SOCIAL INVESTMENT TAX RELIEF – WHAT, WHY AND HOW?

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BIG PICTURE – WHAT IS SITR?

- It's a way in which social enterprises can raise funds by way of investment, and offer their investors tax relief

- Designed to help fill the "funding gap" for social enterprises

- Works like this:
  - **Individual** invests money into a **social enterprise** by way or **shares or debt**
  - Individual claims **tax relief** on the amount invested
  - The social enterprise applies the funds in a **trading activity**
  - After **three years** (or longer) the investment is sold or repaid

- Key point: this is a tax relief to support trading activity

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WHO CAN INVEST AND CLAIM SITR?

- Must be an **individual** – although investments can be held on behalf of an individual by a nominee

- There are restrictions on being an employee, partner, trustee or paid director

- The investor cannot have a material interest in the social enterprise – basically more than 30% of:

    - Voting power, or
    - Ordinary share capital, or
    - Loan capital

- Overriding requirement that the investor cannot "control" the social enterprise

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WHO CAN RAISE SITR MONEY?

- Must be a “social enterprise”:
  - **Charities** – can be a trust or a company
  - **Community Interest Companies** – again, can take any form of CIC
  - **Community Benefit Societies** – must:
    - Not be registered social landlord
    - Be a “prescribed” bencom (i.e. incorporate, in its rules, the asset lock)
  - **Accredited Social Impact Contractor** (typically a special purpose vehicle that will issue social impact bonds to raise finance for a particular project)
- Must meet the “trading requirements” - any trade is okay unless it’s on the list of “excluded activities”
- A number of other conditions (e.g. no more than 500 FTE employees)

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TAX RELIEFS

- **Income tax relief** – 30% income tax relief (with carry back facility for investments made after 5 April 2015)

- **Capital Gains Tax deferral** – if a chargeable gain is invested into an SITR-qualifying investment, the CGT liability on that gain is deferred until the SITR investment is disposed of.

- **Tax free gains** – gains made on disposal are free of capital gains tax

WORKED EXAMPLE

- A Community Interest Company wants to raise a £100,000 loan to refurbish its premises and expand its operations
- It approaches its supporters and ten individuals each offer to lend £10,000 at an interest rate of 5% p.a. repayable in five years' time
- Each investor lends £10,000 but claims back £3,000 from the taxman – so the net cost to the investor is £7,000
- Each year the investor receives £500 in interest, which is taxed (let's say @40%), so the net interest is £300 each year
- At the end of five years the loan is repaid and the investor receives back his or her £10,000
- So for a net investment of £7,000, each investor gets back (after tax) £11,500 [i.e. £10,000 original loan plus £1,500 interest, after tax]

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KEY INVESTMENT TERMS

- **Shares:**
    - SITR shares cannot carry a right to a return which (either partly or wholly):
        - Is fixed
        - Exceeds a “reasonable commercial” rate of return
    - On a winding up SITR shares cannot rank above any other shares
- **Debt:**
    - Cannot be charged or secured on any assets
    - Rate of return cannot be greater than a “reasonable commercial” rate of return
    - On a winding up all monies due to the holders of SITR debt must:
        - Be subordinated to all other debts (other than, presumably, other SITR debts)
        - Where the social enterprise has a share capital, rank equally with the lowest ranking class of share
- You cannot have in place any arrangements for the investment to be redeemed, repaid, repurchased, replaced or otherwise disposed of within **three years**

THE LIMITS

- Individual limit of **£1m per tax year**
- A social enterprise cannot raise more than around **£270K in any rolling three year period** (the cap is calculated using a formula which depends on the GBP/euro exchange rate and the prevailing tax rates)
- Any “de minimis” State Aid counts towards that £270K limit

WHY BOTHER?

- There will be investors out there looking to invest to achieve both a social and a financial return – if a social enterprise can offer tax relief to its investors, it's going to put itself at an advantage
- And if this tax relief takes off there will come a point where many investors might expect SITR to be available. If you can't offer it you'll be at a disadvantage
- Compare SITR debt to bank debt:
  - If lenders are getting tax relief, a social enterprise can offer a lower rate of interest to investors (compared to what it would pay a bank) and investors still make a good return
  - SITR debt must be unsecured – banks typically only lend if they can take security, but this is not an issue for SITR lenders

WHY BOTHER? (2)

- Patient capital – cannot start repaying SITR debt for at least three years so gives a breathing space (unlike bank loan where repayments start immediately)
- With SITR debt there can be no covenants or rights to early repayment during that initial three year period (so no risk of lenders "pulling the plug" early)
- Lenders are likely to be more engaged in the social mission
- Lenders may lend more than just money – expertise, time, contacts, advice

• In short, if a social enterprise can offer SITR to investors, it becomes a no-brainer

WHERE WILL WE SEE SITR?

- Charity with a trading subsidiary
- Charity which carries on "primary purpose trading" itself
- Any other form of social enterprise looking to raise finance for expansion, development, growth – startups and more established businesses
- Joint ventures between charities or social enterprises for specific projects
- New vehicles being established to take over the running of facilities from local government
- Social Impact Bonds
- So far, emphasis has been on debt fund raises, but a social enterprise can offer shares as well as (or instead of) debt – shares can be redeemable, to provide an "exit" route for investors

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WHAT'S NEXT IN SITR?

LIMITS

- The Government announced on 3 December 2014 that it would seek to increase this by introducing:
    - a £5m cap per social enterprise in any rolling twelve month period, but
    - subject to an aggregate cap of £15m per social enterprise
- It has still not happened. Dependent on approval from the EU Commission (which looks like it will take another 6-12 months)

FUNDS

- Resonance
- SIS
- Social Finance
- Social VCTs?

THAT'S ALL THERE IS TO IT…

- Recap:

  - **Individual** invests money into a **social enterprise** by way or **shares** or **debt**
  - Individual claims **tax relief** on the amount invested
  - The social enterprise applies the funds in a **trading activity**
  - After **three years** (or longer) the investment is sold or repaid
  - This is a tax relief to support **trades**

- There is quite a lot more to it – this is very much a whistle stop tour

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