the voice for social enterprise

Social Investment Tax Relief Consultation
Enterprise and Property Tax Team
HM Treasury
1 Horse Guards Road
London SW1A2HQ

5th September 2013

<u>Social Enterprise UK's response to: HM Treasury and the Department for Business, Innovation and Skills' Consultation on social investment tax relief</u>

Dear HM Treasury Enterprise and Property Tax Team,

<u>Social Enterprise UK's letter in response to HM Treasury and the Department for Business Innovation and Skills' Consultation on Social Investment Tax Relief</u>

About Social Enterprise UK
Social Enterprise UK was established in 2002 as the national body for social enterprise in the UK. We are a membership organisation. We conduct research; develop policy; campaign; build networks; support individual social enterprises; share knowledge and understanding; support private business to become more socially enterprising; and raise awareness of social enterprise and what it can achieve.

Social enterprises are businesses driven by social or environmental objectives whose surpluses are reinvested for that purpose in the business or in the community. They operate across a wide range of industries and sectors from health and social care, to renewable energy, recycling and fair trade and at all scales, from small businesses to large international companies. They take a range of organisational forms from co-operatives and mutuals, to employee owned structures and charitable models.

Our members come from across the social enterprise movement, from local grassroots organisations to multi-million pound businesses that operate across the UK. With them we are:

- creating a better environment for social enterprises to do business
- helping the social enterprise movement to grow and become stronger
- building networks to share, learn and create business opportunities

The UK social enterprise movement is recognised as a world leader and our members are united in their commitment to changing the world through business. The current climate presents the social enterprise movement with a unique opportunity. We know it can solve some of the UK's most pressing problems, promote social justice and help to bring about the more diverse, bottom-up economic growth that we urgently need. In particular, social enterprises are well placed to deliver on the Government's three priorities for civil society: empowering communities, opening up public services and promoting social action.

Our involvement and response to this consultation

Social Enterprise UK (SEUK) welcomes the opportunity to respond to this consultation on creating and social investment tax relief to encourage private investment in social enterprises.

SEUK have always championed greater and more inclusive access to finance for our members and social enterprises in the sector. Our own extensive research consistently demonstrates that access to finance is the biggest barrier[1] for social enterprise at start-up and to become sustainable and grow.

To help address this major challenge Social Enterprise UK leads the Social Investment Forum (SIF) – a collective voice for social investment and finance intermediaries – working together to influence policy and provide practical support to help social enterprises access appropriate and affordable finance.

Working through SIF, as well as on an organisational basis representing our members, SEUK has been heavily involved in supporting the development of the social investment market. This includes influencing policy development – SEUK coordinated the public affairs campaign to support the proposal of an amendment to the Financial Services Bill which called for the new financial regulators to recognise the unique characteristics of social investment – as well as providing practical support to social enterprises through holding events and developing online resources and advice. As the lead partner on social investment and finance for the Office for Civil Society's Strategic Partnership we also work closely with Cabinet Office to advise, inform and disseminate relevant policy developments, initiatives to support the sector and information to the social enterprise and social investment communities. We also work through our strategic partnerships with other departments, including the Department for Business, Innovation and Skills and the Department, to raise awareness and facilitate discussions on social investment and finance.

We really appreciate the openness and time taken by the HM Treasury (HMT) team to engage with the social enterprise sector on this consultation and, as members of the expert working group convened by HMT, we found the series of workshops very insightful. Our members, who attended an additional workshop convened by HMT to listen to the view of frontline social enterprises on the tax relief, also found their direct inclusion very welcome and we too found this opportunity to hear their views extremely useful. In addition, since the budget announcement that a tax relief for social investment will be created we have been opening consulting with our members to seek their views to ensure that our response is truly representative.

In our capacity as secretariat to the Social Investment Forum we have coordinated a response to represent the broad views of the forum. This response will be submitted separately to HMT. SEUK supports the views presented in this joint response. In addition to supporting the views presented in the SIF response we will are keen to express our organisational views on issues which are a priority to us and our members:

1. **A wider more inclusive definition of eligible investee organisations**
2. **Increasing the size of eligible investment** into social sector organisations
3. **Ensuring a level playing field** between tax incentives designed for social investment and purely commercial investment
4. **Explore how the tax regime or other initiatives** could be developed to enable and incentivise investment in social enterprise from 'ordinary' investors

Please find enclosed detailed responses to each priority issue.

[1] The People's Business, a report on the State of Social Enterprise Survey 2013, revealed that 40% of social enterprises cited access to finance as the biggest barrier at start-up and 39% of social enterprises cited access to finance as the biggest barrier to sustainability and growth. Access to finance was also revealed to be the biggest barrier in the previous survey undertaken in 2011 (the State is Social Enterprise Survey is undertaken on a biennial basis).

Should you have any questions or require further clarification, please do not hesitate to get in touch with me or my colleagues at Social Enterprise UK.

Yours sincerely,

Peter Holbrook
CEO, Social Enterprise UK

Social Enterprise UK priorities:

1. **A wider more inclusive definition of eligible investee organisations**

As a membership organisation that represents social enterprises in the UK, it is of critical importance that this tax relief will benefit as wide a group of social enterprises as possible.

In response to question 2 - *Would adopting a definition of social enterprise comprising Community Interest Companies, Community Benefit Societies and charities that are registered with the charity (or other principal) regulator and also recognised as charities for tax purposes exclude organisations that might reasonably be included, or include organisations that in your view should be excluded? If so, please say why* – SEUK strongly advocates that the proposed definition for the investee organisation excludes a significant proportion of social enterprises which fall outside the three groups identified.

As acknowledged in the consultation document, the Government is aware that social enterprises take on various forms and are not restricted to Community Interest Companies, Community Benefit Societies and registered charities.

The driving purpose behind the creation of a social investment tax relief stemmed from the recognition that the majority of social enterprises were not able to benefit from existing tax relief schemes such as the Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT) because they were not legally structured in a way to offer share capital. Social enterprises which are companies limited by guarantee (CLG) are one major group of social enterprises which are excluded by virtue of their legal structure.

The CLG legal structure is an established legal form that has proven to be a consistently popular choice for social enterprises. Significantly, since the CIC structure was established in 2005, the CLG continues to be the legal structure most commonly adopted by social enterprises. The State of Social Enterprise Survey, the largest survey of social enterprises conducted biennially in the UK, revealed that over 50% of social enterprises are constituted as CLGs in 2009, 2011 and in the most recent survey in 2013. Further, the 2013 survey revealed that of the 51% of social enterprises constituted as CLGs, 59% are not registered as charities; overall, this means that around one-third of all social enterprises are CLGs, not registered as charities, which would not be eligible for the SITR as it is currently proposed. This is in line with our membership breakdown where CLGs are the largest proportion of social enterprises making up one third of the entire social enterprise membership.

There are normally a wide range of factors which determine what legal structure and/or organisational form a social enterprise adopts. Given the complexity around the backgrounds and motivating factors driving the formation of social enterprises in the sector, any expectation that social enterprises will change legal structures in order to access a tax relief is likely to be misplaced in practice and lead to market distortions.

CLGS that wish to apply for the tax relief need to clearly and explicitly demonstrate that they are driven by a social and/or environmental purpose. SEUK suggests there are a couple of concrete things which government could do to bring them within a 'socially' regulated environment.

i. One is to have a simple registration process with an approved body, whereby any CLGs wishing to take investment involving the tax relief would have to first register – this would probably only be a case of submitting their governing documents (memorandum and articles) to demonstrate they have a social purpose or mission enshrined and to make clear their ownership structure. An additional requirement which prohibits the CLG from changing their legal structure or constitution from what was submitted for the duration of the investment period can be included. A light touch 'spot-check' system can be put in place to ensure compliance.

ii. A second more substantive approach would be to extend the reach of an existing regulator (perhaps, the CIC Regulator) more formally to extend and include this body of organisations for the purpose of accessing this tax relief and only for the duration of the investment period. The regulator would apply a similar registering of governing documents and reporting of community benefit/social impact. If deemed necessary the social enterprise seeking relief could also be subject to restrictions on profit distribution and remuneration to directors and management which are equivalent to those restrictions to which CICs are subject. A failure to honour such CIC-equivalence requirements could lead to the relief being withdrawn.

    Importantly, this would not insist that CLGs become CICs as we do not believe that it is necessary that the CLG is subjected to all the restrictions of a CIC in order to achieve the purpose of this relief – notably, we strongly advocate that it is not necessary to require the investee organisation to be subject to an asset lock on capital assets.

We are also aware of calls for social enterprises organised as co-operatives to be included. We would support this as many of our members are co-operatives. We would like to refer HM Treasury to the joint submission from Co-operatives UK and Locality for their expert views on this matter.

SEUK recommendation: The definition for eligible investee organisations should be widened to include CLGs (subject to additional guarantees as specified above) and co-operatives.

2. Increasing the size of eligible investment into social sector organisations

In response to question 15 - *Would a tax relief allowing investments of a maximum of €200,000 per investee organisation over three years be successful in generating additional social investment? If so, what types and sizes of social enterprise would be likely to benefit?* - SEUK strongly believes that SITR is the best opportunity to create a level playing field between purely for private profit companies and social enterprises. We strongly argue that a tax relief of €200,000 per investee organisation over three years will not be sufficient achieve this for a couple of key reasons:

i. **A limit of €200,000 is likely to be too small to attract the attention of product providers** (e.g. existing EIS product and EIS Fund providers and existing social investment intermediaries) and motivate the distribution channel (IFAs, private banks, and execution only platforms). Intermediaries will be required to develop products, funds and find investors for the tax funds, much like Octopus, MMC and Oxford Capital Partners operate in the EIS market. Initial feedback from existing EIS fund managers and market participants suggests that a £150,000 (€200,000) total limit over a 3-year period is much too low to attract the interest of professional EIS fund managers and advisers that may need to charge substantial costs to arrange and promote any offer (and such cost amounts would be too great a proportion of the investment to be feasible). Evidence about the take-up of EIS funds suggest that at least 50% of the total volume of investments made through the EIS is for amounts of investments into companies of greater than £1m.[2]

ii. **Such a limit would mean that the tax relief has only limited effect in stimulating social investment**:
    - Recent research provides that the average investment size in the social investment market is £264,000, in excess of the £150,000[3]. Further, the average sizes of the most risk-taking products, quasi-equity and equity, were substantially higher at £242,500 and £162,000 emphasising the need to set a higher investment limit.

[2] EIS1 tables from HMRC
[3] See Growing the social investment market: Landscape and economic impact, GHK, 2013, p.20

- Most government contracts that social sector organisations will be seeking to compete for will require working capital funding likely to be greater than this cap – potential million pound contracts arising out of the coming £500m justice reforms would require substantial working capital funding.
- A maximum €200,000 per investee organisation is likely to benefit only smaller social enterprises seeking funding from their Friends and Family network. At this level of tax relief, we see limited prospects for the formation of collective investment schemes offering a less risky diversified portfolio.

We advocate that the size of the relief should be at £5million which is the same amount of tax-advantaged investment investees can currently receive under EIS rules. This will provide a suitable realistic cap to enable qualifying social enterprises to aspire to as the market grows in size.

We understand that the €200,000 limit may have been designed by HM Treasury to comply with the European Commission limit for *de minimis* state aid to assist the rapid implementation of some version of the tax relief within the Finance Bill 2014. We agree with the need to capitalise on the current momentum in the social investment market. However, we also understand from consultation with HMT as part of the expert working group that that the calculation of the state aid may be made on a different basis for debt instruments and equity/quasi-equity instruments.
For quasi-equity and equity products the *de minimis* amount appears to be calculated as the total capital injected, whereas the *de minimis* amount in respect of debt could refer to a calculation about the difference between the actual interest rate charged and the market interest rate multiplied by the principal amount of the debt. If this distinction is possible, it would have a material effect on the amount of unsecured lending that could be permitted under this tax relief.

SEUK recommendation: We strongly advocate that the amount of capital from venture capital schemes any investee can receive in total in any 12 month period should be increased to up to £5 million. This would place SITR on a level playing field with EIS.

HMT to establish whether the calculation of State Aid should be based on the level of subsidy and not on the overall level of investment.

3. Ensuring a level playing field between tax incentives designed for social investment and purely commercial investment

In response to question 2 - *Do you agree with the proposed criteria for assessing options for the social enterprise tax relief? Please provide comments as appropriate* – SEUK would like to advocate an additional criterion: that investment in social enterprises is put on a level playing field with investment in purely commercial enterprises.

A level playing field would enable social enterprises to offer the same tax advantages as purely commercial enterprises to individual investors who want to support their growth. Access to longer-term risk capital would enable social enterprises a more equal chance to play a part in winning government contracts, for example.

Creating a level playing field would mean that central terms under which social investment tax relief is made available are identical to the terms of the existing commercial regimes of EIS and VCT. The need for symmetry would have to apply to important terms like

- amount of capital from venture capital schemes any investee can receive in total in any 12 month period (£5,000,000);
- size of the relief available to the individual investor (up to £1,000,000 for EIS; £200,000 for VCT);

- amount of time an investor is tied to the investment (3 years from when instruments where issued for EIS; 5 years for VCT);
- tax reliefs available to the individual investor, e.g.
    - **Income tax relief** at 30% (including the 'carry back' facility)
    - **Tax free capital gains** on investments
    - **Full inheritance tax relief** provided the investments have been held for two years and are held at time of death
    - **Full capital gains tax (CGT) deferral** on tax due on any other capital gains for the life of the investment
- **Loss relief** which can be taken as a deduction against income or as a capital loss.
- ability to realise an exit from the investment at the end of the tie-in period (e.g. enable SITR instruments to be redeemed from the end of the tie-in period and onward).

We believe this symmetry will be critical for distributing social investments more widely through IFAs, private banks, other intermediaries and online platforms. For instance, the current consultation indicates that the tie-in period for an SITR instrument would be five years. This difference with the EIS rules is likely to put the SITR instrument at a disadvantage to an EIS instrument in the advisory conversations that the investment intermediary has with the end investor.

SEUK recommendation: In addition to the proposed criteria for assessing options for the social enterprise tax relief we would like to add an additional criterion: that investment in social enterprises is put on a level playing field with investment in purely commercial enterprises.

4. **Explore how the tax regime could work to enable and incentivise investment in social enterprise from 'ordinary' investors**

The proposed arrangements for income tax and reinvestment reliefs has the, perhaps unintended, consequence of limiting tax reliefs to high net worth individuals (HNWIs). We don't believe this was an explicit intention of the policy. If the Government is not able to consider other ways to use the tax regime to create incentives for investment in social enterprise for more 'ordinary' investors - even including VAT or council tax or taking inspiration from the Gift Aid model – then further policy work should be undertaken to provide a counterbalance to this focus on relatively HNWIs.

SEUK recommendation: The Government should commit to exploring how either the tax regime or other initiatives that can be developed to enable and incentivise investment in social enterprise from 'ordinary' investors, as opposed to HNWIs.

For queries regarding this response please contact:
Charlotte Chung
The Fire Station
139 Tooley Street
London SE1 2HZ
charlotte.chung@socialenterprise.org.uk