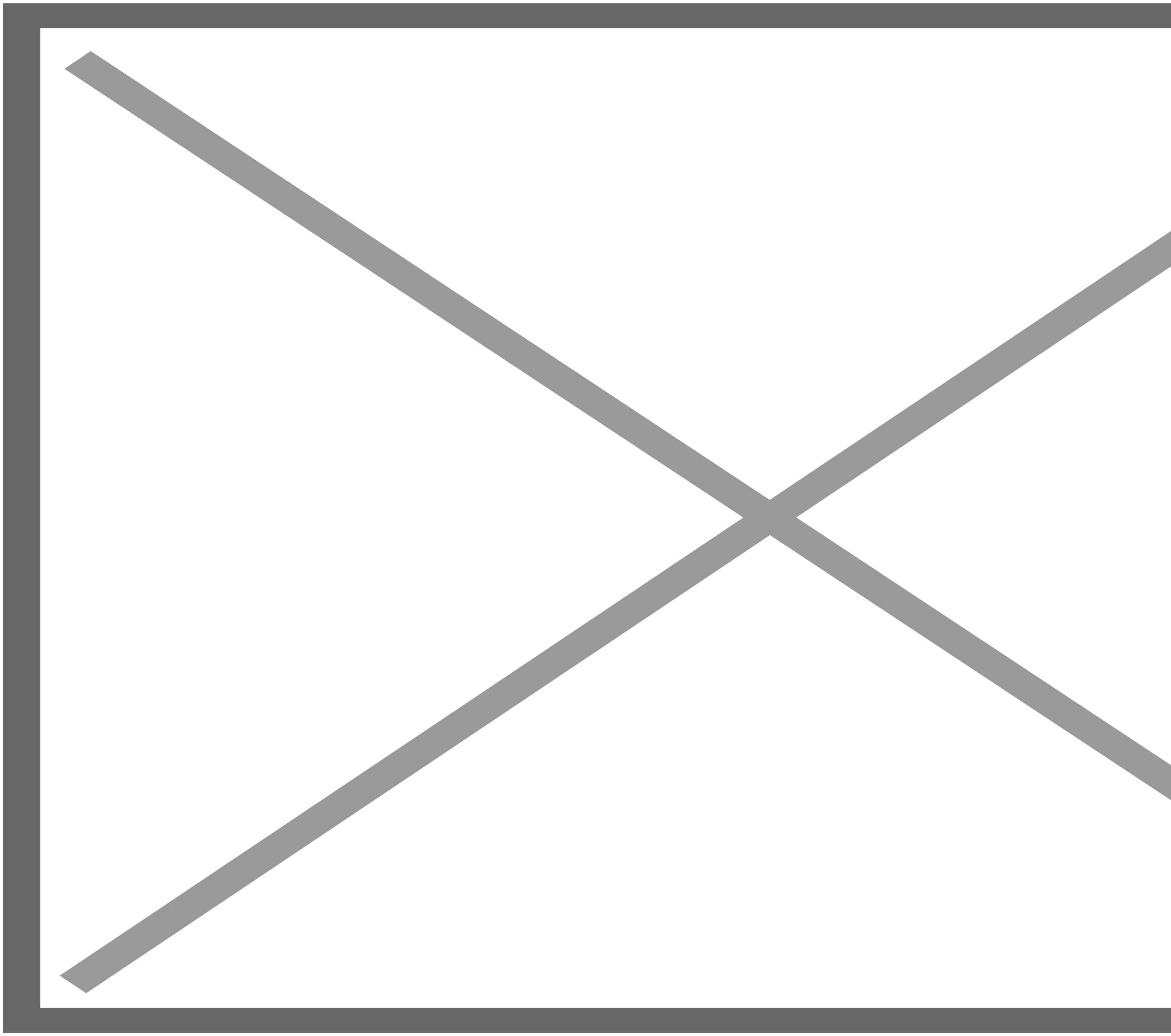
Social incentive

General Features | Personal tax



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Graham Batty looks at social investment tax relief and how social enterprises can use it

Key Points

What is the issue?

Social investment tax relief is a useful break for those seeking to invest in, rather than donate to, social enterprises. But how does it work?

What does it mean to me?

You need to understand the basic rules and short-term barriers to it being widely available

What can I take away?

The basic principles of social investment tax relief and how it might develop over the next few years

It is little over a year since the formal launch of social investment tax relief (SITR) in FA 2014, which introduced ITA 2007 Pt 5B and ss 255A–E and TCGA 1992 Sch 8B. According to Big Society Capital, social enterprises have used SITR to raise £500,000 for investment through loans, loan notes and social impact bonds. Although a modest amount, this is set to grow.

What is SITR?

SITR is closely based on the enterprise investment scheme and its derivative, the seed enterprise investment scheme (EIS and SEIS). It is designed to support social enterprises seeking external finance by offering a range of tax reliefs that can be claimed by individual backers on investments made between 6 April 2014 and 5 April 2019. However, unlike EIS and SEIS, it allows investment not only in shares but also in qualifying debt instruments. This is an important relaxation. Although there had been some limited investment in social enterprises under traditional schemes such as community power generation projects, many social enterprises are established as companies limited by guarantee and so do not have a share capital in which to invest.

A qualifying investment attracts:

- Income tax relief (ITA 2007 s 257 JA) of up to 30% of the amount invested subject to a maximum annual sum of £1 million. Since relief is given by way of a reduction of tax liability, there must be enough UK tax liability against which to set the relief, but there is no need for the investor to be UK resident.
- Capital gains deferral relief (TCGA 1992 Sch 8B) where the gain is reinvested in shares or debt investments that also qualify for SITR income tax relief. Although a claim for SITR income tax relief need not be made to claim deferral relief, the SITR qualifying investment must be made one year before or three years after the gain.
- Capital gains disposal relief (TCGA 1992 s 255B–E) as long as SITR income tax relief was obtained on the cost of the investment and was not later withdrawn, and the investment is disposed of after it has been held for at least three years.

The investment conditions

Although investment can be made either directly or through a nominee (a SITR fund), a qualifying investment must take the form of a qualifying subscription for shares or debt (ITA 2007 ss 257L–H) in a qualifying social enterprise. An investment in equity must be in shares that:

- are fully paid for in cash at the time of issue;
- rank alongside or behind all other shares and debts (other than those that qualify for SITR) in the event of a winding up; and
- are not entitled to a dividend that:
  (a) is of a fixed amount,
  (b) has any part at a fixed rate,
  (c) is fixed by reference to the amount invested,
  (d) is fixed at a rate not dependent on the enterprise's financial success, or
  (e) represents more than a reasonable commercial rate.

A debt investment must:

- be unsecured;
- carry interest that is not more than a reasonable commercial rate;
- rank behind other debts, except other unsecured debt, in the event of a winding-up; and
- rank equally with the lowest-ranking share capital in the event of a winding-up if the social enterprise also has issued share capital.

In addition the investor or any individual associate (business partner, spouse, civil partner, parent, grandparent, children, grandchildren, or the trustees of any settlement where the investor is a settlor or beneficiary) must not:

- be a partner or a trustee of the social enterprise or a subsidiary;
- be a paid director or employee of the social enterprise or a subsidiary, partner or partner of a subsidiary; and
- during the period beginning one year before and ending three years after the investment, together with associates, own more than 30% of the social enterprise's:
  (a) ordinary share capital,
  (b) loan capital, or
  (c) voting rights.

As with the established investment schemes, there are anti-avoidance rules to ensure that money is genuinely being put at risk in the social enterprise. These include rules relating to prearranged exits, investments funded by loans not on normal commercial terms that are linked to making the investment, and the receipt of value from the social enterprise.

The social enterprise

Given its importance, perhaps it would have been a useful starting point to set out a detailed definition of a social enterprise. However, rather than attempt what could have been a difficult task, the legislation restricts relief to particular types of unquoted organisation (ITA 2007 ss 257J and MD). These are:

- a community interest company;
- a community benefit society, with an asset lock;
- a charity (either a company or a trust); and
- an accredited social impact contractor.

In addition, investment is restricted to small- or medium-sized social enterprises because, at the time the investment is made, the social enterprise must have (ITA 2007 ss 257MC and MH):

- fewer than 500 full-time equivalent employees;

- gross assets of not more than £15 million immediately before the investment; and
- gross assets of not more than £16 million immediately after the investment.

If the social enterprise is the parent company of a group, these limits apply to the whole group.

All the money that the social enterprise raises from that investment must be used solely for the chosen qualifying trade within 28 months of the date of the investment (ITA 2007 s 257 ML–MM). The trade must be carried on by either the social enterprise itself or by its 90% social subsidiary (ITA 2007 s 257 MN).

Other than in the case of a charity, the trade must be run commercially with a view to making a profit but does not have to be carried on in the UK (ITA 2007 ss 257MJ and MP). The 'usual offenders' that will be familiar from the EIS/SEIS schemes are excluded activities, but notably not operating or managing nursing or residential care homes (ITA 2007 s 257MQ–MT).

Making use of SITR

On the face of it SITR appears to offer many attractions to social enterprises as a source of funding for projects such as setting up a commercial trading activity, buying community facilities or trying an innovative service where some risk capital is required. However, it is not really an alternative to long-term mortgage finance – other funders can provide this – nor, given the clawback rules, is it designed for funding short-term projects.

Surprisingly, perhaps the biggest short-term block to the take-off of SITR is likely to be the availability of projects in which to invest. Although an individual can invest up to £1 million a year and qualify for SITR under EU state aid rules, a social enterprise can receive only about £250,000 over three years in tax-relieved (government subsidised) investment. Therefore, only relatively small sums can be raised and limits the size of project that can be funded. However, given the number of small projects now financed by crowdfunding, SITR is undoubtedly something that could have a place here.

Government does, though, appear to be committed to the SITR. In January 2015 an application was made for EU state aid clearance on an enlarged SITR scheme and, in particular, to increase the limit on the investment an organisation can receive to £5 million a year and £15 million in total. The process to decide this is likely to take at least 18 months.

In addition, in Budget 2015, details for the design of a new social venture capital trust scheme were announced. Although this will be legislated for in a future Finance Bill, it is intended to be similar to the venture capital trust scheme for indirect investment in commercial companies.

Clearly, there are opportunities for social enterprises to begin incorporating SITR into their funding strategy now. However, it will probably be summer 2016 before the more attractive higher investment limits are available and SITR really begins to take off.