BIG SOCIETY CAPITAL

GET SITR
A tax break for charities and social enterprises

SOCIAL INVESTMENT TAX RELIEF

PROPOSED CHANGES TO THE RULES IN 2017

June 2017

For more information and resources on SITR, please visit www.bigsocietycapital.com/sitr.

This note has been prepared to help provide some further clarity around which property transactions can and can't qualify for SITR, as we understand many have asked questions about this. The note has been prepared for information purposes only and does not constitute legal advice.

INTRODUCTION

Social Investment Tax Relief (or “SITR”) was introduced in 2014, to offer tax reliefs on investments, by way of shares or loans, into social enterprises. The legislation setting out the criteria for SITR was based on the legislation for investments under the Enterprise Investment Scheme but with a few key differences.

Some material changes (the "**2017 Rule Changes**") were proposed to SITR in the Chancellor's 2016 Autumn Statement, and the Budget in March 2017. Draft legislation to enact the 2017 Rule Changes was published as part of the Finance Bill. As a result of calling the General Election in June the Government ran out of time, so those amendments are on hold. But it is widely assumed that the 2017 Rule Changes will be made after the election, and will be backdated so that they apply to all investments made after 5 April 2017.

In this note we will explain the 2017 Rule Changes. If you want to know about the SITR rules as they currently stand please click here.

OVERVIEW

Here is a summary of the 2017 Rule Changes:

- The cap on the amount that a social enterprise can raise under SITR will be raised from around £290K to £1.5m. But this will be a lifetime cap and will (with certain exceptions) be targeted at social enterprises that have been trading for less than seven years
- Certain trades will be excluded from SITR, namely:
  - Leasing or letting assets on hire
  - Receiving royalties or licence fees
  - Operating or managing nursing homes or residential care homes
  - Generating electricity, heat or other forms of energy or producing gas or fuel
  - Lending money to other social enterprises
- Social enterprises will not be able to use SITR funding to repay existing loans
- An individual who already holds investments in a social enterprise may not be eligible to invest further monies into that social enterprise under SITR
- A social enterprise that is in "financial difficulty" may not raise funding under SITR
- A social enterprise that has the equivalent of 251 or more full time employees will not be eligible to raise SITR funding
- New anti-avoidance rules will mean that SITR is not available for investments made under certain arrangements that HMRC regard as "artificial"

In the rest of this note we'll explain each of these proposed changes in a little more detail.

The new £1.5m limit

As the SITR rules currently stand, a social enterprise can raise up to around £290K in any rolling three year period (the "**£290K limit**") We say "around" £290K because the cap is calculated by reference to the exchange rate with the euro, and also the rate of UK capital gains tax. So it fluctuates.

Any “de minimis” State Aid received by the social enterprise during the previous three years (including any previous SITR funding) will count towards that £290K limit.

However under the 2017 Rule Changes a new higher limit will be introduced. A social enterprise will be allowed to raise up to £1.5m under SITR over its lifetime (the "**£1.5m limit**").

However there are two key restrictions on this new £1.5m limit:

- First, it is only available for social enterprises that have been trading for less than seven years (the "**seven year rule**"). Social enterprises that have been trading for more than seven years will remain subject to the £290K limit
- Secondly, any “risk finance state aid” previously received by the social enterprise will count towards that £1.5m limit.

Let's look at each of those two key restrictions in turn:

The seven year rule

As mentioned, a social enterprise can only raise SITR funding in excess of the current £290K limit if that social enterprise made its first commercial sale less than seven years before the date the SITR investment is made.

The seven year period starts to run from the date of the first “commercial sale” i.e. the first sale by the social enterprise on a product or service market, excluding limited sales to test the market.

If the social enterprise is an accredited social impact contractor, the date of the first commercial sale is taken as the date on which the social impact contract was entered into.

The position gets more complex if the social enterprise raising SITR has (or has historically had) subsidiaries, or has at any time in the past acquired a trade or business from a third party. If that is the case, when working out whether or not a social enterprise is within the seven year rule, the seven year period starts on the earliest first commercial sale made by:

- the social enterprise that is raising SITR funding,
- each current subsidiary i.e. each company that is a subsidiary on the date the SITR investment is made,
- each former subsidiary i.e. each company that has at some time in the past been, but is no longer, a subsidiary, and
- the previous owner of any business or trade that may have been acquired (even if that acquired business or trade has been amalgamated with other trading activities or has ceased trading or has been transferred out of the group).

There is an exception to this seven year rule for so-called “follow on investments” – in other words, a social enterprise that has been trading for more than seven years can still raise SITR up to the new higher £1.5m limit where:

- the social enterprise that is raising SITR finance received some form of “risk finance state aid” within the seven years after its first commercial sale, [note that when applying this potential exemption you *cannot* take into account any risk finance state aid received by any other group company or enterprise] and

- some or all of that earlier funding was employed for the same qualifying trade that will benefit from the new SITR funding

This exception means that if a social enterprise raises SITR funding within seven years of making its first commercial sale it may (provided all SITR qualifying criteria are met) continue to raise further SITR funding after that seven year period has ended.

Risk Finance State Aid counting towards the £1.5m limit

As mentioned, when calculating the maximum amount that a social enterprise could raise under the new £1.5m limit, you have to deduct any risk finance state aid received at any point in the past.

In this context, “risk finance state aid” means:

- any investment where the investor was a venture capital trust, or
- any investment where the investor claimed tax relief under the Enterprise Investment Scheme, the Seed Enterprise Investment Scheme or claimed SITR, or
- any other form of state aid which is designated as “risk finance” under EU state aid rules relating to risk finance investments [unfortunately there is no list][1]

The position gets more complex if the social enterprise raising SITR has (or has historically had) subsidiaries, or has at any time in the past acquired a trade or business from a third party. If that is the case, when working out how much SITR funding the social enterprise can raise under the new £1.5m limit, you have to deduct any “risk finance state aid” received by

- any current or former subsidiary, and
- any business or trade that may have been acquired (even if that business or trade has been amalgamated with other trading activities or has ceased trading)

However where subsidiaries or businesses have been transferred out of the group, you can ignore risk finance state aid received by that former subsidiary or business *after* it was transferred out of the group.

Examples

Let’s look at a few examples to explain how this works in practice. In each example we’ll look at:

- whether or not the social enterprise can benefit from the new higher £1.5m cap lifetime cap on SITR fundraising, and
- the maximum amount that the social enterprise could raise under SITR if the social enterprise qualifies to take advantage of the new £1.5m limit

Example 1

Facts:

A community benefit society operates a bakery. It has never had any subsidiary or acquired any other trade or business. It has never raised any previous risk finance state aid. It sold its first loaf

[1] The full definition is” “any aid (whether by way of investment, loan, grant funding or otherwise) which was received by the recipient pursuant to a measure approved by the European Commission as compatible with Article 107 of the Treaty on the Functioning of the European Union in accordance with the principles laid down in the European Commission's Guidelines on State aid to promote risk finance investment (as those guidelines may be amended or replaced from time to time)”

of bread to a customer on 5 January 2006. It now wants to raise £500K by way of a community share issue to investors who want to claim SITR.

Outcome:

It can't benefit from the new £1.5m limit. It made its first commercial sale more than seven years ago. So it remains subject to the current £290K limit

Example 2

Facts:

Same facts as example 1, except that the social enterprise sold its first loaf of bread on 5 January 2012.

Outcome:

It can benefit from the new £1.5m limit. It made its first commercial sale within the last seven years. As the social enterprise has never received any risk finance aid in the past, and has never owned a subsidiary or any other business, it can raise up to the full £1.5m under SITR.

Example 3

Facts:

Same facts as example 1, except that on 1 April 2012, the community benefit society raised £150,000 by way of a share issue in order to refurbish its kitchens and buy new bread ovens. The investors claimed EIS relief on their investments.

Outcome:

It can benefit from the new £1.5m limit. It made its first commercial sale more than seven years ago. However it received some risk finance state aid (an EIS investment) within the first seven years after the date of the first commercial sale. And the new fundraising will be employed in growing the business that benefitted from that original EIS funding. So it falls within the exemption for "follow on investments".

However, as the social enterprise has already received £150,000 of EIS investment (which is risk finance state aid) the maximum amount that it can now raise under SITR is reduced to £1,350,000 (i.e. £1.5m less the £150K EIS investment already received).

Example 4

Facts:

Same facts as example 3, except that we are told that the community benefit society has recently acquired a wholly owned subsidiary that operates a small delicatessen. That subsidiary opened its first shop on 5 March 1999. The subsidiary will not benefit from any of the new SITR fundraise.

Outcome:

It can't benefit from the new £1.5m limit and does not qualify under the exemption for follow-on investments, because:

- By buying that subsidiary, the first commercial sale of the community benefit society is now deemed to be 5 March 1999 i.e. the earlier of:
    - 5 January 2006 (the date the community benefit society made its first "commercial sale"), and

    - 5 March 1999 (the date the subsidiary made its first "commercial sale")

- The EIS fundraise took place more than seven years after the date of that first commercial sale.

And beware of a potential trap here.

If a social enterprise raises SITR under the new £1.5m limit, there may be an issue where:

- The social enterprise qualified for SITR on the basis it has been trading for less than seven years,
- Within three years after the SITR investment was made, that social enterprise acquires a business or subsidiary (the "**newly acquired business**"), and
- Any of the SITR funding originally raised by the social enterprise is applied for the benefit of that newly-acquired business.

In these circumstances:

- If the newly acquired business made its first commercial sale more than seven years before the social enterprise raised SITR funding, the social enterprise is deemed, retrospectively, to have breached the seven year rule – meaning tax relief for SITR investors will be withdrawn
- Any risk finance state aid previously received by the newly acquired business is now counted towards the £1.5m limit – so if, for example, the newly acquired business had already received £1.5m of risk finance state aid before it was acquired, the social enterprise is deemed, retrospectively, to have breached the £1.5m limit – meaning tax relief for SITR investors will be withdrawn

This means that any social enterprise that raises SITR funding and then in the following three years goes on to acquire other companies or trades will need to make sure that it will not inadvertently (and retrospectively) breach the new seven year rule and/or the £1.5m limit.

One final point to note. If a social enterprise cannot satisfy the seven year rule then the maximum amount that it can raise under SITR is restricted to the current £290K limit. However even those social enterprises will remain subject to the £1.5m limit. So all social enterprises raising SITR funding (even if they are within the £290K limit) must also make sure they satisfy the lifetime caps under the £1.5m limit.

The 250 employee limit

Under the SITR rules as they currently stand, a social enterprise cannot raise funding under SITR if the total number of employees, on a full time equivalent basis, of the social enterprise and all subsidiaries is greater than 500.

Under the 2017 Rule Changes that 500 FTE employee limit will reduce to 250.

Financial Health

Under the 2017 Rule Changes, a social enterprise will not be eligible to raise SITR funding if it is in "financial difficulty".

A social enterprise is 'in difficulty' if it is reasonable to assume that it would be regarded as 'a firm in difficulty' for the purposes of the European Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty (2004/C244/02).

Those guidelines are lengthy (too lengthy to summarise in this note). You can see a little more detail in HMRC's manuals (VCM55050).

However HMRC have accepted in their guidance that whether it is 'reasonable' to assume a company is 'in difficulty' in this context might be open to interpretation. So HMRC will not regard a social enterprise as falling within the scope of this restriction if at the date of the SITR investment either:

- The social enterprise is within the first three years of operations in the relevant field of activity and/or
- The social enterprise has been able to raise funds from its existing shareholders or from the market sufficient to meet its anticipated funding requirements at that time.

Excluded Trading Activities

Any trade can be supported with SITR funding unless it is on the list of excluded activities.

Under the 2017 Rule Changes a number of trading activities will be added to the list of excluded activities, meaning that a social enterprise carrying on one or more of those activities may not be eligible to raise SITR funding.

The newly-excluded trades are:

- Money lending

Under current rules, making loans to other social enterprises that are eligible for SITR would be allowed. However this exception is being removed by the 2017 Rule Changes.

- Leasing or letting assets on hire

This covers any trading activity which consists in allowing the customer the use of the social enterprise’s property. Examples are television rental, video hire and the provision of self-storage warehousing facilities. It applies where, subject to reasonable conditions imposed by the social enterprise, the customer is free to use the property for the purpose for which it is intended.

- Generating license fees or royalties

Royalties or licence fees will be received where property rights of certain kinds are exploited by granting permission to others to make use of that property – for instance software.

But HMRC accept that there will be cases where, although the ‘sales’ are made under licence, the receipts are nevertheless consideration for the supply of goods - for example, the retailing of CDs.

The restriction on receiving licence fees may affect social enterprises that trade by providing sports and leisure facilities. Here is what HMRC say about this[2]:

“*At one extreme, a simple activity of making sports facilities available to the general public, with no provision of services, would consist of little more than charging a fee in return for the right to use property. This would be an activity of receiving licence fees. But such a situation would be exceptional. A more commonly encountered activity might be operating a health club which provides a high level of services, including active supervision and advice from qualified staff. Here the licence to enter the premises and use the equipment would be merely incidental.*

In some cases where fees for admission are received, while there is no direct provision of services to customers, continuous work is required to keep the property in a fit state for use by them. The main question to be considered in any such case is the extent to which the fees relate to the cost of such work.”

- Nursing homes or residential care homes

The 2017 Rule Changes will exclude operating or managing nursing homes or residential care homes or managing property used as a nursing home or residential care home. So this goes wider than ownership of such homes, but applies only where the social enterprise occupies the premises or has some legal interest in them.

A “nursing home” means any establishment which exists wholly or mainly for the provision of nursing care for either:

- The sick, injured or infirm, or
- Women who are pregnant or who have given birth.

A “residential care home” means any establishment which exists wholly or mainly for the provision of residential accommodation, board and personal care for those who need such care because of:

- Old age,
- Mental or physical disability,
- Past or present dependence on alcohol or drugs,
- Any past illness, or
- Past or present mental disorder.

HM Treasury have suggested that they will, in due course, introduce a system for accrediting nursing homes and residential care homes in order to make them eligible for SITR investment. However we have no guidance as to what the criteria for accreditation will look like.

[2] See HMRC Tax Bulletin 54 (August 2001)

- The generation or export of electricity or other forms of energy

This change will prohibit SITR funding being raised to support generating or exporting electricity, making electricity generating capacity available, generating heat, generating any other form of energy and producing gas or fuel.

Disqualifying Arrangements – new anti-avoidance rule

The investment cannot be part of so-called “disqualifying arrangements”. This is aimed at artificial deal structures under which either more than half of the money invested is paid out to the benefit of a third party, or where trade might be expected to be carried on by some other party to the arrangements.

Under this requirement HMRC will consider whether the purpose of the arrangements is to “artificially” create an activity or the appearance of an activity which will qualify for SITR. Examples might include (without necessarily being limited to):

- cases where a business appears to be fragmented in a way which is commercially unusual with the result that there is a company which (apart from this test) meets the qualifying conditions for SITR,
- cases where a transaction which would normally be expected to be between two parties, involves three (or more) parties, where the additional party is a social enterprise which (apart from this test) meets the qualifying conditions for SITR, or
- cases where the economic substance of the activities of a social enterprise appears to be at odds with its form (for instance, where contractual arrangements appear designed to generate an outcome similar to a lending or credit facility whilst the contracts are not immediately obviously loan or credit contracts in legal form).

SITR Investors must be “independent”

Under the 2017 Rule Changes, an SITR investor must be “independent” of the social enterprise in which he or she is investing.

That means he or he cannot have an existing investment (by way of shares or debt) in the social enterprise unless either:

- If the existing investment was made by way of a loan, the investor has claimed tax relief on the whole of that loan under SITR, or
- If the existing investment was made in shares, either:
  - the investor has claimed tax relief on the whole of that investment under SITR or under Seed EIS or EIS; or
  - the shares are “permitted subscriber shares” i.e. the shares were either:
    - issued to that individual at incorporation of the social enterprise, and have been continuously held by that individual ever since, or

  - acquired by that individual at a time when:
    - the only shares in issue in the social enterprise were the original “subscriber shares” and
    - the social enterprise had not yet begun to carry on a trade or make preparations for carrying on a trade.

Ban on SITR monies being used to refinance or repay existing loans

When SITR was introduced, a number of social enterprises raised SITR funding in order to refinance existing loans. This often enabled them to reduce costs (as the rate of interest payable under SITR loans may have been lower) and/or create breathing space before the enterprise had to start repaying the debt (as SITR loans are not repayable at all within the first three years).

However under the 2017 Rule Changes it will not be possible to apply any monies raised under SITR in repaying existing loans.