CHARTERED ACCOUNTANTS

# Social investment tax relief

Information

## Overview

The fact that 35% of all social enterprises are 3 years old or less, according to the State of Social Enterprise Survey 2015, shows that this is an area of the UK economy which is booming. These types of start-ups are outstripping the all-for-profit sector, by 3 to 1 compared to newly incorporated SMEs in the last 3 years.

Whilst new all-for-profit companies have been able to attract venture capital investment through tax efficient schemes such as the Enterprise Investment Scheme (EIS) for a number of years, the Government recognised the lack of such schemes in the tax system for social enterprises by introducing Social Investment Tax Relief (SITR) in the Finance Act 2014, proclaiming this to be the first of its kind in the world.

The Relief's objective is to encourage private investment to plug the gap in funding that commercial investors and lenders were unwilling to supply to trading ventures with social objectives.

For investments which qualify under the scheme, an investor's tax liability for the year is reduced by 30% of the eligible investment to a minimum of nil. However, it cannot create a tax refund.

## When does it apply from and to?

SITR applies to eligible investments by eligible investors to eligible organisations made on or after 6 April 2014. There is a sunset clause contained in the legislation whereby the scheme will end on 5 April 2019. The Treasury has the power to extend this time limit.

## Who is an eligible investor?

In order to qualify as an eligible investor, an individual investing in a social enterprise must:

- Be an individual
- Pay tax in the UK but does not necessarily need to be UK resident
- Must not own (together with personal associates) more than 30% of the social enterprise's ordinary share capital, voting rights or loan capital
- Personal associates are spouses, parents, grandparents, children, grandchildren, business partners or the trustees of any settlement where the investor or investor's relatives are a settlor or beneficiary and does not include brothers, sisters, aunts, uncles and cousins
- Must not be employed by the social enterprise, its subsidiaries or linked companies
- Must not (generally) be a paid director within one year before and three years after the investment date

## What is an eligible investment?

There are two types of investment which qualify for SITR purposes: newly issued shares or new debt in a social enterprise.

Any shares must be subscribed for wholly in cash and be fully paid up at the time of issue. HM Revenue & Customs (HMRC) looks at the principle of 'paid up' very closely when it comes to shares qualifying for tax efficient investments. Broadly, on the same day that the money is credited to the social enterprise's bank account, the shareholder needs to be entered into the Register of Members. The Share Certificates need to be dated the same day, along with the corresponding Return of Allotment of Shares to be filed with the Registrar. We would always advise that a solicitor is engaged to carry this out. The administrative requirements for the issue of shares may differ depending on the type of entity; see more on the structures for social enterprises below.

The shares cannot be preferential and must not rank above any other shares in the social enterprise in the event of winding up.

Any debt must be unsecured and with no charge over the assets of the social enterprise. An investor will need to consider their level of lending compared to any loans made by other lenders, in order to ensure their loan would not exceed 30% of the total loan capital.

The debt must rank equally to any other unsecured debts, which should be subordinate to preferential debts owed by the social enterprise, and shares must also rank no higher than the lowest ranking share capital. Effectively, the investor should not be able to retrieve their money ahead of other lenders and shareholders, should the social enterprise fail. We would recommend that the ranking is expressly stated in a formal instrument of debt, Articles of Association etc to ensure that it meets the conditions.

It is important to note that any return on investment must not exceed a reasonable commercial rate. For this purpose, the return would need to be compared to interest rates on unsecured lending offered by commercial banks or building societies, or to dividend yields for a similar sector.

Furthermore, the investor must not receive any value from the social enterprise at the time and in the period after the investment is made, i.e. release of any debts owed by the investor, loans of money to the investor, provision of any benefits, facilities or services to the investor at below market rates.

There should also be no arrangements in place to protect or guarantee the investment in the event the social enterprise fails, nor any loans from the enterprise, or connected persons, other than ordinary commercial bank loans to assist the investor in making the investment.

**What is a social enterprise for SITR purposes?**

Broadly, investments into the following structures qualify for SITR:

- Registered charities (includes charitable companies or trusts)
- Community Interest Companies (CIC)
- Community Benefit Societies (CBS)
- Accredited Social Impact Contractor (SIC)

A CIC is a company with primarily social objectives rather than its main aim being the drive to maximise profit for shareholders, although shareholders can be entitled to a return on their investment. Any profits are mainly either returned to the community or reinvested back into the business. Essentially, CICs use business solutions to serve a social or environmental need. CICs are not eligible to register for charity status with the Charity Commission.

A CBS has the structure of a corporate entity, with members and external shareholders. The business is conducted for the benefit of the community, which is where profits are returned to and not to its members, although CBSs do have the power to pay interest on capital.

A SIC is a new concept in the management of public finances. A government body wanting to expediently deliver a new public service will approach private and third sector investors to put up the initial capital (Social Impact Bond) to fund a project which is carried out by a SIC. The Government will then measure the outcomes of the new service provided by the SIC and pay the investors a return based on the results and performance of the service.

**What is an eligible organisation?**

In order for an organisation to be eligible for the purposes of SITR, not only must it operate in one of the above mentioned structures, it must also:

- Be unquoted i.e. not listed on a recognised stock exchange
- Not be under the control of another company at the time of investment and three years after
- Have fewer than 500 employees at the time of investment
- Only have subsidiaries which are qualifying (for this purpose any subsidiary should be at least 51% owned by the social enterprise)
- Must not be a member of any partnership
- Not have more than £15 million in gross assets immediately before the investment and £16 million in gross assets immediately after
- Carry on a qualifying trade (excluded trades include dealing in shares, lending money – apart from to other social enterprises, insurance, property development, fishing, production of agricultural products, export of electricity, haulage) at the time of investment and three years after

The trading requirement does not apply to SICs and if the social enterprise is a charity, this requirement will be deemed to have been met.

For CICs and CBSs, no substantial investment activities must be carried on.

The organisation itself must not receive more than €344,827 (approx. £266,000 at EURGBP 1:0.77) in government subsidies over a three year period; this includes the social investments themselves. The exact Sterling equivalent is the spot exchange rate on the date of investment. The Government, however, applied to the European Commission for State Aid Approval in January 2015, which once approved, will mean that social enterprises can benefit from up to £5 million of tax efficient social investments per annum (£15 million in total).

All of the money raised from social investments must be used for a qualifying trade of the social enterprise or a qualifying 90% owned subsidiary within 28 months (24 months for SICs). Any insignificant use for other purposes is ignored.

**How is an eligible investment certified by HMRC?**

The social enterprise must submit a Compliance Statement to HMRC declaring that it meets the requirements of the scheme before investors can claim SITR.

Trading must have been carried on for at least 4 months before a Compliance Statement can be submitted.

Once HMRC has accepted that the social enterprise meets the conditions, it will then be authorised to issue Compliance Certificates to the investors to enable them to claim the relief.

**What is the rate of Income Tax relief?**

Income Tax relief for qualifying social investments comes in the form of a 30% tax reducer.

You can make up to £1 million of social investments which qualify for tax relief each year. There is no minimum investment requirement. This limit is not affected by the equivalent limits for the Seed EIS, EIS and investments made under the Venture Capital Scheme.

Relief is given in the year that the qualifying shares or instruments of debt are issued. An investor can choose to carry back all or part of a qualifying social investment to the previous tax year to maximise tax relief across two years.

The time limit for claiming Income Tax relief is by the end of 5 years following 31 January after the tax year for which the relief is to be claimed.

One key condition of the scheme is that an investor must hold the shares or debt for at least 3 years after the date of investment. If the qualifying shares are sold or the debt is repaid, or the conditions of the scheme cease to be met, within this period, the Income Tax relief is withdrawn. Transfers to a spouse do not taint the 3 year holding qualification timeframe.

If the investment ceases to qualify for relief due to a disposal or the conditions failing to be met, an investor must notify HMRC within 60 days from the date of the event.

**What Capital Gains Tax reliefs are there?**

In the case of eligible shares, provided full Income Tax relief has been claimed on the investment and they have been held for at least 3 years, any capital gains will be exempt from tax.

Where a disposal of shares in a social enterprise gives rise to a capital loss, the loss is allowable to be relieved against other capital gains, regardless of whether the shares are disposed within the 3 year period. The base cost of the shares, is however, reduced by any Income Tax relief given on the investment.

Disposals of social enterprise debt at a profit are generally exempt from Capital Gains Tax, as they are regarded as Qualifying Corporate Bonds (debentures which are expressed in Sterling and cannot be converted into another currency).

In the year that an investor makes a social investment qualifying for Income Tax Relief, the investor can defer any capital gains arising on another asset of any kind in the same tax year, to the extent that this gain is reinvested under the SITR. This effectively freezes the gain until a chargeable event occurs.

A chargeable event happens when the social investment is disposed or the social enterprise ceases to meet the requirements of the SITR scheme. The death of an investor is not a chargeable event.

The investor must be resident in the UK for tax purposes when the gain to be deferred accrues and at the time that the social investment is made. Also, the reinvestment must take place within one year before and three years after the gain arising.

The amount of capital gain which can be deferred is the lower of:

- The capital gain itself
- Amount invested in social enterprise
- Amount specified

An investor may wish to specify a particular amount in order to utilise any unused Capital Gains Tax Annual Exemption or capital losses.

The same 5 year time limit applies for claiming Capital Gains Tax Reinvestment Relief as for the SITR.

For further information or assistance, please contact Andrew Scott on andrew.scott@ensors.co.uk.

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