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NCVO Commission on Tax Incentives for Social Investment

Analysis and Recommendations

January 2012

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Executive Summary

A diverse range of social ventures, including charities, voluntary groups and social enterprises, will contribute significantly to the growth of the UK economy over the coming years. But as we face ongoing economic uncertainty and as the challenges for our public finances continue, so our civil society organisations are coming under increasing financial pressure.

Social investment will not fill gaps in income or provide a panacea but is undoubtedly part of the solution. The Coalition Government is committed to supporting the development of the UK's small but well-established social investment market, thereby creating better access to capital for charities and social enterprises. Its social investment strategy has been followed, inter alia, by the establishment of Big Society Capital in the autumn of 2011.

Incentivising social investment through a range of fiscal incentives created for 'mainstream' businesses has had a limited impact. Gaps and inconsistencies in how the current UK tax system applies to social ventures limit the growth of these organisations and hence their contribution to the UK's economic prosperity, social cohesion and environmental sustainability.

The NCVO Commission has brought together a range of specialists and representative bodies, and a diverse range of expertise, experience and evidence from a number of social investors and social investment intermediaries. The group's recommendations are focused on specific technical changes which could help unleash a step change in the level of investment directed towards the growth of social ventures, in order to stimulate a direct positive contribution to the UK economy, society and environment.

Existing tax incentives could be improved and made more effective. Also, some of the rules applying to the schemes make them more difficult to access for social enterprises than other 'mainstream' enterprises, particularly as social ventures can have legal structures which do not allow them to issue shares. So, equity-like risk capital investment into social enterprises takes other forms but the existing tax regime has a 'blind spot' when it comes to recognising these approaches. For the current dominant role of Government in the social investment market to be overtaken by private taxpaying investors, the rules will need to be available for these arrangements which have the substance, if not the form of, equity or share capital.

The Government is committed to trying to improve the Community Investment Tax Relief (CITR) scheme. The Enterprise Investment Scheme (EIS), Venture Capital Trust (VCT) scheme are also undergoing changes and a new Seed Enterprise Investment Scheme (SEIS) is under development.

The Commission proposes that the Government should:

1. Improve the attractiveness of the existing CITR regime for investment into Community Development Finance Institutions.

2. Consider how equity or equity-like investment made directly into enterprises established for community or social benefit (such as Community Interest Companies, Charities and Community Benefit Societies) should be eligible for CITR[1].

3. Amend and simplify the EIS, VCT and SEIS schemes to ensure they work for social ventures.

4. Undertake a longer-term, strategic and more fundamental review of the tax code to ensure its suitability, simplicity and fairness for encouraging growth of investment in social ventures.

[1] While the Community Development Finance Association (cdfa) supports the aims, conclusions and wider recommendations of the Commission, it should be noted that they refrain from endorsing this particular recommendation.

Forewords

At this time of great uncertainty for UK businesses, the public finances and civil society, we all have some responsibility for helping build a more thriving, sustainable and balanced economy. In this context, it has been a pleasure to Chair the NCVO Commission on Tax Incentives for Social Investment and to identify new ways to support the development of businesses which deliver growth, jobs and value across the country.

If we can create the right incentives to help achieve growth of those dynamic businesses which create social, environmental and financial value, then we will have taken some steps towards building what the Prime Minister calls "a fairer, better economy". Encouraging financial institutions, citizens and communities to better engage with financing the growth of business which are grounded in the values of localism, responsibility and the human touch will help us shape a more sustainable capitalism in the UK.

It is an exciting time on the demand side – as the growing diversity and number of promising social ventures represent ever more attractive investment propositions. In parallel, on the supply side, increasing numbers of institutional, social or individual investors are seeking out opportunities to deploy capital with a view to both social and financial returns. So our proposals should be seen in the context of growing demand and supply, a nascent market for social investment, and significant opportunities to deliver growth in a variety of different ways.

We know that existing tax reliefs are rarely exploited by investors in social ventures and yet the contribution of these social enterprises to the UK economy is significant, robust and growing. Furthermore, the preventative interventions they often build their businesses around can also generate savings for the Exchequer further down the line. Here then, is an opportunity for Government to catalyse economic growth and social impact for a fraction of the cost of the potential benefit. We stand ready to help the Government understand the economic case for using the tax system to open up social investment.

We recognise that some of our recommendations may be given more urgent consideration over the coming weeks than others. Nevertheless, we hope that this report helps pave the way for smarter use of fiscal incentives to catalyse the growth of socially conscious investment and more sustainable businesses in the UK over the coming years.

John Kingston, Chair of the Commission

NCVO has a long-standing interest in the social investment market and has for many years supported the development of a social investment wholesale bank, using unclaimed assets, to capitalise this growing market. This ambition has been realised through the development of Big Society Capital, but we believe that the wider market has considerable potential to grow further. That is why we commissioned this report late in 2011 to bring together cross-sector experts with the aim of making practical, workable recommendations to government. This report is intended to make a genuinely useful contribution to the debate, with an achievable number of recommendations for government to consider. We hope that this report is seen as a major stepping stone in our involvement in this debate, building upon the recommendations made by NCVO's Funding Commission in 2011. We look forward to working constructively with colleagues and partners from across civil society, the finance community and government.

Our hope is that social investment can become an increasingly important source of funding to civil society in the UK. With a sharp decline in public funding combining with a difficult economic environment, this has clearly made the need to secure new and different types of resource more acute. Social finance has the potential for organisations to continue to deliver on their mission and to serve acute need whilst giving them the flexibility to invest in future provision and innovation.

Our interest in social investment is not purely short term, or tactical. Our belief is that it has wider potential than simply replacing funding that may be lost from elsewhere. New forms and sources of finance can play an essential role in shaping our mindsets in the sector and in delivering new and innovative services. Rewarding success and, crucially, moving to models of measurement that value outcomes over outputs not only is likely to result in better services and better experiences for users, but also should help services to become more efficient and effective.

Social investment should be seen as one solution to delivering on the Government's twin agendas – deficit reduction and the further development of a vibrant civil society through delivering the 'blended returns' of both economic and social benefit. My view remains that building the social investment market should not be seen as distracting from key issues in the Government's development of a growth strategy but rather as a central part of seeking to build the strong and sustainable economy of the future.

Sir Stuart Etherington, National Council for Voluntary Organisations (NCVO)

Introduction

Social investment and access to finance

As the UK faces ongoing economic uncertainty and as the challenges for our public finances continue, so our civil society organisations are coming under increasing pressure. Our charities, voluntary groups and social enterprises often face substantial hurdles as they struggle to control income and expenditure, manage their assets and keep cash flowing in order to deliver the social purpose they exist to pursue.

Civil society organisations - or social ventures - contribute to growth of the UK economy by:

- generating sustainable employment for c. 765,000 people[2], including for those furthest from the labour market;
- demonstrating relatively strong resilience and growth in difficult economic circumstances[3];
- contributing to a more socially cohesive UK, particularly through supporting the disadvantaged and vulnerable, thereby delivering savings to the public purse including through the delivery of preventative services;
- delivering environmental benefits which help create a more self-sufficient, efficient and asset rich UK;
- delivering efficiencies through the creation of more diverse markets in a range of goods and services, including public services; and
- contributing to Exchequer tax receipts and to innovation by providing funding of £1.8bn per annum to higher education institutions, mostly for research.

Over the past few years, we have seen an increasing policy focus on the capital (or finance) requirements of our civil society organisations[4]. "Social investment" has come to the fore as a term which relates to investment intended to deliver social return alongside any financial return[5]. However,

[2] NCVO, Skills - Third Sector and TSRC *The UK Voluntary Sector Workforce Almanac 2011,* 2011

[3] Social Enterprise UK, *Fightback Britain*, 2011 and Co-operatives UK, *The UK Co-operative Economy Report*, 2011

[4] NCVO, *Capitalisation and Social Investment – Findings and Emerging Recommendations*, 2010

[5] Whether this means surrendering some financial return is less straightforward. For some, the social motivation must come in tandem with an intention to deliver financial return (in the form of interest on loans or dividends from equity) or it simply is not investment. For

we also need to recognise its limitations and that while social investment is undoubtedly part of the solution it is not a panacea - this is not a source of revenue or funding to fill gaps in income.

There is already an embryonic social investment market in the UK, albeit small and dominated by a handful of players. Social investment can also sometimes overlap with public investment - in the case of the Government's Futurebuilders or Communitybuilders funds, for example. And of course, civil society organisations often go to conventional and commercially motivated financial institutions to satisfy their capital needs, typically in the form of secured loans for property acquisition.

Government tax incentives for investment in social ventures

We are pleased to see the Government conclude in its recent strategy document[6] that "it is in the national interest to accelerate the growth of social investment." To further this, the Government has a range of levers at its disposal, including spending, regulation, fiscal and other measures (such as 'nudging').

There are a range of existing fiscal incentives already, which can be applied to a range of investment instruments including equity, debt, grants and hybrids. But as the Government admits "tax-related initiatives... have had a positive, if limited, impact on incentivising social investment." In our view, this is due to gaps and inconsistencies in how the current UK tax system applies to social ventures. While it is true that there are also gaps in supply and demand in what is a nascent market, the absence of a fair, equitable and well understood tax regime for investment in social ventures hinders this development and holds back growth.

Yet the evidence suggests that where fiscal mechanisms to incentivise social investment are available, the balance of net costs and benefits can be significantly to the advantage of the Exchequer. The Government's own recent national evaluation of CDFIs, for example (following a methodology consistent with the Green Book) established the maximum public sector cost per unit of net economic impact delivered by the CDFI sector. The evaluation found a Gross Value Added return of £8.33 for every £1 invested by the public sector through CDFIs in the large social enterprise lending market[7].

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others, who interpret "investment" more widely - in the sense of money which is committed to achieve a future benefit - it can include soft loans and other 'investments', and even grants, which offer a below market return.

[6] Cabinet Office, *Growing the Social Investment Market: A vision and strategy,* 2011
[7] Department for Business, Innovation and Skills, Cabinet Office and GHK, *Evaluation of Community Development Finance Institutions (CDFIs),* March 2010

CITR costs the Exchequer barely a few million pounds per year. Yet £63 million has been raised through CITR since its inception[8] and £200 million was lent by CDFIs in the last reporting year alone. CDFI loan portfolios now stand at over half a billion pounds. Similarly, the EIS and VCT schemes have contributed to attracting perhaps a few million pounds of investment into social ventures, yet the sector as a whole contributes many billions of pounds to the country's GDP.

So encouragingly, the Government has confirmed that tax incentives are one of their six areas for action, stating that "We need a better enabling environment for social investment…. We can review the effectiveness of… tax incentives that encourage a blend of social and financial return". The Government also described how the perception or presence of an unstable or unproven policy environment – for instance on tax incentives – can mean that imperfect information leads to market failure.

The current regime limits the growth of social sector organisations and hence their contribution to the UK's economic prosperity, social cohesion and environmental sustainability. We believe that the Government should share our aspiration to create parity of opportunity for investment in a diverse range of social ventures to support their growth and that of the UK economy.

The Commission

The Commission is chaired by John Kingston, in a personal capacity. John has a portfolio of executive and non-executive responsibilities, including chairing the Investment Committee for the Big Society Investment Fund and the Association of Charitable Foundations. He was previously Founder Director of CAF Venturesome, after senior roles at Save the Children UK and the 3i Group.

Members of the group include:

- Alex Stobart, Robert Owen Institute
- Cliff Prior, UnLtd
- Rhodri Davies, Charities Aid Foundation (CAF)
- Simon Steeden, Bates Wells & Braithwaite
- David Hutchison, Social Finance
- Kevin Russell, Stewardship and the Charity Tax Group

[8] cdfa, *Inside Out*, 2010

- Tim Jones, Allia
- Emma Davies, Big Society Capital
- Ceri Jones, Social Enterprise UK
- Harry Glavan, Community Development Finance Association (cdfa)

The group is supported by Karl Wilding (NCVO), James Allen (NCVO) and Dan Gregory (Common Capital). This group therefore brings together a range of specialists and representative bodies, and a diverse range of expertise, experience and evidence from a number of social investors and social investment intermediaries.

Recommendations

Our recommendations are focused on specific technical changes and based on evidence. While tax incentives alone will not make the market, supporting growth is about a combination of hard technical rules and softer cultural factors, both carrots and sticks. We believe our proposals reflect:

- the potential for the sector to contribute significantly to growth (e.g. lone traders, small firms and new ventures are the largest source of new jobs and innovation);
- the scope for simple and realistic changes as well as more ambitious and game-changing amendments;
- HM Treasury's principles for taxation, including simplification, fairness, etc.; and
- the current state of the market.

These changes could help unleash a step change in the level of investment directed towards the growth of businesses making a direct positive contribution to the UK economy, society and environment.

The Problem

There are two key issues with regards to the gaps and inconsistencies in how the current tax regime applies to investment in social enterprise.

First, limitations within the various regulations limit understanding, uptake and hence, growth. Second, some of the rules (almost certainly unintentionally) make the schemes more difficult for social enterprise to access than other 'mainstream' enterprises. The existing incentives are less easily exploited by those investing in social enterprise than by those investing in 'conventional' businesses. As the Cabinet Office says, these were "designed primarily to incentivise mainstream enterprise."

Equity-like capital for social enterprise

The problem is often, although not always, linked to the Cabinet Office observation of "social ventures choosing legal structures which do not facilitate share ownership and therefore do not permit equity to be traded". There is a considerable body of evidence which sets out how the social sector's potential is held back by the lack of appropriate growth, development and risk capital.

- Bridges Ventures, for example, observed[9] how the "traditional venture capital... model is not appropriate for social ventures, where the social mission is core to the business... usually are not comfortable aiming to sell onto another business or issuing shares on an ordinary exchange because the social mission may be compromised by the new owners' desire to maximize profits. This means that the exit route used by venture capital funds, (including community development venture capital) is not available."

- CAF Venturesome has described[10] how there "are situations in which debt financing is inappropriate or too onerous for charities or social enterprises (especially in early stage, high-risk start-ups), while the use of share capital is simply not possible because of the way many such enterprises are legally structured (e.g. companies limited by guarantee or unincorporated trusts)."

[9] Bridges Community Ventures, *Equity-like capital for social ventures*, 2004

[10] CAF Venturesome, *Quasi-equity*, 2008

Case study: Hackney Community Transport (HCT)

The recent social investment into HCT Group (a registered English charity) included a equity-like element, under which interest payments were a function of gross revenue (with certain revenue items disregarded).

This investment would not qualify as "quasi-equity" if the EU definition is directly replicated in UK legislation relating to EIS and VCT, as the investment return was based upon revenue, rather than "profits or losses". However, the EU definition emphasises the importance of "substance over form" and should be construed purposively. The purpose of the definition is to treat as analogous to equity those instruments and arrangements which exhibit characteristics more akin to equity than debt.

NESTA reported that a "negative lesson from HCT's review of its capital structure is that a well-established, investment ready and scalable social enterprise, which has the ability to use a number of legal forms and whose management was prepared to consider all the available options, was unable to design a suitable financing package to take advantage of the current enterprise tax incentives available."[11]

Responding to this need, examples of equity-like investment into social enterprises (including trading charities) have often taken the form of revenue participation or by participating (unsecured or subordinate) debt, with any interest payments and often capital repayment linked to revenue performance. Revenue is harder to manipulate than profit, making it a more meaningful proxy for the financial performance of a social enterprise, which often by choice is not a profit-maximising model.

[11] Centre for the Study of Financial Innovation and NESTA, *Investing in Social Enterprise: The role of tax incentives*, 2010.

Case study: CAF Venturesome and the Charity Technology Trust

Charity Technology Trust ('CTT') is a rapidly growing social enterprise with charitable status. It is beginning to transition from a traditional grant-dependent charity to an organisation whose activities are both increasingly commercial and able to compete within a competitive market.

The appropriate funding instrument for CTT at this stage of its development is an equity-like investment. This shares the risk and reward of the investment between the investor and the investee by allowing the investor to take a share of future revenue streams. Unlike a loan, this investment is truly 'at risk' i.e. should CTT not achieve the expected financial performance, a low – possibly zero – financial return to the investor will result. If CTT performs better than expected, then a higher financial return would be payable.

The mechanism through which Venturesome offered this equity-like investment is a legal agreement known as a Revenue Participation Agreement, developed by Venturesome in 2007. In this case, Venturesome pays to CTT £50,000 for a Revenue Participation Right. CTT sells this right to Venturesome. The relationship is one of buyer and seller, not lender and borrower. The Revenue Participation Right entitles Venturesome to 2% of CTT's gross annual (audited) revenue, payable quarterly. It is worth noting that investors participate in revenue, not profit. This is because the investee is not primarily motivated by making profits for distribution. Also, there may be an incentive to manipulate profitability in order to avoid paying out under the contractual agreement.

So this equity-like capital has a crucial role to play in supporting the growth and development of social ventures. But there is still a long way to go. Boston Consulting and the Young Foundation recently reported how the market is a "long way from the vision of social investors taking risks to stimulate growth and innovation in front-line social ventures. In fact, only 5% of the investments made last year were categorised as equity or quasi-equity."

One reason for this is because the existing tax regime does not support this model. From a social enterprise perspective, tax incentives do not pass the Treasury's principles that taxation should be efficient, certain, simple to understand and easy to comply with, and fair; support aspiration or ask the most from those who can most afford it.

To ensure that the tax rules can be applied in a meaningful way to non-profit distributing bodies, equity-like investments for social ventures could be defined by the reference, not to profit, but to performance and results, however they may be defined. Instruments and arrangements which exhibit characteristics more akin to equity than debt should be treated as analogous to equity. Characteristics of equity include its ability to absorb losses and its status as risk capital, with returns dependent upon performance. These characteristics are as relevant when return is linked to revenue as when it is linked to profit.

The recent Boston Consulting Group report identified a social investment market of £165m[12] with 50-60% of capital coming from central government and 5% from trusts and foundations. It is perhaps no surprise that - under a tax regime with a blind spot for equity-like investment in social enterprise - Nick O'Donohoe from Big Society Capital describes a market where "secured lending dominates with riskier equity and quasi-equity investments making up a minority of the activity". If private taxpaying investors are to overtake the role of Government, the tax regime will need to start recognising these innovative investment mechanisms.

Case study: Big Issue Invest and My Time CIC

Big Issue Invest undertook a pioneering £200,000 investment in shares of the award winning My Time CIC. Big Issue Invest and Birmingham-based My Time worked together to develop a redeemable preference share investment model for a CIC or social enterprise, with Big Issue Invest investing 200,000, £1 social shares in return for a 35% stakeholding.

Ed Siegel, Director of Investments at Big Issue Invest said: "the redeemable preference share structure gives My Time the investment foundation it was seeking while providing BII with an eventual exit without needing to rely on an uncertain future sale of the shares to a third party". Nigel Kershaw, Chief Executive of Big Issue Invest has often expressed regret that the tax system "doesn't reward investors for taking risks in investing in social enterprises... we're missing out."

[12] It should be noted that this figure ignores socially motivated community share issues (by shops, energy schemes, farms, football clubs, etc.) and direct investment bypassing financial intermediaries. It also ignores financially motivated investments in the sector (such as the recent Places for People bond issue or lending by mainstream banks).

Community Investment Tax Relief (CITR)

The scheme

The Community Investment Tax Relief (CITR) scheme was devised in 2002 to encourage private investment into Community Development Finance Institutions (CDFIs), which are social enterprises providing finance to businesses unable to secure bank credit. The CITR scheme encourages investment in disadvantaged communities by giving tax relief of 25% over five years to investors who invest in accredited CDFIs.

Community Development Finance Institutions (CDFIs) provide loans to businesses, social enterprises and individuals. They help those who cannot get financing from banks, providing sustainable economic prosperity to some of the most disadvantaged areas of the UK.

The scheme's state aid exemption finishes in Autumn 2012 and HM Treasury are currently seeking to extend this and review the scheme.

Currently, CITR provides relief on income tax to individuals and corporations investing in community development finance institutions ("CDFIs") by debt or equity. The recipient CDFI must satisfy certain criteria regarding the form and timing of onward investment into enterprises in "disadvantaged communities". Under the scheme:

- to date nearly £70m has been raised using CITR;
- one large social bank has raised roughly 52% of the total through a deposit taking scheme (with just the few bank CDFIs raising over 70% of total investments to date); and
- 12 CDFIs raised the additional 48%:
    - average amount raised = £1,400,000
    - range = £29,700 - £3,800,000.

Limitations to the scheme

CITR, unlike EIS or Gift Aid, requires investment via an intermediary, in this case a Community Development Finance Institution. However, CDFIs have reported that many of the requirements placed upon them with regards to the terms of disbursing funds raised using CITR can be difficult to meet and burdensome to document. The Government is committed to re-notify CITR to the European Commission and "consult… on how the scheme can be made more effective". Some limitations holding back the success of the scheme include:

- Only bank-deposit-taking CDFIs are able to optimise CITR in its current form. These investors enjoy the benefits conferred by the UK Bank Deposit Guarantee.

- There are limits on the amount of CITR investment that can be raised by a single CDFI.

- Exclusions where the investor is protected against risk by insurance, guarantee or indemnity or by publicly-funded guarantees; equity investment in profit-distributing enterprises, excluding Community Interest Companies; loans to profit-distributing enterprises above £100,000; investments not at market rates; and investment of over £250,000 in residential property and development of non-residential property.

- Investment needs to be invested onward rising on an annual basis.

- Understanding and awareness of the scheme can be limited among banks and corporations and social fund investment managers.

Recommendations

We propose that the forthcoming consultation and review of CITR should be used to make it less restrictive, simpler and more effective, in two ways.

First, the Government should improve the attractiveness of the existing CITR regime in respect of investment into CDFIs as follows:

- The level and type of tax relief available under CITR should be comparable with the relief available under EIS or VCT:
    - income or corporation tax relief should be available to a rate of either 6% per year for 5 years (instead of 5%); or 30% in year one, with no relief available for subsequent years (provided the investment continues to be held for those 5 years;
    - any gain made on shares or securities issued subject to CITR should be free from capital gains tax on sale (subject to the shares /securities being held for a minimum period[13] and subject to maximum relief levels equivalent to EIS[14]);
    - reinvestment relief should apply to defer capital gains on disposal of assets where the proceeds are re-invested into CITR eligible investments; and
    - loss relief should apply to permit an investor to set losses on disposal of eligible CITR assets against taxable income, rather than against gains. Loss relief can be more important than relief on gains in the social/community sector.

- The monitoring and reporting burden of CDFI accreditation should be made more proportionate:
    - revising the onward investment rules which can create perverse incentives and poor quality investment decisions. Aggregate onward investing requirements should be relaxed, such as by removing the rules requiring onward investment of 25% by end of year 1 and 50% by end of year 2. The 75% requirement applying at end of year 3 could be retained, giving the CDFI greater flexibility about how it builds up to this threshold; and

[13] Currently 3 years under EIS.

[14] Currently the maximum level of EIS investment by an individual is £500,000 per year, with the ability to carry back the full allowance to the preceding tax year. Subject to state aid approval it is anticipated that legislation will be included in Finance Bill 2012 for the annual amount that an individual can invest under the EIS to increase to £1 million for shares issued after 5 April 2012.

- the clock should start ticking at the point of the CDFI receiving the investment rather than the point of accreditation of the CDFI, to bring it into line with other schemes.

- Simplifying and broadening the scheme:
  - the limits on CITR investment into a single CDFI over a 3 year period should be significantly increased;
  - consideration of how CITR investments could fall under the deposit guarantee scheme[15];
  - simplifying the definition of the requirement that a CDFI must be interested primarily in providing finance and access to business advice to "enterprises for disadvantaged communities". The criteria which requires that enterprise "are owned and operated by, or intended to serve, individuals recognised as being disadvantaged, on account of their ethnicity, gender, age, religious beliefs, disability or other defining characteristic." should be amended to instead cover those "owned and operated by, or intended to serve, individuals recognised as being disadvantaged or enterprises established for community or social benefit such as a charity, a community interest company, or community benefit society."

- Permitting onward investment by CDFIs into the following areas which currently are prohibited or restricted:
  - equity investment into charities, community benefit societies and Limited Liability Partnerships (LLPs) and other companies majority-owned by CICs, charities or community benefit societies;
  - investment by loan to profit-distributing enterprises where the loan exceeds £100,000 or is not subject to market interest rates and terms, where the enterprise is structured as a charity, CIC or community benefit society;
  - investment into residential housing, provided it is by way of investment into a registered provider of social housing registered as such with the Tenant Services Authority or a care home provider registered with the Care Quality Commission or similar regulators in the devolved administrations;
  - investments that are protected by the Enterprise Finance Guarantee Scheme and the National Loan Guarantee Scheme; and
  - loans to individuals by accredited CDFIs to be included as a qualifying investments.

[15] NB: Credit Union deposits fall under the Financial Service Compensation Scheme

Second, the Government should consider how equity or equity-like investment made directly into enterprises established for community or social benefit should be eligible for CITR, along the following lines:

- The meaning of "CITR"[16] would be extended to read: "entitlement to tax reductions in respect of amounts invested by [individuals or companies] in community development finance institutions or through equity or equity-like investment into enterprises established for community or social benefit".

- The eligible bodies capable of receiving CITR investment would be extended to include:

    - bodies accredited as CDFIs under ITA 2007;
    - registered charities;
    - Community Interest Companies registered with the CIC regulator;
    - Community Benefit Societies registered with the Financial Services Authority (or its successor); and
    - other company forms such as Companies limited by shares and Limited Liability Partnerships (LLPs) majority owned by the above registered charities, CICs or 'BenCom' societies.

- Direct investment of this type would entitle the investor to the same reliefs as those available for investment into a CDFI and would be subject to the same restrictions where applicable.

[16] Such as under section 333 Income Tax Act 2007 and section 218 Corporation Tax Act 2010.

The Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCT)

The schemes

The Enterprise Investment Scheme (EIS) is "designed to help smaller higher-risk trading companies to raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies." EIS is available to individuals only, for a minimum investment of £500 worth of shares in any one company in any one tax year.

The shares must generally be held for three years from the date the shares were issued. Any gain on disposal is free from Capital Gains Tax. If the shares are disposed of at a loss, the amount of the loss, less any Income Tax relief given, can be set against income of the year in which they were disposed of, or any income of the previous year, instead of being set off against any capital gains.
Although the EIS has contributed to attracting investment into some social ventures, particularly into community-owned environmental energy products with an industrial and provident society (IPS) structure, it is best suited to ventures that more closely resemble commercial enterprises. Many social ventures have a legal structure that does not permit the issuing of shares, and therefore they cannot benefit from EIS investment.

Another tax incentive for mainstream enterprise is the Venture Capital Trust (VCT) scheme. The scheme allows investors to set 30% of the cost of shares in a VCT against individual income tax liability, as well as relieving the income tax burden on dividend income. Its use for investment in social ventures has been limited. Apart from in the area of renewable energy, VCT investment into social enterprises has been non-existent.

A new scheme from 2012 – the Seed Enterprise Investment Scheme (SEIS) – will be focused on "smaller, early stage companies carrying on, or preparing to carry on, a new business".

Limitations to the schemes

In its Autumn Statement on 30 November 2011, the Government announced a number of proposed changes to the Enterprise Investment Scheme (EIS) and the Venture Capital Trust (VCT) scheme to be included in the forthcoming Finance Bill. This included the launch of the Seed Enterprise Investment Scheme (for those investing up to £100,000 in shares in a start-up business) and other amendments.

These changes reinforced the way in which the schemes, including SEIS "will only be available for investment via equity investments". Many social enterprises do not have a share capital, meaning that they cannot benefit from EIS/VCT in the same way as other companies.

Furthermore, businesses with majority ownership by another business are excluded, which restricts charities' social enterprise trading arms' ability to raise risk capital whilst continuing to safeguard their social mission. Individuals, however, can remain majority owners in an EIS or VCT investee company.

Recommendations

We propose that the Government should amend and simplify the EIS, VCT and SEIS schemes to ensure their applicability for social ventures as follows:

- Genuine risk capital for social enterprise in the form of equity-like capital which exhibits characteristics more akin to equity than debt should qualify for EIS relief (as being equivalent to relevant shares under EIS rules) and should qualify within the 70% qualifying holdings requirement for the purposes of VCT relief. We would suggest a definition of equity-like investment for social enterprises along the following lines: "Instruments or arrangements whose return for the investor or holder is predominantly based on the performance of the investment recipient and are unsecured in the event of default". The provisions should have effect only where investment is into a Charity, a Community Interest Company, or a Community Benefit Society or other vehicle majority owned by the above.

- Alternatively for VCTs, Government should look to relax the minimum equity component in each qualifying investment if the investee company is a charity, a Community Interest Company, or a Community Benefit Society.

- Ensuring that any other rules or forthcoming changes to the schemes do not accidentally discriminate against social ventures.

- For SEIS, consideration of how syndicates and institutions interested in investing in early stage social enterprises may meet the scheme's criteria; and ensuring the rules on directors do not discriminate against regulated enterprises (such as charities) whose trustees are bound by other regulation.

- The following trades as carried on by an EIS/VCT investee company should not be excluded from EIS/VCT where the investee company is an asset locked and regulated body e.g. a charity, Community Interest Company or Community Benefit Company:
    - dealing in land or financial instruments;
    - financial activities such as banking, insurance, money-lending, debt-factoring, hire-purchase financing or any other financial activities;
    - property development, where the investee company has been established specifically to exercise rights of community ownership under the Localism Act 2011 (or equivalent in the devolved administrations);

- farming and forestry;
- operating or managing nursing homes, residential care homes or social housing, or managing property used as a nursing home, residential care home or social housing, provided the investee is registered with the Tenant Services Authority or Care Quality Commission (or equivalent); and
- leasing or letting assets, where the investee company has been established specifically to exercise rights of community ownership under the Localism Act 2011, or where the relevant assets are used as nursing homes, residential care homes or residential social housing and the investee is registered with the Tenant Services Authority or Care Quality Commission (or equivalent).

- The restriction under EIS/VCT requiring that the investee company cannot be controlled by another company should be amended in the case of companies majority owned by a charity throughout the investment period. This would allow charities to raise risk capital to finance social enterprise trading subsidiaries whilst safeguarding their mission.

- Reconsidering how Industrial and Provident Societies (IPS) share capital could qualify with regard to withdrawable shares, for example, which may not be withdrawn during the investment period or at no guaranteed value.

- Government should ensure that the development of the SEIS scheme does not discriminate against social ventures. This includes:

  - the same issues as outlined above in regard to equity-like investment;
  - removing the unnecessarily restrictive limit to 'pre-trading';
  - consideration of how syndicates and institutions interested in investing in early stage social enterprises may meet the scheme's criteria; and
  - ensuring the rules on directors do not discriminate against regulated enterprises (such as charities) whose trustees are bound by other regulation.

Other Issues

We also propose that the Government should undertake a longer-term, strategic and more fundamental review of the tax code to ensure its suitability, simplicity and fairness for encouraging growth of investment in social ventures. This should address other issues which contribute to the failure of the current tax regime to adequately incentivise investment in social ventures, including:

- How to incentivise the investment of more of the c. £100bn of capital held by trusts and foundation in social ventures, such as:
  - enabling trusts and foundations to receive a similar benefit which others do through the CITR scheme;
  - reinstating Advance Corporation Tax (ACT)[17] relief for asset locked regulated investees of foundations and pension funds; and
  - exploring the scope for a 'transferable tax credit' for trusts and foundations to incentivise others to invest alongside them in asset locked regulated social ventures.

- Working with social investment intermediaries and the investor community, such as pension funds, to improve transparency and understanding of the available tax incentives and existing social investment activity.

- Learning from the experience of Gift Aid reform and other tax reliefs how administration could be simplified.

- Particular consideration of:
  - how special purpose social investment vehicles might be exempted from tax;
  - how a tax relief for social entrepreneurs could compensate for their inability to exploit capital gains relief upon disposal of a business;
  - how securities issued by Industrial and Provident Societies (IPS) may qualify under the ISA regime;
  - how Gift Aid applied to gifts in the form of interest foregone could be claimed more cost effectively; and
  - how other hybrid/structured investments can exploit tax reliefs most effectively.

[17] NB: The reinstatement of ACT relief is a stated long-term objective of the current Chancellor of the Exchequer.

Summary of Recommendations

1. The Government should improve the attractiveness of the existing CITR regime in respect of investment into CDFIs as follows:

    - The level and type of tax relief available under CITR should be comparable with the relief available under EIS or VCT.
    - The monitoring and reporting burden of CDFI accreditation should be made more proportionate.
    - Simplifying and broadening the scheme, including increasing investment limits and simplifying qualifying definitions.
    - Permitting onward investment by CDFIs into areas which currently are prohibited or restricted.

2. The Government should consider how equity or equity-like investment made directly into enterprises established for community or social benefit should be eligible for CITR[18].

3. The Government should amend and simplify the EIS, VCT and SEIS schemes to ensure their applicability for social ventures as follows:

    - Genuine risk capital for social enterprise in the form of equity-like capital which exhibits characteristics more akin to equity than debt should qualify for EIS relief and within the 70% qualifying holdings requirement for the purposes of VCT relief.
    - For VCTs, Government should look to relax the minimum equity component in each qualifying investment if the investee company is a charity, a Community Interest Company, or a Community Benefit Society.
    - Ensuring that any other rules or forthcoming changes to the schemes, including SEIS do not accidentally discriminate against social ventures.

[18] While the Community Development Finance Association (cdfa) supports the aims, conclusions and wider recommendations of the Commission, it should be noted that they refrain from endorsing this particular recommendation.

- Amending the excluded trades where the investee company is an asset locked and regulated body e.g. a charity, Community Interest Company or Community Benefit Company:

- The restriction under EIS/VCT requiring that the investee company cannot be controlled by another company should be amended in the case of companies majority owned by a charity throughout the investment period.

- Reconsidering how IPS share capital could qualify with regard to withdrawable shares, for example, which may not be withdrawn during the investment period or at no guaranteed value.

4. We also propose that the Government should undertake a longer-term, strategic and more fundamental review of the tax code to ensure its suitability, simplicity and fairness for encouraging growth of investment in social ventures. This should address other issues which contribute to the failure of the current tax regime to adequately incentivise investment in social ventures, including:

- How to incentivise the investment of more of the c. £100bn of capital held by trusts and foundation in social ventures.

- Working with social investment intermediaries and the investor community, such as pensions funds, to improve transparency and understanding of the available tax incentives and existing social investment activity.

- Learning from the experience of Gift Aid reform and other tax reliefs how administration could be simplified.

- Particular consideration of:
  - how special purpose social investment vehicles might be exempted from tax;
  - how a tax relief for social entrepreneurs could compensate for their inability to exploit capital gains relief upon disposal of a business;
  - how securities issued by Industrial and Provident Societies (IPS) may qualify under the ISA regime;
  - how Gift Aid applied to gifts in the form of interest foregone could be claimed more cost effectively; and
  - how other hybrid/structured investments can exploit tax reliefs most effectively.

Annexes

Annex A – Changes to one scheme or another?

The amendments suggested above to CITR would move it some of the way towards equivalence with EIS/VCT in terms of the extent of the relief and the ability for community and social enterprises to benefit from that relief.

However, it is necessary also to amend EIS and VCT in order to level the playing field for social ventures. We maintain that changes to one scheme do not entirely render changes to the other unnecessary. It is necessary to amend both. EIS and VCT support equity / risk capital investment. CITR primarily supports lending by CDFIs. These are two different activities.

Even if EIS and VCT were clarified to include risk capital in the form of equity-like investment which exhibits characteristics more akin to equity than debt ("where return is predominantly based on the performance of the investment recipient and are unsecured in the event of default") as qualifying investments, while this would be an important step, CITR would still remain too restrictive for lending e.g. qualifying trades are too narrow, monitoring and reporting burden too onerous, investment limits too low, etc.

Conversely, even if CITR was improved to make it more effective, changes to EIS / VCT would still be necessary as CITR is not as attractive as EIS / VCT in terms of the degree of tax relief it offers; and does not allow onward equity investment by CDFIs except in CICs. So investment in, for example, majority charity-owned LLPs or CLSs would still fall between the cracks.

If CITR was revamped to offer a greater incentive AND allow equity investment in a wider range of vehicles, that would make changes to EIS/VCT less pressing. However, as CITR is less visible to investors than EIS and VCT and does not allow direct investment of the type facilitated by EIS; and as long as EIS and VCT continue to discriminate against investment in social ventures, there is a problem.

It may be the case that CITR reform is the most achievable objective in the short to medium term, as the Government is committed to re-notify CITR to the European Commission and "consult... on how the scheme can be made more effective".[19] CITR is also a more specialist tax relief and perceived in some parts to be 'of the sector' so the sector's views may carry more weight in considering proposed changes. EIS/VCT are subject to a much wider range of vested interests.

However, EIS/VCT have some advantages over CITR which would continue to exist even if all of the changes to CITR suggested in this note were implemented. So we are still recommending changes to EIS/VCT to improve the availability of those reliefs to social enterprises (even if some suspect these changes are less likely to be seriously considered by Government in the short to medium term) in the hope of moving in time towards a tax regime more relevant to those enterprises which contribute directly both to the country's financial and social wellbeing.

[19] HM Treasury, *Budget*, 2011, paragraph 2.39.

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Annex C – Thanks and Acknowledgements

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