problems through a financially sustainable business model, where surpluses (if any) are principally reinvested for that purpose.’ Similarly, Impact Trust (2012) proposed that ‘Social Businesses’ be defined as any business endeavour which is a for-profit company, but whose sole or principal activities are PBAs as defined in the Ninth Schedule to the Income Tax Act. In order to develop a framework to incentivise these organisations, a definition must first be accepted into legislation.

Separate legal entities for social businesses have been established in the UK and the USA. In developing a definition for social enterprise to be incorporated into South African legislation, the characteristics of the CICs and L3Cs should be considered. The criteria for qualifying social enterprises may include a dividend cap, similar to that of the CIC, in order to encourage the investment in social enterprises whilst ensuring that the principle assets and profits of the social enterprise remain devoted to the social purpose.

6.4.2 Make existing tax relief available to social enterprises
The development of a legal framework for social enterprise requires an evaluation of whether new legislation is needed or the adaptation of the existing framework is a better solution. At the 2009 International Labour Organisation (ILO) conference for social enterprise, a revised legal and regulatory framework for social businesses was called for and proposals were submitted to assist with making South African policies consistent with international efforts to encourage investment into social businesses. These proposals included new legislation for social businesses and amendments to the Non-profit organisations Act, the Companies Act and the Income Tax Act for social businesses. In order for legislation to accommodate social enterprises, Steinman (2010) proposed that:

- in the short-term, existing company and non-profit entity legislation be amended to include the concept of social enterprises.
- in the medium and long term, dedicated legislation for social enterprises, similar to the CICs of the UK and the L3Cs of the USA.

Steinman discouraged the amendment and alignment of existing legislation pertaining to models used by non-profit organisations to accommodate social enterprises as this could change the essence of such organisations.

Research conducted by Impact Trust (2012) found that one of the key findings from analysing international efforts around social enterprises was that existing taxation frameworks and incentives should be refined rather than creating new ones. Further research suggests that existing policy vehicles which currently benefit SMEs provide a good base from which social enterprise tax relief can be created (Worthstone 2013).

It is proposed that the eligibility criteria for SBCs be adapted in order for qualifying social enterprises to benefit from similar income tax relief initiatives which support small business. In this way, social enterprises would enjoy preferential tax rates, suggested by Impact Trust (2012), in the form of a progressive rate tax system and accelerated depreciation as well as capital gains tax relief for small business.

6.4.3 Amending current legislation on PBO trading
Legislation governing PBO’s allows a partial tax exemption on trading activities as discussed in section 4.3.2 of this dissertation. This policy discourages social enterprises from trading, especially in competition with for-profit companies. It is therefore recommended that relief be given to PBOs by increasing the cap of 5% or R150,000 on trading activities. This incentive should encourage PBOs to increase trading which may assist in their sustainability.

Impact Trust (2012) has proposed that PBOs with a qualifying taxable turnover not exceeding R35 million (i.e. excluding tax exemption in accordance with section 10(1)(cN) of the Act) receive tax relief in the form of reduced tax rates in accordance with those proposed for the SBC regime.

6.4.4 Tax exemption on grants and donations

Government grants are subject to tax when paid to a qualifying. Impact Trust (2012) recommended that grants made to qualifying social enterprises and utilised for carrying out their social mission be tax exempt. This incentive would allow social enterprises to maximise the use of these grants to achieve their social objectives, increasing their social impact.

Consideration should be given to donations to PBOs by qualifying social enterprises. It is proposed that the current restriction of 10% of taxable income be increased in order to encourage public donations.

Furthermore, a tax deduction is granted for donations strictly to registered PBOs. CSR spend is therefore usually directed at registered PBOs in order for the company to receive a tax benefit. This may prejudice social enterprises that do not have PBO status. It is proposed that the tax benefit be extended to allow for donations made to qualifying social enterprises to be deductible from a donor’s taxable income.

6.4.5 Tax incentive for investing in social enterprise

The UK government has identified that the tax system is a key part in creating the best environment with in which social enterprise can operate. Legislation has been drafted to incentivise investment in social enterprise by providing income and capital gains tax relief (2013). The Social Investment Tax Relief (SITR) allows for a deduction from income tax
liability for qualifying investments. The intention of the incentive is to encourage investment in social enterprise.

In line with international efforts to stimulate investment in social enterprise, it is proposed that a similar tax incentive to that of the SITR be introduced into South African legislation.

6.4.6 Tax incentive for creating employment opportunities

A new youth employment tax incentive was introduced into South African legislation in order to encourage private employers to employ young workers with government sharing the costs of such employment for a maximum of two years under certain conditions. The intention of the incentive is to assist young people to enter the labour market allowing them to gain valuable experience and access career opportunities. The tax relief takes the form of a decrease in pay-as-you-earn (PAYE) tax for every qualifying employee that is hired by the employer making it more attractive for firms to increase employment. It applies to employers taking on people under the age of 29, earning less than the income tax threshold of approximately R60,000 a year. The incentive only applies to new hires and is equal to 50% of the wage in the first year and 20% of the wage in the second (SARS 2013).

Impact Trust (2012) recommended that a tax credit be introduced for SMEs that are growing and create additional full-time employment opportunities either through a percentage-based award or flat rebate. Impact Trust proposed that the incentive recognises the additional intangible cost of compliance with labour regulations and provides tax relief to offset both the risks and costs associated with growing a permanent workforce. They suggested that the tax credit be administered by SARS and calculated on the average number of full-time employees per year, monitored and evidenced by registered PAYE employees in the qualifying company.

Research suggests that social enterprises create employment amongst traditionally under-represented groups.\(^\text{17}\) It is submitted that tax relief be granted to social enterprises, similar to that of the youth employment tax incentive.

\(^{17}\) The State of Social Enterprise Survey in the UK (2013) found that 38% of social enterprise leaders are women, 15% of social enterprise leaders are from Black, Asian and Minority Ethnic (BAME), 28% of social enterprise leadership teams have BAME directors. 52% of social enterprises actively employed people who are disadvantaged in the labour market (for example: long-term unemployed, ex-offenders, disabled people).
6.4.6 Application of the proposed tax incentives

As a development tool, tax incentives score poorly in terms of transparency and accountability however research suggests that the enticement to misuse tax incentives can be mitigated by imposing low basic tax rates, simplifying the policy for easier administration, strengthening tax investigation and audit and enforcing appropriate tax penalties (Schwartz 2012).

If a distinctive policy framework for social enterprise is developed, definitional issues will be important (Worthstone 2013). Social enterprise may be subject to a guarantee and test of social purpose (Fonteneau 2011) and a system would need to be implemented whereby social enterprises measure and report their social impact against set-standards in order to qualify for the tax incentive. In order to identify qualifying social enterprises within the scope of the proposed tax incentive, a standard measuring tool should be utilized and rigorous reporting obligations used, possibly based on the Charities Trustees Annual Report as a model. Comprehensive reporting requirements on the social impact would ensure that the core mission of the organisation is maintained and the potential for exploitation managed.

In terms of administration, Steinman (2010) proposed that the government consider a focal point in the Office of the Presidency to assist with the streamlining of social enterprises and with the development of the entities, similar to that of the Office for the Third Sector in the Office of the Prime Minister in the UK, or to the Office for Social Innovation in the White House.

Impact Trust (2012) proposed that the Tax Exemption Unit (TEU) be extended to include the regulating of social enterprises. The TEU is a special dedicated office established to assist in the prevention of malpractice or abuse related to tax exemptions. The TEU administers applications for exemptions and applications for section 18A status. It undertakes the review and annual assessment of exempt organisations. It is proposed that the application and process for recognition of a social enterprise be identical to that of a PBO. The TEU would identify qualifying social enterprises that meet the requirements of the Ninth Schedule.

The implementation of tax incentives for social enterprises may involve complexities however these should not be insurmountable (Schwartz 2012). A policy framework that supports social
enterprise should not be too onerous in its requirements and should be designed to create an enabling environment for social enterprises, allowing them to meet their social and economic goals and assist in the sustainability and growth of these entities.

6.4.7 Alternative proposal: social value tax credits

Social enterprises have been identified for their ability to improve the quality of public services, generate innovations and have a positive impact on social issues among the population. Social enterprises that achieve this and are able to demonstrate their impact should be rewarded by a tax incentive that compensates them for their measured impact. If social enterprises contribute to services that government would traditionally be providing then government savings on such services would be supplemented by the impact of the social enterprise. It is proposed that a tax incentive to reward the social value created by a social enterprise be considered which would be indirectly funded by government’s savings on these public services.

A proposal to introduce specific legislation in the UK was made by Schwartz (2012) whereby a social enterprise’s social impact is measured and the financial equivalent of this impact be awarded as a tax credit which can be deducted from the taxable profits of the business. It was proposed that the tax credit be based on a formula calculated as:

Taxable Profits = Profits Before Tax – Financial Equivalent of Social Value Created

Schwartz’s (2012) proposed tax credit is based on the Research & Development Tax Credit Claim in UK tax legislation whereby organisations exchange their calculated Social Value Tax Credit to the Government in exchange for a deduction in their PAYE and National Insurance liabilities for the period. It is proposed that the Social Value Tax Credit (“SVTC”) follow a similar principle by providing financial support to social enterprises to encourage and support them with creating further social value in the future. The tax refund would be calculated as:

Tax Refund Due = SVTC % Rate x (Social Value Created – Profits Before Tax)

(In practice, the actual formula would involve more complexities and have built in safeguards and restrictions in order to prevent misuse and abuse).
In this way, social enterprises and the positive social outcomes they generate are encouraged rather than social investment and Government is able to target the intended beneficiaries of any programme by incentivising the creation of social enterprises directly. Government could structure the tax incentive to target intended beneficiaries of any programme by incentivising the creation of social enterprises directly and rewarding the desired social impact itself. Government would identify those outcomes it seeks to support and the tax incentives could reflect anticipated savings in public services budgets proportionate to the outcome achieved (Schwartz 2012).

6.4.8 Other measures required to create an enabling environment for social enterprises

The Social Value Act, introduced into the UK legislation in 2013, requires public bodies to consider choosing providers based on the social value created in an area and not on cost alone. The intention of the Act is to “create maximum benefit for the community and drive up service quality, but it can also lead to cross-departmental savings and support community organisations to enter the market” and increase the role of social enterprises in delivering public services (Social Enterprise UK 2012). The introduction of this Act is further evidence of the UK government’s support of the social sector.

In South Africa, Preferential Procurement Policy Framework Act, Act 5 of 2000 provides for the implementation of a policy and system where tenders are awarded on a prescribed point system with preference given to Historical Disadvantaged Individuals (HDIs) who are South African citizens. It is submitted that the Preferential Procurement Act be amended to include social enterprises.

18 Historical Disadvantaged Individuals (HDIs) South African citizens are those:

- Who had no voting rights in the national elections prior to the introduction of the 1983 Constitution or the 1994 "Interim Constitution"(i.e. people of colour)
- Who is a female (any race)
- Who has a disability
6.4.9 Potential benefits of tax incentives for social enterprises

Research suggests that the benefits of social enterprises are increased when they are adequately supported by public policies. One study demonstrated that the public money spent to support job creation or the provision of goods and services by social enterprises represented a more efficient way of utilising resources than alternative methods. Furthermore, the study estimated the direct savings from reduced social benefits and direct spending and future revenues generated by social enterprises through taxes and found that the support of social entrepreneurs was a cost-effective policy and one that traditional market channels failed to address (OECD/ European Commission 2013).

Governments have found that providing tax credits can stimulate economic and employment growth through encouraging investment in certain business sectors, such as film, green, new technology and manufacturing (LePage 2012). Furthermore, research suggests that reduced tax rates could increase after tax earnings, lower the cost of equity funding, increase equity investment and reduce tax distortion in favour of debt (Ramusetheli 2011).

A tax framework which stimulates social enterprise will allow the organisations to maximise the use of their financial resources for their social purpose. Tax incentives could be utilized to improve performance of social enterprises especially in their most vulnerable phase, the tax relief could offer them assistance, enabling them to establish. Tax relief granted to social enterprises would allow them a better chance to be successful in carrying out their social purpose which in turn would result in more government savings.

Growth in the social sector would result in increased employment in South Africa and contribute to the economy. Furthermore, it would decrease government’s social and environmental spend as the number of people become less reliant on government assistance. Unlike traditional non-profit companies, the social enterprises themselves would require less financial public funding to deliver their social and environmental impact. This government saving could then be reallocated to traditional welfare and social assistance organisations focus that require funding the most.

Incentivising social enterprises may attract new sources of funding through investments in social enterprise. If tax incentives were developed that encouraged the investment in enterprises that delivered reported identifiable social impact, capital markets would potentially favour social
businesses allowing them to successfully achieve their social purpose in a sustainable way through less need of public funding (Schwartz 2012).

6.5 Conclusion

Government is considering developing a policy framework on the social economy and social enterprise. It is proposed that tax incentives for social enterprises be considered in order to provide a more enabling tax environment for these entities. Research suggests that working with social enterprises and promoting their development can result in short and long-term gains for public budgets through reduced public expenditures and increased tax revenues compared with other methods of addressing social needs. It is crucial that policies be implemented that support social enterprises not only at start-up stage but also beyond in order for these entities to fulfil their potential. Policies should focus on promoting social entrepreneurship, building enabling legal, regulatory and fiscal frameworks, providing sustainable finance, offering business development services and support structures, supporting access to markets and supporting further research into the sector.

It is proposed that tax incentives be utilised in order to support the growth of social enterprises. In order to ensure the cost-effectiveness of the tax incentives, revenues foregone must exceed the direct and indirect benefits from the related investment. Therefore tax incentives granted to social enterprise must result in a measurable social impact from the social enterprise. Creating an enabling environment for social enterprises is critical if they are to fulfil their potential in addressing society’s issues, such as job creation, but also contributing to wider social and economic needs, and to promoting more cohesive and inclusive societies. Tax incentives to be considered have been suggested in this chapter and these suggestions have been made with reference to literature on the design of a successful tax incentive.
CHAPTER 7

CONCLUDING REMARKS

This dissertation had two main objectives regarding social enterprises operating in South Africa.

Firstly, it sought to analyse the current income tax consequences of social enterprise and assess whether the current tax legislation supports their growth and sustainability. Before any analysis could be carried out, the definition of a social enterprise was required. A number of definitions of a social enterprise were discussed in Chapter 2. Each definition highlighted the unique characteristics of a social enterprise, namely:

- its primary objective is for social purpose;
- it uses a financially sustainable business model with a significant proportion of its income being earned rather than relying on grants and donations;
- it is accountable to its stakeholders and is able to measure and demonstrate its social impact (Fonteneau 2011).

The chapter continued with an analysis of the various legal forms that a social enterprise can adopt in terms of the Companies Act. Finally, the chapter provided reasons for why social enterprises should be supported by Government. Research indicates that these entities are making a measurable positive impact on society and are able to assist Government in achieving its goals which include halving unemployment and alleviating poverty.

Social enterprises are currently not recognised in South African legislation and must select any one of the legal forms discussed in Chapter 2. Chapter 3 identifies the hybrid model as the most favourable vehicle for a social enterprise to carry out their social objectives. This model allows a social enterprise to pursue a social mission while engaging in commercial activities in order to generate revenue to sustain its operations. Generally, this involves separating the two objectives into a non-profit company and for-profit company. In selecting a hybrid model however the social enterprise may forego the tax exemptions offered if it were to operate as a traditional non-profit company only. Chapter 3 explored the reasons why a social enterprise may be willing to
sacrifice any tax relief. This led to a discussion in Chapter 4 on what the current tax implications of operating a hybrid structure are.

The case study on the UnEarth Group, a group of companies adopting a hybrid structure, was introduced. The UnEarth Group has both social and profit making objectives. Its social mission includes conservation, land reform, job creation and empowerment whilst striving for profitability in order to carry out these social goals and ensure sustainability. The case study was used to demonstrate the different cash flows of the social enterprise operating a hybrid model. An analysis was then performed on the various tax consequences on the cash flows of the structure. On review of the tax implications, it was established that the current tax legislation does not currently support the growth of social enterprises and amendments to the legislation are recommended in order to allow these entities to flourish.

Chapter 4 continued with an analysis of the policies introduced in other countries which have embraced the social sector. The UK and the USA have both recognised social enterprise in their legislation. Furthermore, the UK has acknowledged social enterprise's key role in driving the UK economy and its ability to deliver sustainable solutions to society’s growing issues. Consequently, the UK has implemented a number of initiatives focusing on growing the social sector including a tax incentive for investing in social enterprise. Chapter 4 concluded that the current tax environment is not conducive for the growth of social enterprises. On comparison with other countries, South Africa is lagging in supporting these entities. This led to the second objective of this dissertation which was to propose tax incentives to be used to encourage growth and development in social enterprises, creating a more enabling environment in which the social enterprise may operate.

In designing a tax framework for social enterprises, it was established that qualifying entities needed to measure and report their social impact. Chapter 5 explored whether social impact could be measured and translated into monetary terms. This was found to be possible using the SROI tool which translates social benefits created by a social enterprise into a monetary value. The SROI method allows a social enterprise to report its total benefit return compared with its total investment. Once it was established that social impact could be measured, Chapter 6 explored the concept of incentivising social enterprises.
Finally, using the policies implemented by the UK and the USA as a foundation combined with consideration given to guidelines on designing a successful tax incentive, Chapter 6 proposed amendments to the tax legislation. The proposals drew from other research carried out, notably by Impact Trust (2012) and Dr Susan Steinman (2010) in order to make recommendations for creating a more enabling environment for social enterprises.

The social economy in South Africa is currently in its pre-policy stage and plans toward creating specific legislation for social enterprise have been implemented (Moss 2012). Social enterprise has the ability to assist government in addressing society’s problems while at the same time reducing government spending and contributing to the economy (Worthstone 2013). Government has recognised that the social economy is a key contributor in empowering women, black South Africans, workers, the rural population and young people (Gordhan 2012). However, research suggests that the social economy will have little impact if steps are not taken to define social enterprise and policies are not developed to support these entities. The concept of social enterprise will then remain a theoretical approach rather than reaching its potential of delivering meaningful social value (Moss 2012). The development of tax incentives is one way in which government can directly and effectively support social enterprise. The design of effective tax incentives for social enterprises would support growth in the social sector by acting as a catalyst in attracting additional sources of funding through investment in social enterprise, encouraging innovation and ensuring the effective delivery of social impact. The policy environment in respect of social enterprise in South African has yet to reach a maturation level that best serves the growing number of social enterprises for their sustainability and to further their social mission. The late Greg Dees, a pioneer in social entrepreneurship recognised that social enterprise needs to be supported with a more efficient and robust infrastructure, appropriate public policy, and a change in the culture of the social sector (Dees, Taking Social Entrepreneurship Seriously 2007). Creating an enabling environment for social enterprises in South Africa requires commitment, on a political level, to bring about the changes needed on the legislative and regulatory level (Steinman 2010).

In the current economic climate, South Africa faces the challenges of high unemployment, poverty and inequality. Government is unable to meet society’s demands and is yet to achieve its goals of eliminating poverty and reducing inequality. The non-profit sector is proving to be
unsustainable with many organisations facing closure in an environment of decreasing funding and increasing competition. Social enterprise is a sustainable business model that provides social impact may be the solution. Government has the potential to support social enterprise by developing a policy framework which incentivises growth in the sector. This dissertation submits that Government should take action to address their lack of support in the current tax regime and create a more enabling environment for social enterprise to operate.
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