A look at the social investment tax relief

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Andrew Rainford provides an introduction to the often-overlooked relief and reflects on its recent expansion.

Social investment tax relief (SITR) was introduced in 2014 as part of then Prime Minister David Cameron's "Big Society" agenda. It was devised in recognition of the increasing role social enterprises are playing in tackling social problems. Following changes made in 2017, there is now actually a two-tier system – one for enterprises that are less than seven years old, and one for any others. It is important to note

that the relief is intended to support a trade, and funds raised need to be utilised for the purposes of the trade or relief will be denied.

The reliefs in summary

Due to the fact that SITR is based on the provisions of the EIS legislation, the reliefs operate in much the same way. The main body legislation concerning SITR is found in Part 5B, ITA 2007, and all subsequent references in this article are to that Act unless otherwise stated.

Investments

However, where SITR differs is that investments made via making a loan can qualify, as well as those made by subscribing for shares.

Tax relief

An investor can claim income tax relief at 30% on annual investments of up to £1 million and can claim to carry back relief to the tax year preceding the year of investment. As with EIS, the relief cannot reduce the overall tax liability for the year below £nil.

CGT

Deferral

There is also the opportunity to match the invested amount to capital gains made in the three years prior to, or one year following, the date of the investment. The tax on the matched gains is then deferred until the investment is disposed of, redeemed or repaid, the company stops meeting the scheme conditions or the investor becomes non-resident.

Exemption

Finally, if the investment is by way of subscribing for shares then any gain realised on their disposal will not be subject to tax providing that a claim for income tax relief was made, that relief has not been withdrawn, and the disposal date takes place after the end of the minimum holding period (which is three years from the date of

the investment).

The qualifying enterprise

Naturally there are qualifying conditions and restrictions.

Social enterprise

The first hurdle to overcome when appraising a prospective investment is whether or not the organisation being invested in is a social enterprise for the purposes of the relief. S257J defines a social enterprise as being:

(a) a community interest company,

(b) a community benefit society that is not a charity,

(c) a charity,

(d) an accredited social impact contractor, or

(e) any other body prescribed, or of a description prescribed, by an order made by the Treasury.

Applicable period

In addition to being a social enterprise at the time of the investment, the organisation must remain one throughout the “shorter applicable period”. This is the period that begins with the date of the investment and ending on its third anniversary. Note that the other period referred to in the legislation is the “longer applicable period”, which begins up to one year before the investment, ends three years after it and is important when considering whether an investor has a disqualifying relationship (e.g. employment) with the social enterprise.

Qualifying conditions

Much of the other qualifying conditions relating to the organisation, such as those related to gross assets, unquoted status, qualifying subsidiaries etc. are identical or substantially similar to the EIS. The organisation must not have more than 250 full-time equivalent employees – including directors – at the time of the investment. Prior to 6 April 2017, this limit was 500. The social enterprise is not permitted to be a

member of a partnership.

One condition relating to the investor that is unique to SITR is that they are not permitted to have any existing investment in the social enterprise (either in the form of shares or a loan), unless that investment:

- consists of permitted subscriber shares; or
- was an earlier investment that qualified for SITR.

Trading

The social enterprise must meet the trading requirement under S257MJ throughout the shorter applicable period. The requirement will be met if:

- the social enterprise is a charity; or
- the social enterprise is a single company that is not a charity and:
    - any non-trade activities are merely incidental, and
    - any excluded activities do not form a substantial part of the overall business activities; or
- the social enterprise is a parent company that is not a charity and the business of the group as a whole does not consist to a substantial part in the carrying on of non-qualifying activities.

Non-trading

For these purposes, non-trade activities are any activities other than those carried on in the course of a trade, or in the course of preparing to carry on a trade. This will therefore include things like rental income, and other investment-type activities. Non-qualifying activities include anything that appears on the specific list of excluded activities at S257MQ.

Debt investments

As briefly mentioned above, a qualifying investment into a social enterprise can be made by way of a loan, rather than a subscription for new shares. This may be more appealing to a potential investor, as it allows a modest return to be paid for the duration of the investment (i.e. interest not exceeding a commercial rate) and provides for repayment without needing to find a buyer for shares. The investment is therefore less focused on the hope of an increase in capital value. There are a

number of conditions regarding the loan that must be met in order for relief to apply.

The investment must be a debenture of the social enterprise. It does not matter what precise form this debenture is in, so it can be a straight loan or issued as an instrument like a loan note or bonds, but it cannot be secured on any of the social enterprise's assets (to do so would constitute a form of risk avoidance). Additionally, any interest paid must not exceed a reasonable rate of return. This is not set in stone, but a good rule of thumb for an organisation looking to set a rate would be to obtain quotes for unsecured loans from mainstream lenders for comparison where possible.

A final condition is that the debenture can't have any priority over any other debts, and must rank equally to other unsecured creditors, in the event of a winding up. It must also rank equally with the ordinary shares.

Two schemes, one relief

So, how much can a social enterprise raise via SITR? When SITR was introduced, it was kept small enough to fall under de minimis state aid rules. This meant that it could be introduced without requiring approval from the EU's Commission for State Aid, but the down side is that the amount an organisation could raise was limited. The scheme was expanded in 2017 which increased the maximum amount, but the old scheme continues for older enterprises (see below). The exact limit is calculated by applying the following formula:

((€200,000 – M) / (RCG + RSI)) – T

Where:

T is the total of any relevant investments made in the social enterprise in the aid period

M is the total of any de minimis aid, other than relevant investments, that is granted during the aid period –

(a) to the social enterprise, or

(b) to a qualifying subsidiary of the social enterprise at a time when it is such a subsidiary,

RCG is the highest rate at which capital gains tax is charged in the aid period, and RSI is the highest SITR rate in the aid period. The aid period means the three years immediately preceding the date of the investment.

A further complication is that because the formula is expressed in euro, the figures for M and T must be converted using spot rates at the relevant investment date(s). If there have been no prior investments or de minimis aid receipts in the three prior years, the maximum amount is therefore €344,827 – approximately £310,000 at current exchange rates.

From 6 April 2017 this limit only applies to those organisations who are raising their first SITR investment more than seven years after the date of its first commercial sale. Other organisations benefit from an increased investment limit of £1.5 million. If the seventh anniversary of the first commercial sale has passed, the organisation can still use the expanded scheme if the investment is a “follow-on” investment, i.e. a qualifying investment was made within that first seven years.

Note that older enterprises are still subject to the new £1.5 million lifetime limit, they are just restricted on how quickly they are permitted to raise this by reference to the old three-year rolling window.

The future?

Initially, SITR was supposed to end after 5 years, i.e. on 5 April 2019; however, this has been extended to 2021. It remains to be seen whether the expanded scheme will be successful, but if it leads to an upswing in social investment it would be hard to see this not being extended further. Of course, as the scheme is currently subject to EU state aid rules, it will be interesting to see what effect Brexit will have, as changes will no longer require EU approval. The government has recently indicated that stewardship of state aid rules will pass to the Markets and Competition Authority once the UK leaves the bloc.

Social investment is certainly a growing sector. Modern investors are increasingly conscientious regarding ethical practice (such as renewable energy etc) and social responsibility, and the 2017 changes may lead to mainstream retail investment banks looking to offer investments as part of their portfolio. Previously, at least part of the issue has been that it is simply too small for it to be worth their while – similar to Seed EIS. Of course, this may also be made easier if the Social Venture Capital Trust, first announced in 2015, ever sees the light of day.