GET SITR

Social Investment Tax Relief

SITR MADE SIMPLE

Mills & Reeve LLP and Big Society Capital

October 2019

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WHISTLESTOP TOUR – WHAT WE'RE COVERING

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LEGAL SMALLPRINT (BUT BIGGER…)

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- These notes were prepared to form the basis of a workshop for Big Society Capital held on 9 October 2019.
- These notes are intended solely for individuals who attend that event. These notes should not be passed to anyone else or published (in whole or in part). So don't give these to your clients or contacts and don't put them on your website!
- These notes are not a comprehensive review of the law relating to SITR. They are a (very brief) overview, only designed to give the reader a better understanding of this area.
- Neither Big Society Capital nor Mills & Reeve LLP, nor any of their respective partners, directors, employees, agents or representatives can give any advice in this area and will have no liability to any third party who may rely on the contents of these notes.
- And please also bear in mind that:
    - These notes are based on our understanding of law and HMRC practice as at today's date. But the law can change. And changes can be retrospective.
    - This is a relatively new area of law, so little custom and practice has yet been developed by HMRC. Policy and practice will develop over time.
    - The following notes are a very brief overview of a complex area of tax law. Which means the detail can be more complicated, and by keeping the notes simple, we've missed out loads of detail that may be relevant to you.

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WHAT IS SITR

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RECENT HISTORY

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- SITR was introduced in 2014. We had a coalition Government, which looked quite likely to get re-elected in 2015. The UK was a key member of the EU.
- All change
- Some material changes were proposed to SITR in the 2016 Autumn Statement, and the Budget in March 2017. They finally came into effect in November 2017 (but back-dated)
- These changes are flagged up with: [in effect from 2017]
- As for Brexit, SITR is a form of state aid, and so operates within boundaries set out under EU law
- The Government has recently consulted on the various tax reliefs to support investments into businesses, including SITR – Government's response to the consultation due to be published in 2020
- So what you're about to hear is an explanation as to how SITR works today – but there may be some changes next year

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BIG PICTURE

GET SITR
Social Investment Tax Relief

- It's a way in which social enterprises can raise funds by way of investment, and offer their investors tax relief
- Designed to help fill the "funding gap" for social enterprises
- Works like this:
  - **Individual** invests money into a **social enterprise** by way of **shares** or **debt**
  - Individual claims **tax relief** on the amount invested
  - The social enterprise applies the funds in a **trading activity**
  - After **three years** (or longer) the investment is sold or repaid
- **Key point: this is a tax relief to support trading activity**

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THE TAX RELIEFS UNDER SITR

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- **Income tax relief** – 30% income tax relief (with carry back facility to previous tax year)
- **Capital Gains Tax deferral** – if a chargeable gain is re-invested into an SITR-qualifying investment, the CGT liability on that gain is deferred until the SITR investment is disposed of
- **Tax free Capital Gains** – gains made on disposal are free of capital gains tax

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EXAMPLE – INCOME TAX RELIEF

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- A Community Interest Company wants to raise a £100,000 loan to refurbish its premises and expand its operations
- It approaches its supporters and ten individuals each offer to lend £10,000 at an interest rate of 5% p.a. repayable in five years' time
- Each investor lends £10,000 but claims back £3,000 from HMRC– so the net cost to the investor is £7,000
- Each year the investor receives £500 in interest, which is taxed (let's say @40%), so the net interest is £300 each year
- At the end of five years the loan is repaid and the investor receives back his or her £10,000
- **So for a net investment of £7,000, each investor gets back (after tax) £11,500** [i.e. £10,000 original loan plus £1,500 interest, after tax]
- And the investor has supported the growth of the community interest company

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WHO CAN RAISE SITR FUNDING?

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- Must be a “social enterprise”
- Must meet the “trading requirements”
- Cannot be too big:
  - No more than 250 *employees* (FTE) [**in effect from 2017**]
  - Less than £15m “gross assets”
- *Must not be in “financial difficulty”* [**in effect from 2017**]
- Unquoted (i.e. not traded on a stock exchange)
- Cannot be controlled by another company
- Rules around group structure:
  - all subsidiaries must be “51% subsidiaries” (with a share capital)
  - any subsidiary that uses the SITR money must be a “90% social subsidiary”
  - any property holding subsidiary must be at least 90% owned
- Cannot be in a partnership

But let’s look at a couple of key areas…

?
Can I use SITR?

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WHAT IS “SOCIAL ENTERPRISE”?

- **Charities** – can be a trust or a company
- **Community Interest Companies** – again, can take any form of CIC
- **Community Benefit Societies** – must:
  - not be registered social landlords
  - be a “prescribed” bencom (i.e. incorporate, in its rules, the asset lock)
- **Accredited Social Impact Contractor** (typically a special purpose vehicle [SPV] that will issue social impact bonds to raise finance for a particular project)
- Any other body prescribed by the Treasury – so they have given themselves the flexibility to extend the scheme in the future to other or new types of social enterprises
- Other than social impact contractors, these are all forms of organisation which:
  - are overseen by a regulator (other than HMRC), and
  - are subject to asset locks and restrictions on paying out profits to members

WHERE MIGHT WE SEE SITR BEING OFFERED?

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- Charity with a trading subsidiary
- Charity which carries on "primary purpose trading" itself
- Any other form of social enterprise looking to raise finance for expansion, development, growth – start-ups and more established businesses [note there is a limit to how much can be raised for organisations older than 7 years]
- Joint ventures between charities or social enterprises for specific projects
- New vehicles being established to take over the running of facilities from local government
- Social Impact Bonds
- So far, emphasis has been on debt fund raises, but a social enterprise can offer shares as well as (or instead of) debt – shares can be redeemable, to provide an "exit" route for investors

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ISSUES WITH GROUP STRUCTURES

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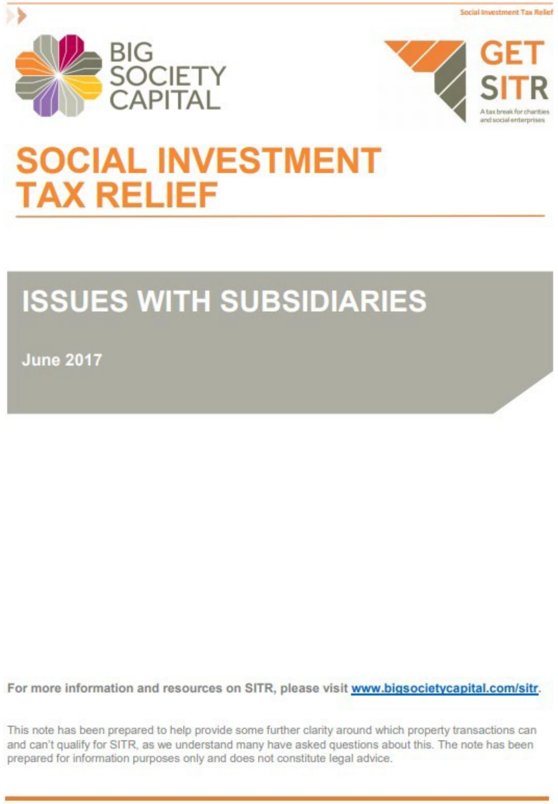
- **Nature of subsidiaries**
  - All must be more than 50% owned
  - Cannot be any arrangement in place under which that might change
  - Must be companies with a share capital – cannot be a company limited by guarantee
- **Overall group trades**
  - Look at the trade carried on by the group as a whole (unless parent is a charity)
- **Which group company will use the SITR money?**
  - Must be at least 90% owned (and no arrangements under which that might change)
  - Must be a “social enterprise”
  - SITR monies will be loaned down to the subsidiary – issues for charities in doing this (possible solution using an alternative loan structure to ringfence the risk to the subsidiary)



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ISSUES WITH GROUP STRUCTURES (2)

- **Minority stakes**
  - Treated as "investments", therefore non-qualifying activity

- **Other issues**
  - Look at date of first commercial sale of all subsidiaries
  - Take into account all state aid received by all subsidiaries
  - Doesn't matter if those subsidiaries will not be receiving any SITR money

WHAT TRADES ARE EXCLUDED?

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

- Dealing in land, in commodities or futures or in shares, securities or other financial instruments
- Banking, insurance, money lending [**in effect from 2017**], debt-factoring, hire-purchase finance or other financial activities
- Property development
- Leasing or letting assets on hire [**in effect from 2017**]
- Generating license fees or royalties [**in effect from 2017**]
- Nursing homes or residential care homes [**in effect from 2017**]
- The generation or export of electricity or other forms of energy [**in effect from 2017**]
- Activities in the fishery and aquaculture sector
- Primary production of certain agricultural products (those covered by the CAP)
- Road freight transport for hire or reward
- Providing services or facilities to another business where that other business would not qualify for SITR, and there is more than 30% common ownership of both the social enterprise and that "other business"

Remember - Some non-qualifying activity is allowed: rule of thumb is 20% [exceptions for charities]

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CHANGES TO RULES ON TRADE

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- **Money lending** – previous exemption for lending to other social enterprises now gone
- **Leasing or letting assets on hire**
  - Community halls and sports facilities?
  - Difference between providing a service and leasing
- **License fees or royalties**
  - Software (no exemption if developed "in-house")
  - Operating concessions – a trap
  - Again, community halls and sports facilities
- **Nursing Homes and Residential Care Homes**
  - HMT had suggested they'd look at exemptions from this – but nothing yet
- **The generation or export of electricity or other forms of energy**
  - Includes generating heat or producing gas or fuel

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PROPERTY DEVELOPMENT

- Means the development of land where the social enterprise:
  - has (now or at any time in the past) an interest in land, and
  - has the sole or main object of realising a gain from the disposal of an interestin that land when it is developed.
- Acquiring or refurbishing premises out of which the social enterprise trades is not property development
- But:
  - Problems if you sub-let part
  - Acting as landlord is not property development but is also not a qualifying trade
  - Same goes for buying property that is simply held as an investment
- See detailed note: a guide to SITR and property development

THE LIMITS (1)

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Social Investment Tax Relief

- Individual investor limit of **£1m per tax year**
- Any social enterprise can raise up to around **£290K in any rolling three-year period** - "de minimis" State Aid counts towards that £290K limit
- *However a social enterprise that has been trading for* **less than seven years** *can raise up to* **£1.5m** *over its lifetime – but any previous "risk finance state aid" counts towards that limit.*
- "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 (EIS), the Seed Enterprise Investment Scheme (SEIS) 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 [HMRC have tried to list them – Venture Capital Schemes Manual]
- The seven year period starts to run from the date of the first "commercial sale" i.e. the first sale by the company or trade 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
- 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 lifetime limit of £1.5m where:
    - the social enterprise that is raising SITR finance now, received some form of "risk finance state aid" within the seven years after its first commercial sale, and
    - some or all of that earlier funding was employed for the same qualifying trade that will benefit from the new SITR funding

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THE LIMITS (2)

GET SITR
Social Investment Tax Relief

- 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 you are within the **seven year age limit**, you have to look at the date of the first commercial sale made by:
    - each subsidiary (whether or not that subsidiary is still part of the group), 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)
- When looking at the **£1.5m lifetime cap**, you have to include any "risk finance state aid" received by
  - any subsidiary (whether or not that subsidiary is still part of the group), and
  - the previous owner of 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)
- Remember: we have a two-tier system and old rules (for lower limit) are still relevant
- 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.

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THE LIMITS (3)

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Example 1

- 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 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.
- *It can't benefit from the new £1.5m cap. It made its first commercial sale more than seven years ago. So it remains subject to the lower limit of around £290K of SITR funding in any rolling three year period.*

Example 2

- Same facts as example 1, except that it sold its first loaf of bread on 5 January 2013.
- *It can benefit from the new £1.5m cap. It made its first commercial sale within the last seven years.*

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THE LIMITS (4)

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Example 3

- Same facts as example 1, except that on 1 April 2013, the community benefit society raised £150,000 by way of a share issue in order to refurbish its kitchens and buy new bread ovens. Some of the investors claimed EIS relief on their investments.
- *It can benefit from the new £1.5m cap. 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.*

Example 4

- 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.
- *It can't benefit from the new £1.5m cap, and does not qualify under the carve out 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.*
- *Makes no difference that the "old" subsidiary is not going to benefit from the SITR monies*

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KEY INVESTMENT TERMS

Shares:

- SITR shares cannot carry a right to a return which (either partly or wholly):
    - is fixed
    - exceeds a "reasonable commercial" rate of return
- On a winding up SITR shares cannot rank above any other shares

Debt:

- Cannot be charged or secured on any assets
- Rate of return cannot be greater than a "reasonable commercial" rate of return
- On a winding up all monies due to the holders of SITR debt must:
    - be subordinated to all other debts (other than, presumably, other SITR debts)
    - where the social enterprise has a share capital, rank equally with the lowest ranking class of share
- You cannot have in place any arrangements for the investment to be redeemed, repaid, repurchased, replaced or otherwise disposed of within **three years**
- Cannot have in place arrangements to provide partial or complete protection for the investor against what would otherwise be the risks attached to making the investment
- *The investment cannot be part of so-called* **"disqualifying arrangements"** *– 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* [**in effect from 2017**]

WHO CAN INVEST AND CLAIM SITR?

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Social Investment Tax Relief

- Must be an **individual** – although investments can be held on behalf of an individual by a nominee.
- *Investor must be "independent". That means she cannot have an existing investment (by way of shares or debt) in the social enterprise unless either:*
  - *If shares, they are "permitted subscriber shares", or*
  - *For either shares or debt, the investor claimed SITR relief on that previous investment* [**in effect from 2017**]
- Can't claim two tax reliefs on the same investment
- There are restrictions on being an employee, partner, trustee or paid director
- The investor cannot have a material interest in the social enterprise – basically more than 30% of:
  - Voting power, or
  - Ordinary share capital, or
  - Loan capital
- Overriding requirement that the investor cannot "control" the social enterprise

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HOW CAN SITR MONEY BE USED?

Who can use the money?

- The money must be employed either by:
  - the social enterprise that raised the money, or
  - a “90% social subsidiary”

How can the enterprise use the money?

- The SITR monies must be used in a qualifying trade, or the preparation for a qualifying trade
- The SITR monies must be used for the purposes for which they were raised (or, in the case of a social impact contractor, in carrying out the social impact contract)
- Money cannot be used in acquiring shares or stock in another entity or enterprise
- *Money cannot be used to refinance an existing debt* [**in effect from 2017**]

When must the enterprise spend the money?

- Social impact contractors have 24 months to spend all of the SITR money
- All other social enterprises have 28 months

CASE STUDY: SECOND SHOT COFFEE

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CASE STUDY: FREEDOM BAKERY

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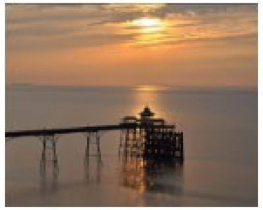
More case studies: getsitr.org.uk/sitr-in-action


FareShare South West


FC United of Manchester


Ambition East Midlands


The Spotted Cow


Clevedon Pier


Burley Gate Community Shop


Portpatrick Harbour


South Bristol Sports Centre

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PROCESS FOR CLAIMING SITR – HMRC CLEARANCES

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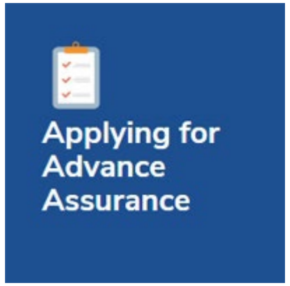
Pre-investment



- Can seek advance assurance from HMRC. Not compulsory. But highly advisable.
- Submit by email – currently takes anything between **six and fourteen weeks** for a response
- Recent promise to cut this to 15 working days!!
- Build that into your timetable

Post-investment

- The social enterprise must submit a "compliance statement" to HMRC. This is a form which sets out details of the investment, and the investors. It is in a standard format available on HMRC's website
- In most cases, the form must be submitted no later than two years after the end of the tax year in which the investment is made. So if an investment were made today, the last date for filing the statement would be 5 April 2021
- The legislation does not contain any "reasonable excuse" for late filing. And without the filing, the tax relief cannot be claimed.
- If there are multiple drawdowns of debt, a compliance statement is needed for each drawdown

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WHY BOTHER?

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- There will be investors out there looking to invest to achieve both a social and a financial return – if a social enterprise can offer tax relief to its investors, it's going to put itself at an advantage
- And if this tax relief takes off there will come a point where many investors might expect SITR to be available. If you can't offer it you'll be at a disadvantage
- Compare SITR debt to bank debt:
  - If lenders are getting tax relief, a social enterprise can offer a lower rate of interest to investors (compared to what it would pay a bank) and investors still make a good return
  - SITR debt must be unsecured – banks typically only lend if they can take security, but this is not an issue for SITR lenders
  - Patient capital – cannot start repaying SITR debt for at least three years so gives the enterprise breathing space (unlike bank loan where repayments start immediately)
  - With SITR debt there can be no covenants or rights to early repayment during that initial three year period (so no risk of lenders "pulling the plug" early)
  - Lenders are likely to be more engaged in the social mission
  - Lenders may lend more than just money – expertise, time, contacts, advice
- In short, if a social enterprise can offer SITR to investors, it becomes a no-brainer

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WHERE COULD YOU RAISE THE MONEY FROM?

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- Existing friends and supporters
- Social Investment Finance Intermediaries
- Funds:
  - EIS style funds already in existence:
    - Social Investment Scotland
    - Resonance
- Social Venture Capital Trusts [**if and when law is changed**]:
  - similar to existing VCTs except they can only support social enterprises
  - tax reliefs for investors will look the same
- Crowdfunding
- IFAs

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SOCIAL IMPACT BONDS

GET SITR

Social Investment Tax Relief

- A social impact bond is a loan – don’t get put off by the jargon
- So all the restrictions mentioned around SITR loans apply equally to SIBs
- Any social enterprise can issue a “bond”
- No particular standard form for a “bond” (but see restrictions under SITR rules for loans)
- Government definition of a “Social Impact Bond”:

  Social impact bonds (SIBs) are a commissioning tool that can enable organisations to deliver outcomes contracts and make funding for services conditional on achieving results. Social Investors pay for the project at the start, and then receive payments based on the results achieved by the project. There now exist over 30 SIBs across the UK, supporting tens of thousands of people in areas like youth unemployment, mental health and homelessness.

- Under SITR, there is a special regime for bonds issued by “accredited social impact contractors”
- Typically, these are new companies set up to bid for a contract to provide services, but focussed on delivering outcomes
- Under SITR, may be a “spot purchase” SIB – a special purpose vehicle (SPV) will enter into any number of contracts, in substantially the same form, with different Contracting Authorities. All the contracts will commit the SPV to deliver the same outcome(s) for a set price. This allows Contracting Authorities to ‘buy’ outcomes for as few as one person, whereas in most SIBs they will agree to buy outcomes for relatively large numbers of people.

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SOCIAL IMPACT CONTRACTORS (1)

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- Must be a company limited by shares
- Must be accredited by DCMS, which will only happen if:
  - It has entered into a "social impact contract" (can be "spot purchase")
  - It was established solely for that purposes (and for no other purpose)
  - The activities under the contract are not "excluded activities"
- Social Impact Contract:
  - One of the parties is a "contracting authority" (reg 2(1) of the Public Contracts Regulations 2015)
  - Contract sets defined outcomes for social or environmental purposes
  - Those outcomes must be capable of being objectively measured (and method of measurement must be in contract)
  - Progress must be assessed at intervals throughout the life of the contract
  - At least 60% of payments must be conditional on achieving the defined outcomes

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SOCIAL IMPACT CONTRACTORS (2)

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- "Contracting Authorities" means the State, regional or local authorities, bodies governed by public law or associations formed by one or more such authorities or one or more such bodies governed by public law, and includes central government authorities, but does not include Her Majesty in her private capacity;
- Outcomes must be outcomes!
- Must be able to show that the defined outcomes:
  - Are tackling a "complex issue", and
  - Would, if achieved,:
    - Deliver significant improvements in the social or environmental well-being of one or more disadvantaged or high need groups; **and**
    - Result in long term positive social and/or environmental impacts
- "Complex issue" – has the social issue being addressed proved to be "intractable" and/or does it require a coordinated effort by a number of different bodies to address it?
- "long term" means the benefit will last significantly beyond the length of the contract (at least 12 months)

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SOCIAL IMPACT CONTRACTORS (3)

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"SOCIAL OR ENVIRONMENTAL PURPOSES" MEANS:

- Relief of those in need by reason of youth, age, ill-health, disability, financial hardship or other disadvantage
- Relief or prevention of poverty
- Promotion of employment, culture, heritage or sport
- Advancement of training or education
- Prevention of crime
- Environmental protection
- Social housing or the relief of the homeless
- The provision of community facilities
- The promotion of social inclusion and cohesion
- Advancement of citizenship or community development
- Improvement of physical or mental health
- Provision of long term care in relation to any infirmity, or
- Any other areas that may reasonably be regarded as analogous to, or within the spirit of, any of the above

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SOCIAL IMPACT CONTRACTORS (4)

- Don’t need to be an “accredited social impact contractor” to issue a SIB under SITR
- Advantage is that:
    - SPV is a private company with a share capital (doesn’t have to be a “social enterprise”)
    - A few of the technical rules relating to SITR are relaxed (due to the nature of the SPV)
- But disadvantage is:
    - Requirement to be “accredited”
    - Rules are pretty strict around qualifying for accreditation
- A social enterprise such as a charity could issue a bond and describe it as a “social impact bond” without having to be accredited (provided the bond, and the terms of the investment, met all of the “usual” SITR criteria)

SOCIAL IMPACT BONDS - RESOURCES

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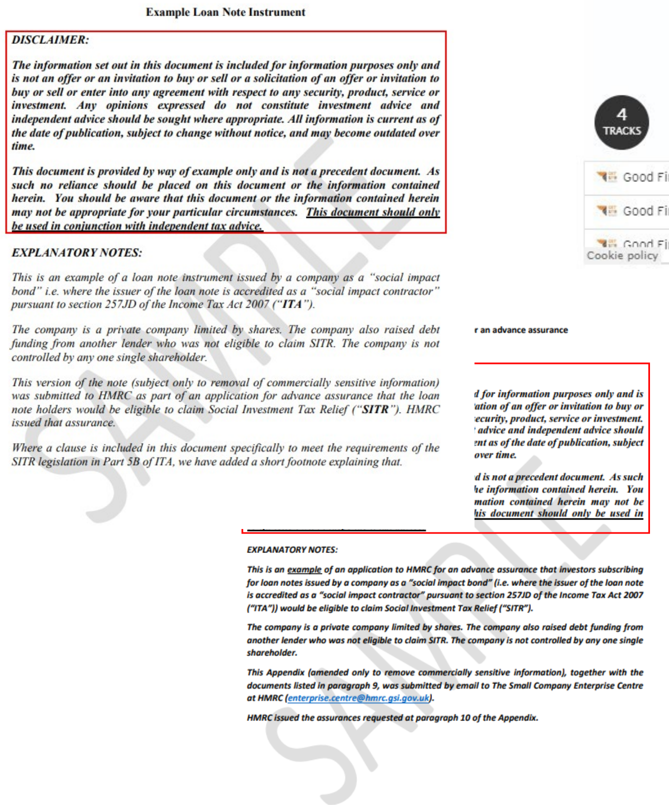

Example Loan Note Instrument

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EXPLANATORY NOTES:

*This is an example of a loan note instrument issued by a company as a "social impact bond" i.e. where the issuer of the loan note is accredited as a "social impact contractor" pursuant to section 257JD of the Income Tax Act 2007 ("**ITA**").*

The company is a private company limited by shares. The company also raised debt funding from another lender who was not eligible to claim SITR. The company is not controlled by any one single shareholder.

*This version of the note (subject only to removal of commercially sensitive information) was submitted to HMRC as part of an application for advance assurance that the loan note holders would be eligible to claim Social Investment Tax Relief ("**SITR**"). HMRC issued that assurance.*

Where a clause is included in this document specifically to meet the requirements of the SITR legislation in Part 5B of ITA, we have added a short footnote explaining that.

r an advance assurance

d for information purposes only and is ation of an offer or invitation to buy or ecurity, product, service or investment. advice and independent advice should ent as of the date of publication, subject over time.

d is not a precedent document. As such he information contained herein. You mation contained herein may not be his document should only be used in

EXPLANATORY NOTES:

This is an example of an application to HMRC for an advance assurance that investors subscribing for loan notes issued by a company as a "social impact bond" (i.e. where the issuer of the loan note is accredited as a "social impact contractor" pursuant to section 257JD of the Income Tax Act 2007 ("ITA")) would be eligible to claim Social Investment Tax Relief ("SITR").

The company is a private company limited by shares. The company also raised debt funding from another lender who was not eligible to claim SITR. The company is not controlled by any one single shareholder.

This Appendix (amended only to remove commercially sensitive information), together with the documents listed in paragraph 9, was submitted by email to The Small Company Enterprise Centre at HMRC (enterprise.centre@hmrc.gsi.gov.uk).

HMRC issued the assurances requested at paragraph 10 of the Appendix.

SAMPLE

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THAT'S ALL THERE IS TO IT

GET SITR
Social Investment Tax Relief

- Remember:
  - **Individual** invests money into a **social enterprise** by way or shares or debt
  - Individual claims tax relief on the amount invested
  - The social enterprise applies the funds in a trading activity
  - After three years (or longer) the investment is sold or repaid
  - This is a tax relief to support trades

- There's a lot more detail. If you want to find out more:
  - Visit: getsitr.org.uk for detailed information and links to other useful resources, as well as examples of SITR fund raises

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GET SITR

GET SITR
Social Investment Tax Relief

Free support and resources to help you understand what SITR is, how it works and to use it including:

- Case studies
- Guides
- Templates
- Podcasts
- Webinars
- Database of SITR deals
- Events

getsitr.org.uk

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THANK YOU

For more information, please contact:

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Neil Pearson, Mills & Reeve, Neil.Pearson@mills-reeve.com

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