

**Response by the Social Enterprise Coalition to the joint
HM Treasury and Cabinet Office consultation on the operation of
CITR and other tax incentives**

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Community Investment Tax Relief

Introduction

Community Investment Tax Relief (CITR) is an incentive which encourages both individuals and companies to invest in a Community Development Financial Institution (CDFI), by offering a tax relief on their investment. The tax relief provides a reduction of an investor's tax liability and is set at 25% of the investment, on the terms of 5% a year over the five year period of the investment. Investments may be in the form of loans, equity investment (either shares or securities) or deposits (for those CDFIs that are banks).

To date CITR has raised £38 million of capital in CDFIs. The Community Development Financial Association (CDFA) estimates that a further £15 million to £20 million could be raised by the end of 2007, bringing the total to £55 million. By autumn 2004, less than half of the investment made by CITR had been on-lent to social investment entities.

The Social Enterprise Coalition was established in 2003 as the national voice of social enterprise. We provide a platform to showcase the benefits of social enterprise, share best practice and influence policy. We represent a wide range of social enterprises, umbrella bodies and networks, with a combined membership reach of over 10,500 social enterprises. These include co-operatives and mutuals, development trusts, housing associations, leisure and football supporters' trusts, Social Firms and other social businesses. While some social enterprises are large, the majority are small and medium-sized enterprises.

This paper has been informed by consultation with members of the Social Enterprise Coalition (SEC), and by discussion with financial organisations such as Buzzacott, Triodos Bank, Big Invest and Bridges Community Ventures. It builds on SEC's earlier submission to HM Treasury and the Cabinet Office in October 2006 on tax incentives for social enterprises, as part of the Third Sector Review.

Financing social enterprises

SEC has anecdotal evidence to suggest that the social enterprise sector currently has a demand for finance which is often unmet by traditional forms of lending. Social enterprises often require a distinct form of patient capital, usually over a longer term and often at a lower than market rate. There is also a growing supply of investors that seek to acquire a balance of social and financial return for their investment.

Support for CDFA views on CITR reform

SEC supports calls by the CDFA, the trade association for CDFIs, to make design changes to the operation of CITR to encourage longer-term investment in social enterprises and other businesses operating in deprived communities.

Given the nature of social investment, which represents a longer term commitments to growth and objectives, SEC believes that CITR should be altered to allow investors to withdraw their investment from a CDFI after the five-year holding period and immediately reinvest it in the same CDFI with the same 5% income tax relief per annum. With a similar intention, SEC suggests it would be advantageous to extend investors' tax relief period for investments under CITR from five years to ten years.

SEC also supports the proposal to increase the time period within which a CDFI must onward-invest 75% of its funds to be equivalent to the five year term of an individual's investment in a CDFI, rather than the current three year requirement.

Limitations of CITR for social enterprise

Although CITR is an attractive investment product, it remains limited in its ability to supply finance to social enterprises. This is due to a number of factors, including the geographically defined areas of deprivation in which CDFIs can invest; limited access to CDFIs; and lack of clear benefit to borrowers except an alternative supply of finance.

Whilst SEC recognises the Government's current position widening the scope of CITR, it is worth restating that there remains strong support within the Third sector for CITR to be extended. SEC suggests that the following issues are worth reviewing:

- Changing the CDFI requirement to onward-invest 75% of its funds, to an average figure over the course of a year instead of an absolute figure which may punish an organisation for temporarily falling below the line;
- Altering the conditions of the second tranche of CITR investment regarding the time period in which the CDFI is required to invest. Removing the distinction from three months to a period closer to that of the first tranche would prevent a need for inappropriate lending;
- Allowing CDFIs to lend to social enterprises which are set up by housing associations, where the primary trading activity is not residential; and
- Consideration of a relaxation in the scope of social enterprises that CDFIs are permitted to lend to based on their geographical location.

CDFIs, CITER and social enterprise

SEC urges the government to review the role of CDFIs in supporting social enterprise. As part of our consultation process, SEC sought the opinions of its members on their experience with access to finance and CITER reform, the survey received 26 responses. In particular, the consultation suggested that CDFIs must be supported to deliver at scale, to work on investment readiness, to promote and market social investment opportunities, particularly in relation to the awareness and knowledge around the uptake of CITER finance by social enterprises, and to have access to an appropriate wholesaler.

Proposal for a new investment vehicle

SEC supports the creation of a new investment vehicle which would offer incentives for suitable forms of finance to social enterprise. This product maybe similar to the current Enterprise Investment Scheme, but based around subordinate debt equity with some form of yield.

The scheme could have the following features:

- Incorporate the annual rate of return tax incentive mechanism of the CITER has, which may be more appealing to investment as a debt vehicle;
- Accept the lack of capital gains as the 'social return' whilst other equity benefits such as exemption from inheritance tax would allow it to remain an attractive investment;
- Not be limited to a £250,000 maximum, as many organisations looking to take on finance require more than this;
- Operate on a longer time period than mainstream equity investment, for example five to seven years; and
- Establish the risk assurance of the scheme, which could be done by writing off a proportion of losses against income tax.

One way to establish an investor assurance of risk would be through an organisation such as the proposed Social Investment Bank, which could guarantee a percentage of potential investor's losses.

A direct investment scheme would also have to be carefully constructed so that the role of the intermediary CDFI is not undermined.

The social enterprise sector needs both debt and equity-like forms of finance. Whilst many social enterprises will only seek debt finance, there is proportion that would make use of an equity-like product. The issue of latent demand for a share-based equity product by social enterprises would need to be

ascertained before introducing a new product. In order to take on such a product a social enterprise would need to be able to issue a form of shares. Of the 890 CICs that have registered to date, only 239 (27%) are registered as companies limited by shares. The application of equity for social enterprises can be illustrated by the fact that members of Industrial & Provident Societies are able to invest up to £20,000 in the society's shares. Many organisations have made use of this mechanism to obtain capital.

On a related note, SEC encourages HM Treasury to support continued work around the development of equity-like finance to social enterprises.

In terms of how the new vehicle could be managed, an option for direct investment in some social enterprises would be particularly appropriate as it would allow explicit identification of the investor with the project that is being financed. There is evidence to suggest that the ability to observe the social return will be important to the development of a successful investment¹. There is also a need for a pooled fund, to provide a source of capital for less visible and attractive projects.

In order to establish a venture capital like programme for social enterprise the liquidity of investments must be looked at with some ability to transfer investments and an exit strategy for capital. The development of a secondary market in debt/equity finance for social enterprise requires further work in terms of transferability of social enterprise investments. An exit strategy needs to be a part of the suitable and attractive investment product. This could be a repayable debt at the end of the period, a matched bargaining system or an alternative transferable 'social stock exchange'.

Wider tax incentives

As articulated in SEC's earlier submission to HM Treasury and the Cabinet Office in October 2006, there is concern that the current tax regime is not even-handed in taxing the business profits of social enterprises used to further social and/or environmental purposes. Under the current system, charities engaging in social enterprise (whether "primary purpose" trading by the charity or commercial trading through a subsidiary) have a competitive advantage over organisations working for community benefit without charitable status. While social enterprises can legitimately find ways of shielding business profits to be used for public benefit from tax, this frustrates the benefits of avoiding charity status.

SEC fully supports the taxation of earned profits that are distributed to external shareholders. Where SEC believes the tax system is disproportionate and must be reviewed is in relation to the taxing of profits that are locked into a social enterprise in perpetuity for social and/or environmental purposes. In social enterprises of this kind, the owners and/or shareholders

¹ Paul Hackett (eds) 2006. *Incentives for Growth*. Smith Institute

sacrifice any prospect of making significant capital return. Constraining the use of profits is legally required of a CIC and can be achieved in other social enterprises by means of indivisible reserves.

Under the current tax system, providing that a business spends all of its income in its accounting year and does not purchase assets which do not qualify for tax relief, none of its earned profits will be taxed. However, tax charges may arise if an organisation:

- Generates profits it wants to hold over to future years for the benefit of the community;
- Generates profits it wants to retain as savings toward a future purchase of community assets;
- Achieves its social aims through expenditure which cannot be offset against its income in arriving at taxable profit; and
- Acquires community benefit assets which are not eligible for capital allowances for tax purposes.

SEC is concerned that this may encourage inefficient and distorting behaviour in social enterprises working for community benefit, such as corporate structuring and the bringing forward of expenditure.

What is required is a mechanism to provide appropriate tax relief for social enterprise activity, while avoiding anti-competitive advantages and state aid restrictions. SEC proposes a mechanism that would not tax any profits used, or put aside to be used, to further the social and/or environmental purposes of a social enterprise. The system should be accompanied by appropriate controls to ensure that any profits distributed, or intended to be distributed, to external shareholders are taxed.

Recommendations

1. Implementation of the reforms suggested in this paper regarding changes to Community Investment Tax Relief, to allow longer investment periods and more suitable requirements for onward-investment.
2. Consideration of the role of new equity-like investment vehicle for social enterprise.
3. A review by HM Treasury into tax relief on the profits earned by regulated social enterprises which are used to further social and/or environmental purposes.

SEC looks forward to working with HM Treasury and the Cabinet Office in formulating the outcomes from this review, ensuring its implementation

makes a real difference for social enterprises and helping to improve their relationships with the Government.

SEC Policy Team
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