Taking Advantage of Social Investment Tax Relief

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At a recent Philanthropy Impact Roundtable discussion one of the participants, as a result of the establishment of the Social Investment Tax Relief, created a controversy by questioning whether there should be tax relief on donations and social investment. Members of the audience and other panel members provided an alternative view providing a business case for the continuation and enhancement of tax reliefs on donations and social investment.

The Social Investment Tax Relief is an attempt to level the playing field between donations and social investment. This article describes this new tax relief, benefits, how investors can take advantage of the relief, issues and its implications for financial advisors and wealth managers.

Introduction

Social investment tax relief ('SITR') is a new form of tax relief for individual investors who invest into community benefit societies, charities and community interest companies.

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Individuals investing into these qualifying organisations are able to offset 30% of the value of the investment from their income tax bill. This is a serious incentive which could have a big impact on investment behaviour and investment flows into the social sector over time.

Guidance has already been released by HMRC showing how SITR will operate. At the time of writing, it is anticipated that the Finance Bill will receive Royal Assent in July 2014.

Policy Context and Aims

When I (Luke) was seconded to the Cabinet Office in 2011-2012 to advise on the law, regulation and tax treatment of social enterprise, we looked at the possibility of introducing a new tax relief for social enterprise and how it might be structured.

Our analysis showed very clearly that the tax system disincentivised investment into social enterprises. On the one hand, Gift Aid incentivised giving to charities. On the other hand, specific tax reliefs – enterprise investment scheme and venture capital tax reliefs – existed to encourage investment into small and medium sized companies limited by shares. However, there was no incentive for investment into social sector organisations, many of which are unable to issue equity or access SME tax reliefs. A level playing field was needed.

One of the key questions we had to consider was "how can a new relief for social investment be 'ringfenced' to avoid abuse?". I was an advocate for the idea of ringfencing the relief by reference to charities, community interest companies and community benefit societies, which we described as 'regulated social sector organisations', as they are regulated and exist for public or community benefit and so the risk of abuse or fraud is generally much reduced. This is the form of ringfencing used by SITR, alongside other eligibility criteria and conditions.

SITR in Outline

SITR is available for investment in newly issued ordinary shares and qualifying debt instruments of charities, community interest companies and community benefit societies.

The relief is targeted at small and medium sized social enterprises: only social enterprises with less than 500 full-time equivalent employees and less than £15m of assets are eligible.

The key principle is that the investment must not be protected from the ordinary risks of investment, as the intention is to encourage investors to provide risk capital. This means that ordinary shares must carry no preferential rights to participate in capital or income and debt instruments must be unsecured and must rank after all other debt obligations. To receive the relief, investments must be paid up in cash in full when the investment is made.

Investors and connected parties must not own or have voting rights in more than 30% of the social enterprise investee and must not hold any office or employment with the investee.

Investments must be for a minimum of three years and, due to State Aid rules, social enterprises are only currently able to raise up to approximately £290,000 of investment.

There are a number of other conditions designed to limit tax avoidance and abuse.

The Benefits to Investors

If all the conditions are met, individual investors are able to offset 30% of the value of each qualifying investment against their income tax liability in the year the investment is made.

There are also capital gains related reliefs. No capital gains tax is payable on any capital gain from an SITR investment. In addition, if an individual has a capital gains tax liability from other investments in a given tax year, the liability can be deferred by investing the gain in an SITR qualifying investment, so that tax is only payable when the SITR investment is realised.

Individual investors can invest up to £1m in more than one social enterprise. Importantly, the £1m limit is independent of any investments made under other tax reliefs.

Relationship to Business Property Relief (BPR)

An important point to note from a financial planning perspective is that Business Property Relief (BPR) applies by coincidence to SITR qualifying share investments as it does to Enterprise Investment Scheme (EIS), although not to SITR qualifying debt investments.

Why is this important? In my (Gavin) experience, when advisers are putting in place long term planning for individuals the following points are considered:

1. **The characteristics of the type of investment.** Bonds apart, direct investment for social impact investments are by their nature long term investments (lack of liquidity; needs of social enterprise for patient capital to meet its objectives), so it is a significant advantage that IHT (or any capital tax for that matter) may not be charged on the investment.
2. **Keeping the choices presented as straightforward as possible.** Currently, advisers view direct social investments as better suited to wealthier individuals and to a proportion of their investable wealth. BPR may present a further motive to invest, but the typical profile of a BPR investor is an older investor. Social investments will be considered alongside EIS or other investments, which qualify for BPR, and the opportunity to invest in social enterprises using SITR will therefore be assessed by financial advisers on an equivalent basis.
3. **The need for intergenerational planning.** Social investments lend themselves well to embedding a family culture of productive investment and can be seen as a way of educating the next generation on the true worth of wealth. Some investors access social investments via a family trust. In such cases, it is a family matter and there is engagement with the next generation. This way the investment does not need to be sold at probate but can follow ownership on to the next generation without IHT being chargeable and reducing the value of the investment by

40% - and the capital is able to stay with the social enterprise.

In summary, BPR provides a further motivation for social investment. It helps establish a position of 'fairness' in that participation in social enterprise is not eroded through taxation, the investment is retained for the social enterprise and for the investor (and/or succeeding generation) and greater engagement between investors and social enterprises is possible.

Model Agreements

At BWB, we are in the process of creating a form of loan agreement which is specifically designed for SITR investments. It will include warranties and undertakings on the part of the investee to comply with the conditions applicable to SITR, including with respect to obligations such as the requirement for the investee to use all the investment monies for the purposes of the relevant qualifying trade within 28 months of the date of the relevant investment. We will create a similar form of shareholder agreement for equity investments.

Over time, we will probably see a number of model forms of agreement developing in the marketplace for SITR-qualifying debt and equity investments. One key question will be the extent to which investees will be willing and able to indemnify investors against the risk of loss of the tax relief due to a breach on the part of the investee of one or more of the qualifying conditions. On the one hand, it is a principle of the relief that investees should not protect investors from the ordinary risks of investing. On the other hand, investors will want protection from the risk that a tax liability could arise as a result of the investee unnecessarily breaching one of the qualifying conditions. This is likely to be an issue for negotiation.

Financial Advisers, Wealth Managers and SITR

As a new tax relief, SITR is of particular interest to financial advisers and wealth managers. However, advisers and managers who are considering recommending or making an SITR investment on behalf of clients will need to consider the 'suitability' of the investment.

The Financial Conduct Authority is focused on ensuring that regulated investment advisers are placing the interests of the client first and foremost. This means that advisers and managers should make sure that the whole advice process centres around the needs and objectives of the client.

To ensure compliance, it is essential that the process of advice starts with the adviser fully understanding a client's ambitions and goals. In thinking about wealth, this process has traditionally centred around exploring the goals a client has with regard to:

(a) first, meeting the client's own and their family's lifetime cash flow requirements; and

(b) second, the other things the client may wish to acquire with any surplus.

We take the view that it is important for 'conventional goals' to be satisfied and accounted for before thinking about wider objectives that clients may wish to consider. Having prioritised conventional goals, enhanced questioning is required with regard to other ambitions clients may have which may focus on society, the local community and the environment.

Put simply, clients will often have social goals as well as financial goals, a fact which has been expressly acknowledged by the Financial Conduct Authority in its statements. If financial advisers and wealth managers wish to offer a truly holistic and independent service, clients will need to be given the opportunity to explore and express any latent social goals. At Worthstone, we have developed (in conjunction with a behavioural finance expert in this field and a number of financial planning firms) a 'client values' process which helps an adviser elicit these latent goals form their clients.

Conclusion

SITR has the potential to attract many more individual investors to give social investment a go. It is also a nudge to investment advisers to understand and recommend investments in social enterprises to clients. Many individuals will be attracted to the fact that it is possible to make a positive difference when investing, with the potential for a positive return too.

In short, SITR gives investors a new reason to invest in social enterprise and provides the opportunity for more social impact bang for the buck than ever before. The Government has already committed to apply to Europe to enlarge SITR and allow enterprises to raise more investment under State Aid rules. In the meantime, all eyes are on the early adopters.