

**A proposal for simplifying the legal form and
regulation of small for-profit businesses and not-
for-profit entities**

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1 Overview

Small for-profit (FP) and not-for-profit (NFP)¹ organisations use a number of legal forms available for their formal entity status under both state and federal law – including unincorporated associations, incorporated associations, corporations, companies limited by guarantee, trusts, joint venture companies, and partnerships.

The legal form chosen may be determined by law; by the members themselves; by historical circumstances; by the type of activity being undertaken; by needing to hold a license or permit; by the need to access tax concessions; or, by a perceived need to remain in or out of state/federal jurisdictions.²

The limited liability company structure has much to recommend it for many small FP and NFP organisations. It also has much to recommend it to governments for ease of regulation and public administration.

The problem is that *Corporations Act* (the Act) is an impediment to small entity incorporation.

The Act has evolved to deal primarily with the needs and problems encountered by larger, public and for-profit companies, where protection of the equity investment of shareholders is paramount.

The Act has quite onerous obligations and is of a length and complexity that makes incorporation under the Act inappropriate for smaller for-profit and not-for-profit organisations, even where they have felt obliged to incorporate.

Smaller organisations are often closely held, where shareholders and management are the same set of natural people who manage and protect their own funds. So, unlike larger companies, they have little need for many laws that protect equity investors.

Unlike small FPs, small NFPs may not be closely held, for instance having hundreds of members in a local club. While FPs do share the profit motive of larger companies, and equity does matter to them, by definition it matters much less to NFPs, who have little need for laws to protect equity investment. Where NFP ‘shareholders’ exist, they are shareholders

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- 1 The NFP sector comprises a very wide range of organisations, ranging from giant multi-nationals to small local bodies. There are for example: non-government, community, voluntary, club, society, association, co-operative, friendly society, church, union, foundation, charity and other entities, some set up under specific sectoral legislation.
 - 2 For instance the Workplace Relations Act uses the Corporations power to ‘cover the field’, but unincorporated associations under state law are generally not subject to it.

in a nominal sense only as the equity (including any profits) in each entity, is entirely for the organisation's beneficiaries.

There is also not the same need for small FPs and NFPs to have the advanced integrity, record-keeping, accounting and reporting measures that larger organisations require.

The case for a combined small FP/small NFP system is unambiguous. A single approach is sensible for both small FPs and NFPs, because both need a simple, flexible framework, uncluttered by the protections afforded to equity investors in companies legislation, with a regulator that is focused on facilitation (not least through the innovative use of technology).

2 Proposal

This discussion paper proposes that the federal government examine the potential for introducing a simpler form of the Act to apply to small FP and NFP entities.

The suggestion in this paper is that there is merit in the establishment of the following:

- A new legal entity to facilitate both small business and NFP activities – the Incorporated Organisation (IO).
- A specific category of IO for charities and related organisations – the Charitable Incorporated Organisation (CIO). (The identical term is now used in the UK following the introduction of their *Charities Act 2006*).
- Two new pieces of legislation – an Incorporated Organisations Act and a Charities Act. To be eligible for favourable taxation status and to use terms such as 'charity', organisations would be required to be registered under the Charities Act and to have a corporate form as either a company or an IO.
- A new federal regulator – The Registrar of Incorporated Organisations which would have as its primary mandate the facilitation of small business and charitable services, and which would regulate both these Acts.

3 The case for change

The extent of small business – a very significant sector

According to the Council of Small Business of Australia Ltd there are more than 1.88 million small businesses in Australia employing 3.6 million people and with a total capitalised worth of \$4.3 trillion, four times that of the Australian Securities Exchange (ASX).

There are over 1.6 million companies in Australia³, the vast majority of which are proprietary companies set up for small business or similar purposes. The number of companies registered by the Australian Securities and Investments Commission (ASIC) grows by approximately 10% per year.

For a huge number of small businesses, company law is full of irrelevant requirements and provisions.

The federal government is making a concerted effort to eliminate red tape and reduce bureaucracy, but in corporate administration this has been approached from the standpoint of a single framework: the *Corporations Act* administered by a securities regulator, ASIC. The result is that the legislation tries to be all things to all people – trying to regulate, on the one hand, international hedge funds, markets and corporate conglomerates and, on the other, the family company running the corner shop.

Small businesses would benefit from a system of incorporation that does not bring with it all the legislative and regulatory baggage that comes with the Act. A rationalised simpler system that retains key principles of the Act without excess regulation would be more appropriate for small companies.

A regulator focused primarily on facilitation would be good news for small business and the economy, and would free up ASIC to concentrate where its attention should be: the large securities and large markets regulation that underpins Australia's financial and economic health, and that underpins Australia's reputation as an international financial services centre.

The NFP sector – diverse and complex

Senator Andrew Murray's July 2006 discussion paper 'The Case for Introducing a New Regulatory System for the Not for Profit Sector' sets out three key justifications for "introducing a coherent national independent regulatory system for NFPs," namely:

- *Heavy public investment in NFPs through direct government expenditures and through tax expenditures requires compliance with advanced integrity, reporting, and accountability standards;*
- *NFPs play a large part in the provision of government services, the private provision of public services, and the representation of public and community interest groups, so requiring regulation to ensure the safeguarding of the public interest; and*
- *Modern governance recognises that economic or social sectors of a size such as the NFPs need to fall into an overall coherent framework of regulation that meets public expectations and standards, and matches the standard of regulation applying in other sizeable sectors.⁴*

The challenge with this very large, diverse and complex sector is that it comprises a multitude of often small organisations, projects and activities, with some of them run on a very amateurish basis.

A solution is needed that provides a simple but uniform framework which can be augmented on a case-by-case basis to deal with larger or more significant undertakings. Traditional company structures are too complex, too inflexible and too focused on equity investment protection to provide that framework.

A special case for charities – attitudes and accountability

Charities are a category of NFP organisations that require special attention. They receive contributions from donors and – directly and indirectly – from governments, so justifying additional accountability and transparency. Unlike many overseas jurisdictions comparable

4 One regulator One System One Law: The Case For Introducing a New Regulatory System for the Not for Profit Sector: Senator Andrew Murray July 2006 p4.

to Australia, we do not have legislation in place that ensures charities meet a public benefit test, and that promotes public trust and confidence in charity conduct and administration.

One of the consequences of more tailored legislation leading to better regulation may be increased donations to the charity sector. Australia's wealth has grown substantially, yet donations to charity are still less than they could be, according to the recently released report 'Good times and Philanthropy'.⁵

Complicated taxation arrangements and difficulty with data make it difficult to judge just how generous or not Australians have been, but the report's authors mined what tax data they could to come up with the dismaying statistic that four in 10 of the wealthiest Australians do not appear to give away anything at all.

When wealthier Australians do give to charity, the rates are apparently far below their counterparts in the US, Canada and Great Britain. The report acknowledges that Australia's affluent are giving more than they did a decade ago, but it must be recognised that their level of personal wealth has accelerated at a much faster rate over that period.

Could a better regulatory system make donations more likely? Although the robustness and durability of Australian society, and the financial system, depend on social policies (inclusiveness, caring, compassion) as well as economic ones, intuitively it does seem that a dependable well-regulated charity framework would assist if Australia is to expand its culture of giving.

In addition, as outlined in Senator Murray's July 2006 paper, charities rely on donors believing donations are used for proper purposes, so the case for accountability and transparency is more acute than for other NFPs.

4 Proposed features of an Incorporated Organisation (IO)

Herewith is one set of outlines that could work effectively.

Purpose – simplification

The basic purpose of an IO would be to provide a simplified corporate form for both small business and small NFP organisations. The IO structure would be available so long as a business was being carried on. The advantage of limited liability would be available other than in situations of gross abuse.

Concept – separate legal entity

An IO would be a body that had its own legal personality and perpetual succession. It would have the capacity and powers of a natural person of full capacity. Its name would end with the abbreviation 'IO' and it would be assigned an ABN number.

If the FP and NFP organisation have internet connection (most would, but some small FPs and NFPs might not) interaction with the Registrar would be chiefly through online

5 The Age, 15 March 2008.

interaction, using systems designed to facilitate small FP and NFP business activity. The cost of registration and other interaction with the Registrar would be minimal or zero.

Membership – perhaps 10 natural persons, but what about NFPs?

An IO could have members, not shareholders, if they wished. Membership would be restricted to natural persons. A company could not be a member of an IO.

Should members be able to have the option of having a percentage interest in the IO, not shares?

- ***Maximum number for FP IOs:*** Close corporations have been limited in other foreign jurisdictions to 4 members or less. It would seem sufficient to set the maximum number of members of an FP IO at 10, but the government may wish to consider whether the number should coincide with numbers of members used or to be used for other small business laws, such as on tax.
- ***Maximum number for NFP IOs:*** NFP IOs would probably have to distinguish between types of member – say a maximum of 10 managing members and an unlimited number of non-managing members. Each member of an NFP IO should still have an equal (voting) interest.

The Registrar would provide an online facility for IOs to manage their register of members. Membership would take effect once recorded on the online register. The register would be publicly available. NFP IO non-managing members would not be recorded.

Fiduciary duties – members more like directors than shareholders

Each member would stand in a fiduciary relationship to the IO. The IO Act would specifically include certain duties for members of an IO, for example that members must avoid material conflicts of interest, must notify other members of interests in contracts, and must not compete in any way with the IO in business activities, or take commercial advantage from an IO. Members therefore would be in a very different position from that of shareholders in relation to a company. Members of an IO are in a similar position in relation to the IO as directors are to a company.

Size – unlimited turnover, assets etc

While there would be a limit to the number of members of an IO to 10, there would be no restriction on turnover, value of assets, number of employees and so forth. The IO could not outgrow its legal form (for so long as it did not require outside equity investment).

Formation of an IO – online registration of charter

The formation of an IO would be very simple. Incorporation would merely require the online registration of a Charter, containing key information (such as IO name, principal business, address, contact details). Registration would be subject to presentation of relevant member identification documents for AML/CTF purposes.

The Charter would be a ‘living’ (i.e. periodically updated by the IO) public document, publicly available on the Registrar’s website. The existence on the Registrar’s website of the

Charter would be conclusive evidence of incorporation. While there would be no annual return, IOs would have to annually confirm online that the Charter information and register of members was up-to-date.

No one (aside from the members) would be deemed to have knowledge of any information included in the Charter.

Internal management – optional member agreements

The management of an IO where there is more than one member would be based on partnership concepts. Although it would not be a requirement, the members could agree with each other on the management, control, or any other internal matter of the IO. These internal Member Agreements would not be public, but they would take effect only after they had been uploaded onto a confidential part of the Registrar's website, accessible only by the Registrar and the IO's members.

For ease of usage, the registrar could construct pro-forma agreements, for members to use if they wish.

The day-to-day running of NFP IOs would be delegated to managing members. A court, on application, would have very wide powers to regulate relations between members.

Acquisition of interest – by agreement for FPs only

- ***For FP IOs:*** The following persons would be able to acquire the interest of an existing member: other members, outsiders and the IO itself. The consent of existing members (by Member Agreement) would be necessary before outsiders and the IO itself could acquire the interest.
- ***For NFP IOs:*** Member interests cannot be acquired.

Member contributions – flexible

If a person acquires an interest from an existing member, no contribution would be made to the IO.

If a member acquires a new interest in an IO on incorporation, or from the IO after incorporation, the member would need to make a contribution to the IO – of corporeal or incorporeal property, or services. Such contribution would not necessarily determine the size of the member's interest in the IO.

There are no rules for the maintenance of members' contributions as is the case with the maintenance of a company's share capital.

Financial assistance to purchase interest – permitted

The IO would be able to provide financial assistance for the purchase of a member's interest provided certain formalities were complied with.

Disposal of interest

- ***For FP IOs:*** A member's interest could be disposed in any of the following ways: by the member, under enduring power of attorney, by a court, by the trustee of an insolvent estate or by the executor of a deceased member's estate. Provisions would exist which effectively gave remaining members' first option of acquiring a member's interest prior to its disposal in certain circumstances.
- ***For NFP IOs:*** Member interests cannot be disposed and cease to exist on the member's resignation, permanent incapacity or death.

Payments to members

- ***For FP IOs:*** Unlike for companies, there would be no complex rules regulating what amounts may be distributed to members of a FP IO. Members would be able to receive a payment (similar to a company dividend or a partnership profit share), if after the payment the IO is solvent and able to meet its debts when they fall due. If not, members (and in some instances former members) would be liable to repay the IO the amount received. Payments to members include the repayment by the corporation of members' contributions and the payment of any salary.
- ***For NFP IOs:*** Payments in any form to members would be prohibited, other than normal reimbursement for incidental costs incurred, or for services rendered on normal arms-length terms.

Accounting

An IO would be obliged to keep accounting records and to prepare annual accounts. The accounts would be able to be structured to suit the circumstances of the IO.

Application of the existing set of accounting standards is far too onerous for many small FPs and small NFPs. The choice for government to make is either for the development of very simplified IO sectoral accounting standards by the Australian Accounting Standards Board (AASB), or to determine that IO accounts do not necessarily need to be prepared in accordance with accounting standards or on an accrual accounting basis.

NFP accounts would be lodged confidentially online with the Registrar, in the same form as with the tax office.

Audit

Audit is costly and onerous for small NFPs in particular, and it is questionable whether it serves much purpose in many small FPs.

Audit should perhaps not be required for IOs except for specified entities, such as charities. Charities over a certain income would be required to have an auditor. Charities with annual revenues or assets above a reasonably high amount would have to have accounts prepared in accordance with normal accounting standards.

Charities with under \$1 million (\$5 million?) in annual revenue and year-end net assets would be able to opt for a limited scope review (instead of an audit) by a registered company auditor. The review would confirm that the annual accounts fairly present the affairs of the IO and that adequate controls exist over key systems (eg receipt of donations and their application for charitable purposes).

Alternatively, FPs and non-charity NFPs could still be required to be audited but less frequently - i.e. triennially not annually, and otherwise only on dissolution or sale.

No auditor need be appointed if an IO has an accounting officer (a member or employee with professional accounting qualifications). The accounting officer would have to certify that the annual accounts fairly present the affairs of the IO.

Members would still be able to require annual audit if they wished, and could agree to appoint an auditor.

Personal liability – triggered by serious abuse

Incorporation and limited liability is conferred by the state, and beneficiaries owe a duty to the state for the advantages that flow from reducing their exposure.

The proposal is that IO members, and in some cases former members, be personally liable⁶ for the debts of the IO if they wilfully or recklessly abuse or ignore significant laws. This should extend to abuse not only of the proposed IO Act, but also of significant laws for employee relations, consumer and environmental protection and so forth.

However a practical business judgement rule would apply for FPs and NFPs so that IO members would be protected from vexatious claims. This would guarantee the attractiveness of the IO corporate form was not lost because of unreasonable fears as to potential liability.

Even so, to avoid costly interpretation through courts, a fast and cheap disputation system would need to be developed.

NFP IO non-managing members would attract no personal liability unless they purported to act as managing members.

Winding up like companies

The Registrar would have wide powers to deregister an IO if it is not carrying on business. Winding up and dissolution arrangements similar to companies, but simplified, would be provided.

6 Note: Questions around personal liability raised significant reservations regarding the proposed *Australian Close Corporations Act 1989*. That they were not resolved was a major reason why that legislation never took effect. Liability for directors of companies has evolved in the last two decades so viewpoints are different now. However, the fine-tuning of this aspect of the proposed IO Act is critical to its success. The principle is that serious abuse should warrant lifting of the corporate veil: the challenge is to define serious abuse (and to ensure that definition covers societal stakeholders more broadly than those simply with direct financial interests in the IO).

IOs and companies – IOs can own shares

While a company would not be able to be a member of an IO, the reverse would be allowed: IOs would be able to hold shares in a company.

If the IO stands in relation to a company in such a manner that the IO would have been a holding company if it were a company, the provision of loans by the company to the IO or to the IO members would be regulated.

Conversion: company to an IO permitted

A company would be able to convert to an IO if:

- the company had 10 or fewer shareholders;
- all shareholders were natural persons;
- every shareholder becomes a member; and
- the auditor of the company issues a certificate.

There would be nothing to prevent a company organising its affairs so as to comply with these requirements. An IO would also be able to convert to a company, and the provisions of the *Corporations Act* would be modified to enable this to occur.

The identity of the company (and vice versa) would be preserved to the extent that its continued existence as an IO did not affect its property, rights and obligations, and did not render defective legal proceedings involving that corporate body.

Conversion from incorporated association – states refer powers

Subject to the constitution and/or a referral of powers, all existing incorporated associations formed and regulated under the jurisdiction of the States and Territories would convert to IOs. A short transition period (no more than a year) that allowed for the registration of Charters would be provided.

As with companies, the incorporated association's identity would be preserved.

5 Proposed features of the Charities Act

The purpose of a *Charities Act*, operating in conjunction with the IO Act, is to provide flexibility and less bureaucracy for charities, and accountability and transparency for donors.

There are five fundamental assumptions behind the proposals set out below:

- All charities will be either companies or IOs.
- Because many charities run on a small scale and attempt to minimise costs, the IO structure will offer many advantages. A traditional company form may be more appropriate for large charities.
- An IO would be so easy and inexpensive to set up and administer, there should be no exemption from the proposals below for very small charities.
- Outside equity investment (i.e. investors expecting a financial return), if not prohibited, should at the very least not be facilitated in charities.
- Charities receive significant contributions from donors and – directly and indirectly – from Government, justifying additional accountability and transparency.

Single registration – compatible legislation and one-stop Registrar

The Charities Act would be structured to build on the IO Act (and for larger charities to dovetail with the *Corporations Act*).

All regulatory interaction for both acts would be with the Registrar. The process of registering as a charity would be part of the process of registering as an IO.

The emphasis of the Registrar would be on facilitation: making administration of a charity easier and providing clarity and certainty in rules.

Charitable purpose – public benefit test

For registration as a charity, the entity must be established exclusively for a charitable purpose that benefits the public. The Act would define charitable purpose and the Registrar would have the power to declare particular purposes as charitable or not.

Registration and audit – obligatory and flexible

To be eligible for favourable taxation status and to use terms such as ‘charity’, organisations would be required to be both registered with the Registrar as a Charity and audited by a registered company auditor.

Charities with under \$1 million (\$5 million?) in annual revenue and year-end net assets would be able to opt for a limited scope review (instead of an audit) by a registered company auditor. The review would confirm that the annual accounts fairly present the affairs of the IO and that adequate controls exist over key systems (eg receipt of donations and their application for charitable purposes).

Mergers, property transfers – facilitated

The Charities Act would facilitate the transfer of property and the merger of entities for bona fide charitable purposes.

Dispute resolution – independent review

The Registrar would have powers to conduct inquiries into a charity’s activities and to adjudicate on disputes. A framework would be established for donors, recipients, employees (and whistleblowers) and Charitable IO members to refer matters to the Registrar in certain circumstances.

The AAT would have jurisdiction to review administrative decisions of the Registrar.

Regulation

At the end of the 1980s, the need for a single, national corporate regulator was accepted as paramount. ASIC’s predecessor, the Australian Securities Commission, was established, and

its first notable accomplishment was to set up a national companies database, a world leader at the time.

Both the financial sector and regulation have evolved significantly since then. Globalisation and the increasing complexity of financial products and markets – all underpinned by colossal technological advances – have driven a geographic convergence: no longer is the challenge a question of state-federal uniformity, now it is all about Australia's international astuteness and competitiveness. While transactions and governance will always be important to the regulator, the primary risks are seen to be at a systemic whole-of-market and corporate conglomerate level.

Likewise, deregulation has driven another sort of convergence: functional convergence. A focus on companies has broadened to securities, derivatives, insurance, superannuation and banking, not to mention financial intermediation. Again ASIC – in partnership with the Australian Prudential Regulatory Authority (APRA) – is preoccupied with systemic risks, and the challenges of its consumer protection mandate.

Is this the best environment to refresh Australia's approach to small business and the third sector? Are ASIC and the Corporations Act well placed to take on this challenge? Can a single regulator and one gigantic piece of legislation properly navigate this wide spectrum, when simplicity and facilitation is called for small FPs and small NFPs?

This paper proposes a separate Registrar of Incorporated Organisations in the belief that a separate regulator and a new piece of legislation will serve not only smaller organisations well, but also will free up the securities regulator to concentrate on what it does best: regulate the market.

Acknowledgements

In preparing this paper, various persons have been consulted. Significant use has been made of:

- Analysis of the proposed *Australian Close Corporations Act 1989* and the *South African Close Corporations Act 1984*, notably the CCH's sole publication on the former and Geach and Schoeman's guide to the latter. An article on the potential usefulness of Close Corporations in New Zealand (Spisto and Samujh, Waikato Law Review) was also beneficial.
- Senator Andrew Murray's July 2006 discussion paper: 'The Case for Introducing a New Regulatory System for the Not for Profit Sector – a discussion paper.'
- 'Charities Act 2006: What trustees need to know' – a publication by the UK Cabinet Office / Office of the Third Sector.