Alternative loan structure for charities with subsidiaries

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1. BACKGROUND

1.1 Social Investment Tax Relief ("**SITR**") was introduced in 2014 to allow tax relief on investments, by way of shares or loans, into certain forms of social enterprises, including charities.

1.2 The SITR legislation allows qualifying social enterprises to raise funding that will be employed in the trading activities of a subsidiary, provided the subsidiary is a "90% social subsidiary"[1], and the monies raised will be employed in a qualifying trade.

1.3 Charities that raise debt funding for use by a 90% social subsidiary face issues that act as a deterrent to raising SITR finance.

1.4 This note explains those issues, and suggests a way in which SITR-qualifying loans might be structured in order to mitigate that problem and, hopefully, result in increased uptake of SITR by charities with trading social subsidiaries.

2. THE ISSUE

2.1 If a social enterprise is a 90% social subsidiary of a charity, it cannot raise SITR investments directly from third party investors.

2.2 This is because of the so-called "independence requirement"[2] which requires that a social enterprise raising SITR funding cannot be a subsidiary of, or controlled by, another company or corporate body.

2.3 Which means that where a subsidiary of a charity wishes to raise funding to develop its trading activities, the parent charity must:

2.3.1 raise the funding directly from investors, and

2.3.2 then on-lend the cash to the subsidiary.

[1] s.257MV ITA 2007

[2] s.257ME ITA 2007

2.4 However, charities are reluctant to take on any form of borrowing to fund the activities of trading subsidiaries.

2.5 There are two main reasons for this:

2.5.1 charity law, and

2.5.2 solvency risks

2.6 Charity Law

2.6.1 Under the Charities Acts, charities may only carry on trading activities if the trading is so-called “primary purpose” i.e. the trading activity is consistent with its charitable objects and aims.

2.6.2 As a result, most charities that carry on trading activities will incorporate one or more wholly-owned trading subsidiaries.

2.6.3 However, a charity must exist solely for the purposes of carrying out its charitable objects. Meaning that charities are restricted from providing any material support to subsidiaries that are not also charities.

2.6.4 Which, in turn, means that a charity’s trustees may have some difficulty in persuading themselves that it is within their rights and obligations as charitable trustees to raise monies for the purposes of on-lending those monies to trading subsidiaries. This is particularly the case where the charity raising the funding by way of loans[3] bears the risk of loss.

2.7 Solvency Risks

2.7.1 Charity trustees are under a duty to ensure that their charity is run prudently, and that charitable assets are safeguarded.

2.7.2 This inevitably means that charity trustees are (quite rightly) risk-averse.

[3] charities cannot raise SITR funding by way of issue of shares

2.7.3 However, if the charity raises SITR funding and then on-lends the funding to its 90% social subsidiary, the charity remains liable to repay that debt to investors irrespective of whether or not the subsidiary is able to repay.

2.7.4 In other words, the charity takes on a solvency risk in respect of the activities of its subsidiary – if the activities of the subsidiary fail, then other charitable assets must be employed to repay the SITR loans.

2.7.5 Many charity trustees regard this as a risk they are unwilling to take.

3. POSSIBLE SOLUTION

3.1 We would construct a loan arrangement under which:

3.1.1 a charity raises SITR loan investments ("**SITR Loans**") from investors

3.1.2 the charity on-lends that money to its 90% social subsidiary by way of an intra-group loan (the "**Subsidiary Loan**") to support the qualifying trading activities of that subsidiary

3.1.3 the date on which the Subsidiary Loan is to be repaid matches the date on which the charity is liable to repay the SITR Loans

3.1.4 the SITR Loans provide that, if and to the extent that the 90% social subsidiary defaults in repaying the Subsidiary Loan, the investors to whom the SITR Loan was issued cannot enforce their rights to repayment of the SITR Loans

3.2 In other words, the SITR Loans are "limited recourse loans" i.e. the right of investors to enforce repayment are limited by reference to the ability of the subsidiary to repay.

3.3 We would expect the documentation relating to the SITR Loans to include some sort of obligation on the charity to take reasonable endeavours to enforce its rights to repayment of the Subsidiary Loan – in the absence of such provisions it would be too easy for the charity to simply avoid its repayment obligations to investors.

3.4 Such a loan arrangement would have the following benefits:

3.4.1 the charity is insulated from the risk of its 90% social subsidiary being unable to repay, because if the subsidiary fails the charity cannot be compelled to repay the SITR Loans

3.4.2 this means that, under charity law, trustees are much more likely to be persuaded that the raising of the SITR Loans is within (and is not a breach of) their fiduciary duties, because other charitable assets are not put at risk

3.4.3 it actually *increases* (rather than mitigates) the risks that investors take in making the SITR Loans – given that the SITR legislation contains a number of key features to ensure that tax relief is afforded only where genuine risk is being taken by investors, such an arrangement would be entirely within the spirit, as well as the letter, of the SITR legislation.

4. EXAMPLE

4.1 Let’s take the following scenario as an example:

4.1.1 AB is a registered charity targeting the rehabilitation of offenders upon leaving prison

4.1.2 CD is a community interest company with a share capital, that runs a café in Birmingham which employs, and trains, ex-offenders, giving them skills that allow them to get jobs in the catering industry, as well as a cv to offer potential employers

4.1.3 CD is offered a lease on new and bigger premises which will allow it to expand its operations, increasing income, profits, and the number of ex-offenders whom it can employ

4.1.4 CD needs £200,000 to fit out the kitchen of the new building to meet applicable health and safety legislation

4.1.5 AB therefore issues £200,000 of loan notes (the "**Loan Notes**") to investors (the "**SITR Investors**") on the following terms:

i. interest payable quarterly in arrears at 3% per annum,

ii. if any interest is not paid on the due date the outstanding amount carries a further 3% p.a. interest (meaning the rate on the outstanding balance increases from 3% to 6% for the default period)

iii. all monies to be on-loaned to CD and employed by CD in fitting out the new kitchen, and

iv. Loan Notes to be repaid, by way of one instalment, on the fourth anniversary of the date of issue.

4.1.6 AB immediately lends the £200,000 to CD under a loan agreement with CD (the "**Subsidiary Loan Agreement**") on the following terms:

i. interest payable quarterly in arrears at 3% per annum,

ii. if any interest is not paid on the due date the outstanding amount carries a further 3% p.a. interest (meaning the rate on the outstanding balance increases from 3% to 6% for the default period)

iii. all loan monies to be employed by CD in fitting out the new kitchen, and

iv. loan to be repaid by way of one instalment seven days before the fourth anniversary of the date of issue.

4.1.7 However, to allay the concerns of the trustees of AB, the Loan Notes also provide for the following:

i. if and to the extent that CD fails to pay any interest, under the Subsidiary Loan Agreement, on the due date, AB may defer payment of interest on

the Loan Notes to the SITR Investors to the date on which CD actually pays that interest to AB; and

ii. if and to the extent that CD fails to repay any or all of the principal sum (£200,000), under the Subsidiary Loan Agreement, on the due date for repayment, AB may defer repayment to the SITR Investors of that amount of principal to the date falling seven days after the date on which CD actually repays that amount of principal to AB.

4.1.8 The Loan Notes also provide that:

i. AB must use all reasonable endeavours to enforce payment of interest, and repayment of principal, under the Subsidiary Loan Agreement, and

ii. if it becomes reasonable to assume that any or all of the principal due from CD under the Subsidiary Loan Agreement is irrecoverable (i.e. the debt is "bad"), the corresponding portion of the Loan Notes are also to be written off and SITR Investors will suffer the loss.

5. CONCLUSION

5.1 We believe that the structure suggested in this note:

5.1.1 would encourage more trustees of charities with trading subsidiaries to raise funding under SITR to support the qualifying trading activities of those subsidiaries,

5.1.2 is not in breach of any of the requirements of Part 5B of ITA 2007, and

5.1.3 is also within the spirit of the legislation, as it increases the risk taken by SITR Investors (thus ensuring that tax relief is subsidising genuine risk of loss).