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Social Investment Tax Relief Consultation
Enterprise and Property Tax Team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

By email and post

30th August 2013

Dear Sir/Madam

Big Society Capital's Response to the Consultation on Social Investment Tax Relief

Big Society Capital welcomes the Government's commitment to establish a social investment tax relief. We believe it is an extremely timely initiative with the potential to transform the social investment market.

The consultation document released on 6 June outlines the main design features of the relief. Many of these are sensible, including the focus on individual investors and risk capital. However, there are four remaining issues that need to be addressed as a matter of priority if the tax relief is to be truly effective:

1. Ensure **simple investment products** are eligible (including unsecured loans);
2. **Increase the size** of eligible investment into social sector organisations;
3. **Extend the range** of permitted indirect investment schemes (including VCT-like schemes); and
4. Permit investment into **social impact bonds**.

Please find enclosed the detailed response of Big Society Capital to the consultation, highlighting the above priority issues as well as responses to many specific consultation questions. If my colleagues or I can expand on these points, or provide more information, please do not hesitate to contact us.

Yours sincerely

Nick O'Donohoe
Big Society Capital

Matt Robinson

Simon Rowell

BSC – RESPONSE TO CONSULTATION ON SOCIAL INVESTMENT TAX RELIEF

Introduction

This paper is the submission and response of Big Society Capital (BSC) to HM Treasury's Consultation on Social Investment Tax Relief. Part A discusses why this tax relief is so important. Part B then highlights four key unresolved issues with the current proposal, namely to: ensure simple investment products are eligible (including unsecured loans); increase the size of eligible investments into social sector organisations; extend the permitted indirect investment schemes (including VCT schemes); and permit investment into social impact bonds. Part C responds to certain questions asked in the consultation and other issues raised by it. Part D then discusses some further specific issues arising from the consultation that are not asked directly as questions.

PART A - Why this tax relief is so important

Charities and social enterprises are already a key part of the social fabric of the UK. Social sector organisations in the UK already make a tremendous contribution to community and public life, with employment in the charity sector alone standing at 765,000[1] and the social enterprise sector a further 800,000,[2] and are a conduit for the nearly 20 million UK adults who volunteer every year.[3] The success of the current reform agenda will critically depend on the ability of social sector organisations to participate:

- In advancing *localism*, charities and community groups have long driven local engagement. Recent years have seen community groups take control and/or ownership of important local assets and new Community Rights that came into law during 2012 are already generating widespread interest, with greater than 356 assets of community value already registered and over 431 neighbourhood planning forums in process;[4]
- In *payment-by-result* markets, charities and social enterprises are often better placed than the private sector to deliver the social result required - the pioneering work by St Giles Trust is addressing re-offending via packages of peer-led support in Peterborough, which has already shown a reduction of 6% in re-offending when national re-offending rates increased by 16%;[5] and
- For *public sector "spin-outs"*, charities and social enterprises are the natural legal forms to adopt – safeguarding the assets, intellectual property and ethos of public services but providing

[1] See Almanac, NCVO, 2012

[2] See Government estimates from BIS, Small Business Survey, 2010

[3] See Almanac, NCVO, 2012

[4] Neighbourhood Planning Areas at June 2013: By Stage Reached, DCLG, 2013

[5] See MOJ statistical notice, 2013: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/206686/re-conviction-results.pdf

operational independence. It is no coincidence that 56% of all spin-outs are community interest companies – and these organisations now provide £1.2bn of services per annum.[6]

But charities and social enterprises often lack access to the capital they need to do more and take advantage of these new reforms. Much of the social sector is under-capitalised – the median level of free reserves for operating charities with more than £10,000 income is only 1.1 months' worth of expenditure.[7] Risk-bearing capital to finance innovation and growth remains in particularly short supply: 63% of social enterprises seek long-term loans and 48% want funding with a mix of debt and equity.[8] However, there is currently a lack of risk capital available for social sector organisations, with unsecured lending having been reduced to only 5% of the capital provided by the social investment market in 2012.[9]

Social investment can be part of the answer in improving the availability of capital for social sector organisations. Big Society Capital is working hard to strengthen existing and develop new social investment finance intermediaries by aiming to make at least £120m of cumulative commitments by the end of 2013. Many of these commitments will provide risk capital needed by social sector organisations. But both BSC and these intermediaries are looking for others to invest alongside them (co-investment) to extend the reach of their social investment. So far, only a very small proportion of co-investment has flowed from individual or mainstream institutional investors and BSC's match ratio for co-investment is around 1:1. Our long-term aspiration is to increase this to 3:1. New investors with greater risk appetite are clearly needed.

For the social investment market's next phase of growth, individual investors are vital. We know many individuals are already interested in social investment.[10] We also know that they have the capital - EIS has seen over £10bn be invested since establishment in 1994. We further understand that in the right conditions, they could invest substantially in growing social sector organisations – Worthstone estimates this amount as £480m over the first five years.[11] Getting the terms of the tax relief right will be essential to successfully matching the needs of individual investors with the needs of social organisations, and to developing a "self-sustaining industry in the long-term."[12]

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[6] See Soft Finance, Hard Choices, BCG, 2013, at 1

[7] See Almanac, NCVO, 2012

[8] See Government estimates from BIS, Small Business Survey, 2010

[9] See Growing the Social Investment Market: Landscape and Economic Impact, GHK, 2013

[10] See for example: Investing for the Good of Society, NESTA, 2011

[11] See The Role of Tax Incentives in Encouraging Social Investment, Worthstone, 2013, at 26

[12] HMT Consultation on Social Investment Tax Relief, 2013, at 3

PART B – Four priority issues with the current proposal

The current proposal for social investment tax relief outlined in the consultation dated 6 June includes a number of terms that we agree with, notably the focus on individual investors and on risk capital. However, we believe that four priority issues need to be addressed to ensure the tax relief is effective:

1. Ensure **simple investment products** are eligible (including unsecured loans);
2. **Increase the size** of eligible investments into social sector organisations;
3. **Extend the range** of permitted indirect investment schemes (including VCT schemes); and
4. Permit investment into **social impact bonds.**

We provide an overview of why we feel these four issues are so important below. We also go into some more detail on these issues in Part C.

1. Ensure *simple investment products* are eligible (including unsecured loans)

The current proposal uses a set of key principles to determine risk capital and thus a set of eligible investment products.[13] However the current proposal also requires a link between the investor return and the financial performance of the social sector organisation.[14]

We agree with the broad intention to focus on risk capital. This is the sort of capital subject to the most acute market failure at present. Social sector organisations are forecast to demand around £550m of risk capital by 2015,[15] however currently only around £20m of such risk capital is being provided in the social investment market.[16]

We disagree with the need for a *specific link* between the return to the social investor and the financial performance of the social sector organisation. Such a restriction would prevent the use of simple financial products by social sector organisations and effectively only provide relief for quasi-equity investment products, such as revenue participation agreements.[17] This in turn would:

- Prevent relief for the simple and plain vanilla unsecured lending products that offer a fixed coupon rate – the product most needed by social sector organisations;
- Not permit emerging investment products that align the investor return with the social performance of the organisation, such as social impact bonds; and
- Limit the range of social sector organisations that the relief would apply to because quasi-equity is primarily used by larger organisations due to the complexity and cost involved with creating bespoke quasi-equity products (for example, the landmark quasi-equity deal was completed by HCT group which has an annual turnover of over £23m).

[13] See the broad summary criteria in Box 4.A of the consultation at 17

[14] See section 4.8 of the consultation at 16 "returns offered on social investment should be linked to the financial performance of the qualifying organisation"

[15] The size of demand for the social investment market is forecast to be approximately £750m by 2015 and equity and quasi-equity products are forecast to be 15% and unsecured lending products are forecast to be 58% of this demand. See The First Billion: A Forecast of Social Investment Demand, BCG, 2012, at 16

[16] See Growing the social investment market: Landscape and economic impact, GHK, 2013, at 22

[17] For example, see the revenue participation agreement between CAF Venturesome and Charity Technology Trust as described in the NCVO, Commission on Tax Incentives for Social Investment: Analysis and Recommendations, January 2012 at 13

BSC proposal: • Allow simple investment products (including unsecured loans) to be eligible by not requiring a link between investor return and the financial performance of the social sector organisation

See the commentary in Part D (I) for further detail.

2. *Increase the size* of eligible investment into social sector organisations

The current proposal aims to comply with European Commission State Aid *de minimis* requirements, and as such, is restricted to €200,000 (approx. £150,000) of investment into a social sector organisation over three years for all types of investment products. Whilst we recognise the benefits of avoiding a State Aid exemption application, this size limit will severely restrict the effectiveness of the tax relief:

- Recent research shows that even now, the average investment size in the social investment market is £264,000, which is substantially in excess of a £150,000 limit;[18]
- Most government contracts that social sector organisations will be seeking to compete for will require working capital funding likely to be greater than this cap – for example, potential multi-million pound contracts in the coming £500m justice reforms would require substantial funding; and
- Interviews with mainstream financial institutions suggest that market failure for lending to social sector organisations exists for amounts up to £5m of investment, and a total absence of mainstream finance for investment amounts below £2m.[19]

BSC proposal: • Investigate whether the calculation of State Aid for certain debt products can distinguished from equity and quasi-equity to increase possible size of *de minimis* investments permitted in the *Finance Bill* 2014 • Regardless of the above, HMT to publicly commit to work with the European Commission to raise the investment limit to £5m for inclusion in the *Finance Bill* 2015

See the response to Question 15 in Part C for further detail.

3. *Extend the range* of permitted indirect investment schemes *to VCTs*

The current proposal aims to encourage new individual investors to enter the social investment market. To access and reach these new individual investors, the permitted indirect investment structures must be suitable to them and their advisors, such as Independent Financial Advisers (IFAs). The current proposal broadly follows the EIS scheme and therefore investors can only invest directly or through "nominee" schemes.[20] We agree that many potential individual investors would like to

[18] See Growing the Social Investment Market: Landscape and Economic Impact, GHK, 2013, at 20

[19] As provided in Internal Report for BSC on State of Secured Lending Market, Management Consultant, 2013

[20] Also often referred to as "nominee funds" or "EIS funds"

invest directly because of the motivation to be "engaged with the social sector organisation"[21] and EIS has managed to raise significant amounts of capital (over £10bn since inception in 1994).

However, restricting investment structures to only nominee schemes may miss a large group of potential investors. EIS nominee schemes traditionally appeal to very high-net worth individuals that make an investment, as they often require minimum investment of around £25,000. In contrast, venture capital trust (VCT) schemes can appeal to a broader cross-section of potential investors. This is because of the consumer protection offered through compliance with the listing regime, an increased ability for IFAs to recommend the products and because of the much lower required minimum investment size of around £3,000.

Extending the reach of the indirect investment structures to include VCTs would broaden the pool of investors available to social organisations to provide risk capital. It would also help accelerate the development of the social investment market through promoting the growth of a diverse landscape of social investment finance intermediaries.

BSC proposal:

- In addition to nominee schemes, permit indirect investment through VCTs (through extending the current VCT scheme)

See the response to Question 25 in Part C for further detail.

4. Permit investment into *social impact bonds*

The current proposal does not permit individual investment into social impact bonds (SIBs). This is because:

- Social impact bond delivery organisations are not within the scope of eligible organisations as none of them are charities, IPS (BenComs) or CICs; and
- Social impact bond structures are not eligible as nominee schemes.

As social impact bonds have been playing an increasing role in working alongside Government commissioners to fund innovations in addressing important social issues, they should be included within scope of this tax relief.

BSC proposal:

- To provide for a separate registration scheme conducted by HMRC to assess the eligibility of social impact bonds products that are not otherwise within the scope of the eligible social sector organisations
- If a separate regime is not possible, to ensure that the regulations relating to CICs are reformed to make them fit for use by social impact bonds delivery organisations

See the commentary in Part D (III) for further detail.

[21] Approximately 40% of "active interest" high-net worth individual investors suggest that "engagement with the social enterprise/charity" as their primary motivation for investment, in the Role of Tax Incentives in Encouraging Social Investment, Worthstone, 2013, at 14

PART C - Responses to specific questions in the consultation

Part 2 of the Consultation - The Investee Organisation

Consultation Question No. 2

Would adopting a definition of social enterprise comprising Community Interest Companies, Community Benefit Societies and charities that are registered with the charity (or other principal) regulator and also recognised as charities for tax purposes exclude organisations that might reasonably be included, or include organisations that in your view should be excluded? If so, please say why.

We broadly agree with the current proposal. We think that the current proposal would leave a substantial proportion of social sector organisations in scope. However, we recommend that adjustments are made to take account of trading subsidiaries.

The definition in the current proposal as it stands would leave **a large number of social sector organisations in scope.** For example, it would include 160,000 voluntary organisations, with over 700,000 employees.[22] We acknowledge that there are many other organisations that identify themselves as social enterprises/social sector organisations that take other legal forms, such as non-charitable companies limited by guarantee or limited by shares. But we also recognise that HMT and HMRC must find a relatively straight-forward way of targeting the proposed relief and so the current proposal is certainly a way of achieving that.

There is a potential issue with treatment of **trading subsidiaries**. Subsidiary organisations are commonly used by charities and other organisations to operate commercial activities within a broader group structure that maintains a social mission – these are already expressly referenced by HMRC.[23] These subsidiaries may likely be the parts of the organisation that are particularly interested in obtaining additional finance to expand their operations. Existing tax reliefs (for example, VCT) do not allow the investee to be controlled by another company[24] and therefore if the same rules apply to this tax relief, trading subsidiaries will be effectively excluded.

In addition, social impact bonds should be included within the scope of this tax relief – see the commentary at Part D (III).

BSC proposal:
• Retain the proposed definition of eligible organisations as provided in the current proposal, but also permit investment into subsidiaries that are *wholly owned* by eligible social sector organisations (prior to the investment being made) within this tax relief

[22] See Almanac, NCVO, 2013

[23] See http://www.hmrc.gov.uk/charities/tax/trading/subsidiary.htm

[24] See HMRC Guidance About Venture Capital Trusts

Consultation Question No. 4
Are there any particular advantages or disadvantages to making charities eligible for the relief? In particular, is there a risk that donations to charities will be displaced into investments and what would be the consequences of this?

Yes, there are clearly advantages in making charities eligible for the relief and the risks of displacement of donations are limited.

Charities should be eligible for the relief because they are a major source of demand for social investment. Registered charities represented 32% of social investment recipients in a randomly selected sample in 2013[25] and registered charities represented at least 35% of organisations with greater than 25% of income through trading identifying themselves as social enterprises (which is the group traditionally considered particularly interested in obtaining social investment).[26]

The **risk of displacement of existing charitable donations is not likely to be significant** because:

- The tax relief is being designed to ensure that the eligible investment products "look and feel" like other tax-incentivised investment products by including terms common to such schemes, such as minimum investment period, investment criteria and specific administrative processes for obtaining the tax relief – these products do not look and feel like substitutes to making donations and receiving GiftAid;
- Research has suggested that a "change in mindset" is required by those who wish to engage in social investment that requires thinking of social investment as a new "wealth pot", distinct from both investment or from charitable giving;[27]
- Existing charitable giving from individuals is already well established - around £16.5 billion was given by individuals in 2010/11;[28] and
- Social investment is also not viewed as a pure substitute for grant funding or donations from the perspective of charitable organisations because charitable trustees have strict obligations as both company directors and trustees to take external financial advice and to act prudently when considering investment [29] – they will not opt to take out investment unless it meets the needs of the organisation and the beneficiaries.

BSC proposal:

- To ensure that registered charities are eligible for the tax relief as in the current proposal

[25] See Growing the Social Investment Market: Landscape and Economic Impact, GHK, 2013 at 35

[26] See The People's Business, SEUK, 2013

[27] See the Role of Tax Incentives in Encouraging Social Investment, Worthstone, 2013, at 11-12

[28] See NCVO, Almanac, 2012

[29] See The Essential Trustee: What you Need to Know, Charity Commission, 2012 at G8.

Consultation Questions No. 6 and 7

Would a size requirement of up to 250 employees be appropriate for the social investment tax relief, or should a lower limit be introduced initially? What are the benefits and disadvantages of using gross assets or turnover to measure size, and what would the appropriate limits be? Please provide reasons and evidence.

No. Ideally no size limit should be imposed. If a size limit must be placed on the relief, then a gross assets test should be used instead of numbers of employees or level of turnover.

Ideally, no size limit should be imposed on eligible social sector organisations. The current proposal already tightly defines the social sector organisations that are within scope for this tax relief (i.e. registered charities, IPS (BenComs) and CICs) and all of these types of organisations struggle to access risk capital.

If a size limit absolutely has to be imposed, neither employees nor turnover is a suitable measure:

- Number of employees is not an appropriate measure of size because it does not take account of the labour-intensive nature of social sector organisations[30] nor that much of the social impact of some social sector organisations is derived from employment of disadvantaged groups. For example, a limit on the number of employees would significantly restrict the ability of larger service organisations to participate, such as the public service spin-outs where at least 7 mutuals have greater than 1,000 employees and the average number of staff at all mutuals is 390;[31] and
- Annual turnover is an inappropriate measure of size because it is unrepresentative of an organisation's ability to raise finance. Turnover levels for social sector organisations are likely to comprise a mix of different measures, including grant funding, donations and trading income, much of which can be particularly volatile. Social sector organisations should not be penalised for being successful in achieving increased grants or trading income through their good management.

If a size limit must be placed on the relief, the amount of gross assets appears to be the most appropriate measure to determine eligible organisations. This is because gross assets is the measure that is the closest related to the problem this tax relief is trying to address – lack of assets available to secure against investment (for further discussion on this issue, please see the response to Question 11 below). Many of the social sector organisations that should benefit from this tax relief are unable to raise capital as they only hold small amount of assets even though they may have large numbers of employees and significant annual turnover. For example, research from a survey of 26 health and social care spin-outs that are seeking working capital investment to help service government contracts shows that on average they only hold assets of £124,000, even though they have an average turnover of around £18,000,000 and up to 2,000 employees.[32] In this case, the limit of £15m of gross assets used in EIS seems to be the most appropriate amount.

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[30] Compared to all SMEs, social enterprises tend to be larger in terms of employees – a fifth of social enterprises have between 10-49 employees compared to 14% in SMEs generally, see Social Enterprise Barometer, BIS, Feb 2010

[31] See Soft Finance, Hard Choices, BCG, 2013, at 5

[32] See Spin-Out, Step-Up, SEUK, 2013, at 16

BSC proposal:

- Ideally there should be no size limit for eligible social sector organisations
- If there must be a size limit, (i) gross assets should be used as the most appropriate measure, (ii) a gross assets limit of £15m (consistent with EIS) should be used, and (iii) an initial grace period (for example, 3 years) for the size limit to take effect should be permitted to encourage larger social sector organisations that may be able to use the tax relief more quickly to demonstrate the potential of the tax relief

Consultation Question No. 8

Would it be appropriate to exclude particular activities from the social investment tax relief, in order to keep the tax relief well-targeted, or would the existing regulation of the qualifying organisations be sufficient? If the Government does introduce exclusions, should specific organisations be entitled to the social investment tax relief that are not currently able to access the venture capital reliefs, for example organisations delivering social care, or arts based organisations? Should any additional exclusions apply? Please give reasons.

No, it is very important that no particular activities are excluded.

The other venture capital schemes (EIS and VCT) have deliberately excluded activities we understand to avoid purely speculative activities. The **current proposal already provides a clear list of eligible social sector organisations, which by definition precludes organisations that would undertake speculative activities (for private gain)**.

Moreover, **many social sector organisations have been set up to help address social issues in precisely these excluded activities**, for example:

- Financial activities, such as banking, insurance, money-lending, debt-factoring, hire-purchase financing or other financial activities - these are precisely the activities that Community Development Financial Institutions deal in to assist individuals experiencing financial exclusion (9% of social sector organisations are engaged in these activities); [33]
- Property development and leasing and letting assets – these are precisely the activities that community organisations, such as IPS (BenComs), deal in to exercise rights of community ownership under the *Localism Act* 2011 and to build community cohesion in deprived areas; and
- Operating or managing nursing homes, residential care homes or social care housing, or managing property used as a nursing home, residential care home or social housing – these are precisely the activities that health and social care charities deal in to improve the lives of the elderly and infirm (10% of social sector organisations are engaged in these activities[34]).

Many social sector organisations are currently prevented from accessing current venture capital schemes (EIS and VCT) because of the above excluded activities, even if they have an equity structure. These organisations may include CIC CLSs (which there are around 2,000), IPS (BenComs) with redeemable shares, and theoretically some charities. This means it is very important that the new tax relief can also be used by social sector organisations with equity structures in order to ensure that they could pursue many of these activities.

[33] See The People's Business, SEUK, 2013, at 18

[34] See The People's Business, SEUK, 2013, at 18

BSC proposal:

- No activities should be excluded
- Social sector organisations with equity structures should also be permitted to use this tax relief (particularly those that undertake activities excluded under EIS and VCT)

Part 3 of the Consultation – The Investment

Consultation Question No. 10

What would be the most appropriate way to ensure that tax relief is not provided for less risky debt investments? Do the summary criteria set out in Box 4.A achieve this aim?

Yes. A set of summary criteria (such as in Box 4.A) is more effective than an exhaustive and prescriptive list at capturing the variety of investments (other than less risky debt investments) emerging in the social investment market[35] that should be within scope in this tax relief.

Consultation Question No. 11

Would a rule requiring investments not to be secured against assets or subject to guarantee ensure that the tax reliefs are well-targeted? Would this create any substantive difficulties for investors?

Yes. Security is an appropriate measure of the riskiness of capital, if it is defined appropriately. We think linking the tax relief to investments subject to guarantee is more problematic.

Security is an appropriate measure for distinguishing the less risky from more risky investments. Clearly there is greater certainty of the recovery of original principal invested in the event of failure to repay when security is present. And lack of security is also at the heart of why social sector organisations have particular difficulty currently accessing the capital they need:

- Around 90% of the social investment market is "secured lending", which illustrates the existing capacity of the social investment market to provide products that have security as against the very limited capacity to provide any other type of investment products;[36]
- The institutions within the social investment market that are the most risk averse by virtue of they being guardians of depositor funds, the four social banks, invest almost entirely in secured lending (£165.5m out of £165.8m in 2011-12) demonstrating their approach to distinguishing secured debt as less risky;[37] and
- A lack of security was the most commonly cited reason why social organisations had been unsuccessful in an application for investment (cited by 37% of applicants) and also the most

[35] These include:

- Equity (for example, Charity Bank, SettleHydro);
- Quasi-equity (for example, CTT revenue-participation agreements, Peterborough Social Impact Bond);
- Performance-related debt (for example, HCT group part-fixed, part-social loan); and
- Unsecured lending (for example, Scope fixed coupon bond)

[36] For example, Triodos expressly states on their website that "In general, we expect all our loans and overdrafts to be fully secured" at http://www.triodos.co.uk/en/business/borrowing/

[37] See Growing the Social Investment Market: Landscape and Economic Impact, GHK, 2013, at 23

common reason for social organisations not applying for finance in the first place because of a fear of being unsuccessful in the application process.[38]

The type of security that is less risky and should be outside the scope of the tax relief is residential and commercial property and land[39] **(together "property assets")** because these offer by far the lowest level of risk and are already the most attractive security to investors. Investments secured by property assets are demonstrably less risky than other assets because they offer a greater likelihood of recovering the original amount invested because of:

- Established procedures governing the recovery of property assets, meaning the investor can reliably take ownership over the asset for the value it anticipates when security is called;
- The market practice of providing loans for a significantly lower percentage of the total value of the property asset that is secured against. For example, many property assets are secured at 50% "loan-to-value" effectively meaning that the investor has a "buffer" of the difference between the loan value and the property asset value to help shield the investor from any drop in asset value; and
- Property assets generally hold their value over time (in fact appreciation is normally expected, save for in exceptional circumstances). [40]

Other assets do not traditionally provide this level of certainty and amount of recovery. For example, investments secured by a contract (for example, revenues expected from a local authority contract) are very difficult to enforce and assets secured by a brand (for example, a popular product trademark) are very difficult to value correctly.

Investments secured by "property assets" can be practically identified and distinguished through a straight-forward process in the new tax relief:

- Declarations can be required from relevant eligible organisations (in a process similar to submissions to the Small Company Enterprise Centre for EIS) that no security against property assets is provided in respect of the investment; and
- "Property assets" are easy to observe and confirm by HMRC and HMT because they must be registered either at Companies House (http://www.companieshouse.gov.uk/) or at the Land Registry (http://www.landregistry.gov.uk/) in order to be enforceable at law, therefore there is a strong incentive for investors to ensure that they are registered. These registers are updated regularly and are publicly available. HMRC can monitor and enforce such provisions through spot-checks or audit on specific organisations of concern, as necessary.

Guarantees are not as appropriate a tool for distinguishing the less risky investment products. Guarantees obviously increase the likelihood of recovering the principal investment (and reduce the risk of non-recovery) compared with holding no security whatsoever. However such investments remain substantially risker than harder property assets because:

- They are clearly more dependent on the credibility and continued good credit of the underlying guarantor, which can be more volatile than fixed assets; and

[38] See Growing the Social Investment Market: Landscape and Economic Impact, GHK, 2013, at 43

[39] Land is normally treated as slightly more risky by investors than residential and commercial property, however for consistency according to the policy criteria is included within the working definition

[40] The other assets that could potentially be included within the scope of less risky assets are receivables, such as accounts receivable, invoices and trade creditors

- Enforcement action as against guarantors is particularly difficult and requires complicated and lengthy legal actions (particularly against individuals with serious consequences including eventually selling the guarantor's personal holidings, including its residence).

If it is necessary to exclude investments subject to guarantee, it may be possible to **distinguish the guarantees that are useful at reducing risk from the less useful ones**. A government-sponsored guarantee (such as the Enterprise Finance Guarantee) would substantially de-risk the proportion of the loan that it guarantees, whereas a guarantee provided by an individual social entrepreneur will provide less comfort to the investor about the return of its capital. Anecdotally, we have not heard that many social investment finance intermediaries require personal guarantees from their entrepreneurs or organisations they invest in.[41] Therefore, if necessary, it may be possible to develop criteria that only exclude guarantees provided by Government and supranational bodies. This would also serve to ensure that multiple Government interventions are not targeted at the same investment.[42]

BSC proposal:

- Investments cannot be secured against "property assets" (including commercial and residential property and land), but investment can be secured against other assets
- Security against property assets can be determined by a combination of self-declaration and monitoring of existing security registers
- If there must be exclusions of investments that are subject to guarantee, only exclude investments that are subject to Government- and supranational-sponsored guarantee schemes

Consultation Question No. 12

Is it reasonable to require an investment return at a commercial rate, given the nature of the social investment market? If so, what would be the most appropriate way to ensure that any dividends or interest payments that form a return on the investment are paid at a broadly commercial rate? How can the Government best limit opportunities for manipulation on returns?

It is not reasonable to require an investment return at a commercial rate, unless "commercial rate" can be effectively defined. If such a requirement must be included, the commercial rate should be a maximum rate not a minimum rate.

We understand that Government's concern that lies behind Question 12 is to prevent extraction of substantial value from social sector organisations that is disproportionate to the risk that the investor has borne (profit-stripping) and to avoid any schemes designed for tax avoidance and manipulation. We sympathise with this concern. However, **a commercial rate of return is not easy to define for social investments**. The social investment market does not yet have the clear and robust information to conclusively define the expected rate of return for investments for a given risk

[41] In the case of social sector organisations, requiring personal guarantees may be less likely because many social entrepreneurs and organisations are not undertaking their activities primarily for personally financially benefit (rather for societal benefit). Therefore requiring the social entrepreneur to bear personal financial risk of a personal guarantee would not help align the investors and entrepreneurs' motivations in any more robust way. Personal guarantees are provided however in the mainstream SME lending field, for example, FundingCircle is a leading crowdfunding organisation and requires a personal guarantee from entrepreneurs it facilitates investment from (see https://www.fundingcircle.com/)

[42] Such a definition could be determined from ITAA 2007, section 288

level and social impact, given the market's nascent stage of development[43]. It is also unclear as to whether any definition arising from the mainstream finance market would be workable, given that a market failure to provide finance to social sector organisations has brought about the social investment market in the first place.

If a workable definition for commercial rate of return is found, the commercial rate of return should be a maximum rate and **no minimum rate should be set**. This prevents undue restriction on the flexibility of the investment products given many will be deliberately high risk, particularly quasi-equity and equity, and a traditional commercial investor would never be able to be confident of returning all of its principal investment in such products.

BSC proposal:

- To not include any requirements for a commercial rate of investment return, unless a precise and workable definition can be found
- If necessary to include reference to commercial rate, only provide for it as a maximum rate of return and not set any minimum rate of return

Consultation Question No. 13

Would it be appropriate to allow redeemable shares, or an equivalent for debt-like investments, after the minimum period for investment had been reached?

Yes. Redemption and the equivalent for debt-like investments should be permitted after the minimum investment period.

Most traditional financial products allow for some measure of redemption of the investment product after a time. For example, regular interest-bearing loans have set maturity dates whereby the outstanding principal and interest becomes payable. Investors will likely expect this structure for many types of investment products that are not equity. Existing social investment products with redemption periods include the Scope bond, which is repayable in full after three years, and even revenue participation agreements, that may require redemption after a fixed time period.[44] This redemption period also offers social sector organisations the chance to know when they will be finally free and clear of debt.

"Amortizing" loans, which repay both interest and a proportion of principal investment prior to the maturity date, should also be considered within the scope of the tax relief. HMT would need to decide how much outstanding capital would be permitted at the end of the minimum investment period to ensure amortising loans are within scope.

In relation to IPSs, **withdrawable shares** should also be permitted to be redeemed or withdrawn after the minimum investment period at "par value", in keeping with their current practice of using

[43] Only a minor difference in expected returns is currently found between secured lending, unsecured lending and equity products in the most recent market survey, which contrasts with the obvious return differentials evidenced in mainstream financial markets, which perhaps indicates that the market may not have yet established clear pricing trends. See Growing the social investment market: landscape and economic impact, GHK, 2013, at 24

[44] See An Introduction to Quasi-Equity or Revenue Participation Agreements, Mutuals Information Service, Cabinet Office, 2013

them to raise community investment capital. The requirement for a maximum investment of £20,000 per individual investor and the investor's ability to only be able to obtain par value would help ensure that the investor still bears a sufficient amount of risk in making the investment.

BSC proposal:

- To permit redemption of all investments (including withdrawable shares in IPSs) after the minimum investment period
- To permit amortizing loans, subject to certain restrictions

Consultation Question No. 15

Would a tax relief allowing investments of a maximum of €200,000 per investee organisation over three years be successful in generating additional social investment? If so, what types and sizes of social enterprise would be likely to benefit?

Yes in and of itself, but a limit of €200,000 per investee (or approximately £150,000) misses a huge opportunity.

Such a limit would mean that the tax relief would have only **limited effect** in stimulating social investment:

- Recent research provides that the average investment size in the social investment market is £264,000, in excess of the £150,000 limit.[45] Further, the average size of the most risk-taking products, quasi-equity and equity, were substantially higher at £242,500 and £162,000 emphasising the need to set a higher investment limit;
- Most government contracts that social sector organisations will be seeking to compete for will require working capital funding likely to be greater than this cap – potential multi-million pound contracts arising out of the coming £500m justice reforms would require substantial working capital funding;
- More bespoke social investment products that need to be developed in the social investment market require a much greater level of investment size to make the economics work, given the extra effort and resources required to develop them. These include performance-related debt, such as the £5m HCT group part-fixed, part-social loan, and social impact bonds, for which the range of social impact bonds invested in by BSC commences at £450,000 with the average size being greater than £1m; and
- Interviews with mainstream financial institutions suggest that the market failure for lending to social sector organisations exists for amounts up to £5m of investment, and a total absence of mainstream finance for investment amounts below £2m.[46]

Further, it is **unclear that a £150,000 investment limit would be adequate to attract existing and mainstream intermediaries** to engage in this tax relief. Intermediaries will be required to develop products, funds and find investors, much like Octopus, MMC and Oxford Capital Partners operate in the EIS market. Initial feedback from existing EIS fund managers and market participants suggests that £150,000 limit is much too low to attract the interest of professional EIS fund managers and advisers that may need to charge substantial costs to arrange and promote any offer (and such costs would become too high a proportion of the investment to be feasible for both the investee and

[45] See Growing the Social Investment Market: Landscape and Economic Impact, GHK, 2013 at 20

[46] From interviews with mainstream banks, as provided in Internal Report for BSC on State of Secured Lending Market, Management Consultant, 2013

investor (for example, 30% of the investment amount). Evidence about the historical take-up of EIS investments suggests that at least 50% of the total volume of investments is greater than £1m per investee company.[47]

We understand that this investment limit has been designed by HMT to comply with the European Commission limit for *de minimis* state aid to assist the rapid implementation of some version of the tax relief within the *Finance Bill* 2014. We agree with the need to capitalise on the current momentum in the social investment market. However, we have two specific comments about how this investment limit can be applied within the context of State Aid regulations.

Firstly, the calculation of the state aid would ideally be made on a **different basis for debt products** to quasi-equity and equity products.[48] From our reading of the relevant Commision Regulations and discussions with stakeholders,[49] it may be possible for the *de minimis* amount in respect of quasi-equity and equity products to be calculated as the total capital injected, whereas the *de minimis* amount in respect of debt could refer to a calculation about the difference between the actual interest rate charged and the market interest rate multiplied by the principal amount of the debt. If this distinction is possible, it would have a material effect on the amount of unsecured lending that could be permitted under this tax relief.[50]

Even if this *de minimis* calculation is possible, it is still important to set a **higher level of maximum investment per organisation of £5m** (to be comparable with EIS). Whilst we appreciate that such an investment limit increase remains subject to the approval of the European Commission, we believe that a public commitment to seeking approval to increase the investment limit would have a productive effect on the development of the tax relief for intermediaries as well as generate greater attention about the relief in the social sector.

BSC proposal:

- Investigate whether the calculation of State Aid for certain debt products can distinguished from equity and quasi-equity to increase possible size of *de minimis* investments permitted in the *Finance Bill* 2014
- Regardless of the above, HMT to publicly commit to work with the European Commission to raise the investment limit to £5m for inclusion in the *Finance Bill* 2015

[47] See Enterprise Investment Scheme Statistics, HMRC, 2012

[48] Assuming that plain debt products are included within the remit of the relief, as provided in our responses in Part B and Part C

[49] This includes Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to *de minimis* aid Article 4 and the consultation on the draft regulation at Article 4(2)(b) (“Loans”) and 4(4) (“Risk finance”) on the application of section 107 and 108 of the Treaty and Functioning of the European Union to *de minimis* aid

[50] For example, a 5% difference between the reference rate and actual rate could mean that a social sector organisation could obtain £3m of unsecured loans instead of the current £150,000 limit

CIC Regulator Questions - within Part 3 of the Consultation

Consultation Questions No. 18, 19 and 20

(18) Is the double cap, (aggregate cap at 35 per cent and dividend cap – maximum 20 per cent) on distribution by CIC limited by shares too burdensome and does it therefore discourage investment or setting up such a CIC? How and why?

(19) If there were to be a change to the caps, should one or both of the caps be removed or increased? Please give reasons and explain how this should be done. Would this change allow adequate protection of community assets?

(20) What would be the effect of changing or removing the peg to the initial paid up value of shares? Would this affect the statutory asset lock and the protection of community assets? If so, please say why. How should the value of shares be determined – by the market, by inflation, by a specified percentage?

The current CIC dividend caps and pegs to initial paid up value of shares are burdensome and discourage investment. To address this, the aggregate dividend cap should be raised to 49% and pegs to the initial paid up value of shares should be removed.

Community Interest Companies have been attracting increasing interest – there has been a 20% increase in the number of CICs on the public register in 2012/2013 from the previous year. We also understand that many large public and private sector commissioners (such as the NHS) are favouring the CIC form as an easy way of distinguishing organisations that they want to contract with. However, these trends seem to conflict with other experiences about the use of CICs limited by shares:

- CIC limited by shares comprise less than 25% of overall number of CICs, suggesting they may be being under-used;
- Lack of funding was the most common reason that dissolved CICs stated as leading to their dissolution (25% cited this) often still relatively soon after their establishment.[51] Interestingly, only 0.5% suggested they dissolved because of a failure to be awarded contracts that they were expecting; and
- Feedback from key stakeholders including social entrepreneurs suggests that the CIC model, particularly the dividend caps, remains confusing and unattractive for social sector organisations keen to undertake substantial growth.[52]

The peg to initial paid up value of the shares exists not just in the dividend cap, but also in the event of redemption of shares, reduction of share capital and the ultimate wind-up of the CIC. This peg remains a significant barrier to encouraging greater investment in CICs limited by shares:

- **For investors**, the current pegs are unattractive because it means the price of shares is effectively always set at the initial investment amount providing no potential for capital growth over time. Further, even though sales to third parties are permitted by the CIC regulations, it is extremely unlikely that any third party investor will purchase any shares (certainly not at a premium to the initial paid up value) if this restriction is embedded;
- **For social entrepreneurs** that found CICs limited by shares with the hope of growing scale and social impact, the current pegs severely impede their ability to share in the growth of CICs (i.e. obtain “sweat equity”). Social entrepreneurs effectively cannot sell shares back to the CICs (through redemption) or to a third party investor at any premium; and

[51] Many CICs dissolved prior to 21 months when they are required to submit their first community interest report

[52] All data in this paragraph from Annual Report 2012/2013, Regulator of Community Interest Companies, CIC Regulator

- **The social investment tax relief** will not be able to be effectively used by CICs limited by shares in their current form. The tax relief is meant to incentivise long-term patient capital that is inconsistent with the current CIC CLS structure that effectively prohibits investors obtaining any capital gain over the long-term.

There are two parts to reform of the CIC regulations that we recommend investigating.

First, the aggregate cap on dividends should remain to safeguard community assets however it should be increased to **49% of all distributable profits accumulated over time**.[53] This altered structure would be beneficial because:

- It is simpler to understand for entrepreneurs and investors (i.e. just one dividend cap);
- It provides flexibility for CICs to design the capital structure to attract a wider variety of investors (for example, a different share class could be used to attract a particular investor class);
- Setting such a dividend cap structure would be broadly consistent with other approaches in the social investment market to identifying social purpose private companies that can receive social investment. By way of example, BSC has published a Governance Agreement[54] that mandates that all investees that are private companies must ensure that "surpluses are principally used to achieve social objectives … (as) the pay-out of cumulative profit after tax to shareholders will be capped at 50% over time." SEUK also suggests that the majority of the surplus is re-invested in the social enterprise.[55]

Second, **removing the pegs to initial paid up value of shares** will provide greater flexibility and significantly better access to capital and ensures that CICs limited by shares can effectively utilise the new tax relief. Protection of community assets would be maintained by the requirements flowing from the existing legal duties imposed on directors to adhere to the community objects of the company, as well as the existing requirements to produce community interest reports. If concerns still exist about the protection of community assets, **enhanced reporting of community interest** could be required for CICs that obtain significant amounts of external equity investment (for example, investment amounts higher than £1m).[56] Another option that could be investigated would be to ensure that each CIC has a "golden share" that has no economic value but has control of the CIC's community objects. This golden share would help prevent a change of the social mission in the case of a new equity owner. Of course, at all times, dividend payments will remain subject to the existing restrictions on unlawful distributions and directors' duties under English corporate law meaning that appropriate restrictions on abuse of these regulations will continue to exist.

We do note that a question could be raised about whether the changes to the caps on redemption of shares, repurchase of shares and winding-up of the CIC would fundamentally change the nature of the asset lock. If this was a significant concern to the CIC regulator, one idea to address this issue is to ensure that private investors would be able to share in any appreciation in value of the CIC in the same proportion as with dividends. That is, private investors should be able to receive up to 49% of dividends from CICs (as in our current proposal) and also up to 49% of the capital gains from the CICs (arising on redemption, repurchase or wind-up). This approach would ensure that investors could receive some benefit from the appreciation of the value of the CIC (and if less than 49% of shares are

[53] Currently section 6.3.1 provides an ability to carry forward unused dividend capacity from year to year up to five years, see the Information and Guidance Notes, Office of the Regulator of Community Interest Companies, March 2013

[54] See the Governance Agreement applying to For-Profit Social Sector Organisations, available at the BSC website: http://bigsocietycapitalblog.files.wordpress.com/2012/09/governance_agreement1.pdf

[55] See SEUK's membership badge criteria at http://www.socialenterprise.org.uk/membership/membership-badge-criteria

[56] This concept was referred to by UnLtd at http://www.theguardian.com/social-enterprise-network/2013/apr/26/trust-social-enterprise and has been discussed in the context of a roundtable hosted by BSC and UnLtd in early August

issued to private investors, their full entitlement to that appreciation) whilst the community, including other investors that are "asset-locked bodies" within the meaning of the CIC regulations[57] and the CIC itself, would continue to receive the majority of the appreciation of value of the capital gain. Sales of shares by private investors (even if wholly owned by private investors) would continue to be allowed however the shares sold would retain the same rights on redemption, repurchase and wind-up.

Whilst we understand there is limited evidence about the views of key CIC stakeholders for such reforms, the responses from a survey of CICs conducted in early 2013, *A Fair Share: 2012 Review of the CIC Dividend Caps* are encouraging. It provides that the most common suggestion for reform to the CIC regulation from CIC CLSs and key stakeholders was to have one unified cap of 49%.[58]

It is our view that these reforms could produce a very attractive model of investment for social investors, entrepreneurs and the community. If these suggested reforms are undertaken, we expect an increase in both the number of new social organisations constituting themselves as CICs, particularly mutual spin-outs and social impact bonds (see Part D (III) below) and the number of existing social organisations constituted as (non-charitable) CLS and CLGs to transfer to the CIC form. The anticipated increase in investment into CICs would also mean that many CICs may now be a larger size as well. To properly implement these reforms, we would also support an increase in the resources available to the CIC Regulator to ensure that it can effectively regulate and raise awareness of the CIC model throughout the UK.

BSC proposal:

- Increase the aggregate dividend cap to 49% of distributable profits
- Remove all the pegs relating to initial paid up value of shares, being the cap of 20% on dividend, cap on redemption of shares, repurchase of shares and cap on recovery in wind-up of the CIC, and investigate the potential for an aggregate 49% cap on capital gains to private investors
- If necessary, enhance the community interest reporting obligations for CICs limited by shares that obtain external equity investment for amounts greater than £1m

Consultation Question No. 21

Should the performance related interest cap be raised or removed, and what impact would that have on the protection of community assets?

Removed. The performance-related interest cap should be removed in its entirety to increase the capacity of CICs to obtain appropriate and affordable finance in the flexible form that they need.

The current performance-related interest cap restricts payment of performance-related interest to 10% of total debt outstanding. This creates an effective interest rate or return cap of 10%. This is problematic because:

- It restricts an investor's ability to share in the upside of a growing CIC that the investor's patient capital contributed to, however it retains all the downside risk;
- It is too low – 10% effective interest rate would prohibit many previous social investments that have been made and it would make it difficult for investments that pay-out different amounts over time; and

[57] As described in section 6.1.1 of the Information and Guidance Notes, Office of the Regulator of Community Interest Companies, March 2013

[58] See A Fair Share: 2012 Review of the CIC Dividend Caps, CIC Association CIC, January 2013

- It is also complex for investors and social sector organisations to understand and may be a reason for the anecdotal evidence of its limited use by CICs.

We suggest that no cap on performance-related interest is necessary. The terms of the investment (including the amount of performance-related interest payable on debt) should instead be determined solely by the management and board of directors of the CIC, as they are best placed to understand the opportunities and risks involved with undertaking such debt. If it was not possible to remove the cap, **the cap could be made consistent with the level of aggregate dividend caps** (as provided above), i.e. in our response, 49%.

BSC is supportive of any broad anti-avoidance measures that the CIC regulator deems reasonable and necessary to ensure that the removal of the performance-related interest cap does not serve to effectively circumvent the revised dividend cap.

BSC proposal:

- Remove the cap on performance-related interest
- If this is not possible, make the cap of performance-related interest consistent with the aggregate cap on dividend pay-outs (i.e. in our response, 49%)

Part 4 of the Consultation – The Relief

Consultation Question No. 23

Would the proposed five year time period for minimum investment be appropriate? If not, what would be a more appropriate investment period and why?

No. **The proposed five year time period for minimum investment would not be appropriate** because:

- New investors in particular are less likely to be attracted to investments requiring a longer-term commitment in their first foray into social investment because of the greater uncertainty of return of their capital over time;
- In practice, investments cannot be exited instantly on demand. One leading EIS provider that we spoke to suggested to build in a “12 to 18 month” delay on the return of any funds after providing notice of intention to exit because of the difficulty of arranging fast exits from investments (meaning selling shares to another buyer) for organisations without a liquid market for the investment products;
- Many current products that meet the needs of social sector organisations, such as the social impact bonds that BSC has invested in (including Think Forward Social Impact, Triodos New Horizons, Teens & Toddlers Innovation, Energise Innovation and 3SC Capitalise) have around three year periods to deliver the intended social outcomes. This particular period has been chosen to provide the right level of certainty of investment for the social sector organisation and to deliver social outcomes to allow for future replication of successful investments; and
- It is inconsistent with the minimum investment period for EIS (3 years), and would make the social investment tax relief less attractive in the eyes of potential investors.

In any event, social sector organisations are still able to require investors to commit for a longer period of time than the stated minimum investment period in the tax relief before repayment, just not a shorter period.

BSC proposal:

- Reduce the minimum investment period to three years

Consultation Question No. 24

The Government welcomes views on the appropriate balance to be struck on offering any tax reliefs in addition to initial income tax and reinvestment reliefs. If in addition the Government were to offer a tax relief on disposal of qualifying social investments, would a tax relief on gains, or a new rule to encourage serial investments into social enterprises be preferable?

The **reliefs offered should follow as closely as possible those offered to investors in EIS**. IFAs, financial planners and private wealth managers, which will be necessary for the distribution of these products to a wide selection of investors, are naturally risk averse to new forms of investment and will be more attracted to investments that look the same and attract the same reliefs accustomed to in established tax schemes.[59] We would therefore suggest inclusion of the following reliefs:

- Initial income tax relief at 30%;
- Tax free capital gains on investments;
- Full inheritance tax relief provided the investments have been held for two years and are held at time of death;
- Full capital gains tax deferral on tax due on other capital gains for the life of the investment; and
- Loss relief, which can be taken as a deduction against income or as a capital loss.

A new rule to encourage serial investments would not be as effective at attracting new investors this early stage of the development of the social investment market. This is because it would require investors to effectively lock up their capital a very long period of time – at least ten years, if the assets are held for two consecutive minimum investment periods (assuming the five year minimum investment period as defined in the current proposal).

BSC proposal:

- Provide the same forms of tax relief as in EIS

Consultation Question No. 25

Do you agree that the Government should not introduce a new set of rules specifically to support indirect investment into social enterprises via a separate legal entity such as an LLP? What are the potential effects of using the nominee approach outlined above? Are there likely to be fund managers who are able to offer nominee investments?

No. The Government should design the relief to be attractive to as wide a range of investors and intermediaries as possible in order to maximise the take-up of the relief and therefore should expand the amount of indirect investment schemes to include VCT schemes.

The current proposal acknowledges the importance of providing investors with an opportunity to make indirect investments and therefore permits indirect investment through nominee schemes (similar to the EIS nominee schemes). Whilst there is limited information publicly available about the conduct and performance of EIS nominee schemes, we understand anecdotally that such nominee

[59] See Financial Planners as Catalysts for Social Investment, NESTA, June 2012

schemes have achieved some success in raising investor funds in recent times[60]. We also understand that nominee schemes are intended to be less complicated, less regulated and less costly to the investor because there is no need to comply with the listing requirements required in other tax incentivised venture capital schemes. We further understand that these EIS nominee schemes are often operated by traditional fund managers, alongside other funds such as VCTs, limited partnerships and others.

However, restricting indirect investment to only nominee schemes may **miss a large group of potential investors** (particularly when compared to VCT) because:

- EIS nominee schemes appeal to very high-net worth individuals often requiring a minimum investment size of £25,000 - by contrast, the minimum investment size for many VCT funds is around £3,000;[61]
- Additional consumer protection offered through compliance by the VCT with listing rules of an exchange may help in convincing first-time investors to enter the social investment market;
- IFAs may feel less comfortable recommending investments without the branding and rigour offered by compliance with a listing regime, limiting the likely breadth of product distribution; and
- Some investors will demand a scheme that offers relief from income tax immediately at the time of investment, rather than wait a lengthy period of time for the initial income tax relief to be used (up to a year under EIS).

Therefore, we suggest that **indirect investment schemes with the same characteristics as VCT should also be permitted** for the purposes of the tax relief. The key terms of such a scheme were outlined in the Appendix of *The Role of Tax Incentives in Encouraging Social Investment*[62], however broadly it could use and build on the discussions and considerations within this current proposal and other existing tax relief schemes, namely:

- Eligible social sector organisations should be the same as in this tax relief;
- Eligible investment products should be the same as in this tax relief; and
- The broad structure of the vehicles permitted can follow the VCT regime.

Practically, this could be implemented by either extending the existing VCT scheme to permit eligible social sector organisations and eligible social investment products or creating a new VCT-like scheme to fit within the social investment tax relief. We would recommend **extending the existing VCT scheme**. This is because it would leverage established investment structures and intermediary and investor networks, as well as (we assume) require significantly less additional regulation. This approach would also help accelerate the development of fund investment into social sector organisations because raising the minimum economical fund size of £7 to £8m[63] for a new fund purely focused on social sector organisations would naturally take some time.

[60] For example, we understand that a number of funds are currently raising capital, including MMC Ventures EIS Fund, Octopus EIS and Oxford Capital Infrastructure EIS

[61] For example, see the VCT current offers available from Hargreaves Lansdown requiring between £3,000 and £6,000 minimum investment at http://www.hl.co.uk/investment-services/venture-capital-trusts/current-offers and the minimum investment size at MMC Ventures of £25,000 at http://www.mmcventures.com/media/82736/mmc%20eis%20marketing%20leaflet%20-%20june%202013.pdf

[62] See The Role of Tax Incentives in Encouraging Social Investment, Worthstone, 2013, at Appendix

[63] Our understanding of the minimum economic VCT fund size was developed from conversations with VCT market actors

We understand if there is a reluctance to tamper with an existing functioning tax scheme (VCT), not to mention the possibility of needing to seek further European Commission approvals, and that HMT might therefore prefer establishing a new VCT-like scheme for social investment. If a new scheme is established to enable VCT-like funds, we propose that investment must be possible into both eligible social sector organisations and SMEs that are already eligible under existing VCT tax relief schemes (at least for an introductory period). A minimum level of investments into social sector organisations could be set at 35%, being half of the 70% requirement to invest in qualifying holdings existing under the current VCT scheme. The proportion of investment required into social sector organisations could be increased over time as the social investment market develops.

Operating such a scheme in addition to the nominee schemes would offer a number of benefits:

- Attract a broader pool of investors to provide social investment through creating a spectrum of complementary investment options available, comparable to the options available to mainstream tax-incentivised SME financing;
- Build on the past success of VCT and its recognition with investors and IFAs – over £4bn has been raised by VCT since establishment in 1994;
- Help create a more diverse social investment finance intermediary landscape that offers fund structures that would more likely appeal to a greater number of current and potential fund managers; and
- Provide structures in which, in the right conditions, BSC and other large investors could make cornerstone investments, which can be important to building profile for the new funds and scale.

We have not suggested that separate sets of rules should be provided in the tax relief to allow other legal entities, such as limited partnerships, that could be mechanisms for indirect social investment. This is primarily because we understand that limited partnerships often are designed to target the largest investors, such as institutions and pension funds, which are not the target of this tax relief. It may be easier for investors and IFAs to identify a new indirect investment scheme that is based on an existing indirect investment scheme targeted at risk capital, such as EIS, than an entirely new and bespoke tax relief, such as a limited partnership. We also understand the recent experience of HMRC with limited partnerships in the context of film tax relief. We understand from public information that HMRC determined that many of the film tax schemes provided the potential for creative structuring of the investment arrangements and partnership structures to produce unintended tax benefits that did not target successful production and completion of UK films (instead they focused purely on obtaining tax relief).[64] As we currently understand, film tax relief has been changed to no longer apply to partnerships or individuals because of such concerns.[65]

BSC proposal:

- In addition to nominee schemes, permit indirect investment through VCTs (through extending the current VCT scheme)

[64] See the commentary by Accountancy Age, Gwen Souter, 13 May 2010 at http://www.accountancyage.com/aa/feature/1807754/film-tax-tax-cuts

[65] See description by Kingston Smith North America Group at http://www.kingstonsmith.co.uk/upload/pdf/Kingston%20Smith%20Film%20Tax%20Relief%20in%20the%20UK.pdf

PART D - BSC's specific comments on other issues arising from the consultation

In addition to the comments in Part C responding to specific Questions asked by HMT, we have some further comments that have not been specifically asked as Questions in the consultation. We would particularly like to discuss how the tax relief can ensure that: (I) simple investment products (including unsecured loans) are eligible; (II) relevant distribution mechanisms are able to be used; and (III) social impact bonds are within scope.

I. *Ensure simple investment products are eligible (including unsecured loans)*

The tax relief aims to help provide the financing that social sector organisations want and cannot currently obtain because of their inherent legal structure and/or current market failure. The current proposal identifies the capital needed as more "risky capital" through reference to a set of key principles provided in the broad summary criteria in Box 4.A at 17. It also makes reference to a requirement that the "returns offered on social investment should be linked to the financial performance of the qualifying organisation" (section 4.8 at 16).

We agree with the broad intention to focus on risk capital. This is the sort of capital suffering from the most acute market failure at present. Social sector organisations are forecast to demand around £550m of risk capital by 2015,[66] however currently only around £20m of such risk capital is being provided in the social investment market[67]. Over half of social sector organisations' demand for investment will not be serviced without targeted intervention to address this "risky" capital need. For this reason, Big Society Capital has already recognised this need for unsecured lending and has identified it as one of its top strategic priorities.[68]

The broad summary criteria in Box 4.A at 17 set for types of investment are also about right (subject to our other comments above). Distinguishing investments that are secured by property assets (see our response to Question 11 above) will be an effective way of targeting both the capital that is needed (unsecured lending, quasi-equity and equity) and the capital that is not currently being provided by mainstream institutions (that largely require security on property assets).[69]

We disagree with the need for a *specific link* between the return to the social investor and the financial performance of the social sector organisation. Such a restriction would prevent the use of simple financial products by social sector organisations and effectively only provide relief for quasi-equity investment products, such as revenue participation agreements.[70] This in turn would:

- Prevent relief for the simple and plain vanilla unsecured lending products that offer a fixed coupon rate – the products most needed by social sector organisations;

[66] The size of demand for the social investment market is forecast to be approximately £750m by 2015 and equity and quasi-equity products are forecast to be 15% and unsecured lending products are forecast to be 58% of this demand. See The First Billon: A Forecast of Social Investment Demand, BCG, 2012, at 16

[67] See Growing the Social Investment Market: Landscape and Economic Impact, GHK, 2013, at 22

[68] See blog entry for May 9, 2013 at http://bigsocietycapitalblog.com/

[69] Only 10% of current social investment falls within the category of non-secured lending products

[70] For example, see the revenue participation agreement between CAF Venturesome and Charity Technology Trust as described in the NCVO, Commission on Tax Incentives for Social Investment: Analysis and Recommendations, January 2012 at 13

- Not permit emerging investment products that align the investor return with the social performance of the organisation, such as social impact bonds; and
- Limit the range of social sector organisations that the relief would apply to because quasi-equity is primarily used by larger organisations due to the complexity and cost involved with creating bespoke quasi-equity products (for example, the landmark quasi-equity deal was completed by HCT group which has an annual turnover of over £23m).

BSC proposal:

- Allow simple investment products (such as unsecured loans) to be eligible by not requiring a link between investor return and the financial performance of the social sector organisation

II. *Distribution of eligible investment products*

The current proposal does not expressly provide for how investment products can and should be distributed to individual investors. Ideally, the tax relief should enable distribution of eligible investment products to individual investors through a broad range of distribution channels, including the emerging distribution tools of peer-to-peer lending and crowdfunding,[71] subject to appropriate regulation.

BSC proposal:

- Ensure that the tax relief is compatible with a broad range of distribution channels, including crowdfunding platforms

III. *Application of current proposal to Social Impact Bonds*

This tax relief should incentivise investment by individuals in social impact bonds, however the current proposal does not provide for this.

Social impact bonds are an important and very public component of the social investment market. Britain is a leader in social impact bonds, having already launched 14. Big Society Capital has invested in six social impact bonds so far. Various national and local Government departments are using social impact bonds to address key social issues, including Department for Work and Pensions (through its Innovation Fund rounds 1 and 2),[72] Essex County Council SIB for children in care[73] and the Greater London Authority rough-sleeping SIB.[74] In addition, the Cabinet Office is heavily promoting the role of SIBs through its Centre for Social Impact Bonds.

However, **the current proposal does not permit investment by individuals into social impact bonds**:

- The current structure of social impact bonds means that they will not be eligible organisations under the current proposal - they are not charities, IPS (BenComs) or CICs). The vast majority of

[71] See www.abundancegeneration.com for an example of the current use of crowdfunding in the social investment market

[72] See http://www.dwp.gov.uk/supplying-dwp/what-we-buy/welfare-to-work-services/innovation-fund/

[73] See http://www.essex.gov.uk/News/Pages/ESSEX-COUNTY-COUNCIL-FIRST-AUTHORITY-TO-GET-GOVERNMENT-SUPPORT-FOR-SOCIAL-IMPACT-BONDS.aspx

[74] See http://www.london.gov.uk/priorities/housing-land/tackling-homelessness-overcrowding/homelessness-rough-sleeping/social-impact-bond-for-rough-sleepers

the social impact bonds that BSC has currently invested in are private companies limited by shares and these would not be included within the scope of this tax relief; and
- The current proposal also does not provide for social impact bonds as an indirect investment scheme, as only nominee schemes are currently permitted. The special purpose vehicle established to administer the SIB financial structure and enter into the contracts with Government, the investors and the social sector delivery organisations does not meet the definitions of nominee scheme, particularly the requirement to make multiple investments.

There appears to be three distinct options for including social impact bonds in the tax relief:
- **Establishing a separate registration regime for social impact bonds** where HMRC would assess the eligibility of a social impact bond application on a case-by-case basis. This would help account for the diversity of social impact bond structures, however we recognise may require some additional HMRC resources;
- Ensure that the **rules relating to CICs permit and encourage more special purpose vehicles within social impact bonds to use CIC structures** (the responses to Questions 18 to 21 above provide some guidance about this). This could be enabled through a relaxation of the capital gains restrictions (in case of redemption, repurchase and wind-up) for eligible social impact bond delivery organisations. However, as no SIBs have been delivered using the CIC CLS structure as yet, it is unclear as to whether this would be effective for social impact bonds; and
- Adjust the rules relating to permitted nominee schemes to enable a social impact bond to be treated as a nominee scheme. However, it feels unlikely that the substantial changes required to make social impact bond delivery organisations eligible will be easily managed within the existing nominee scheme regulation, given that it has been designed to keep nominee schemes as simple and uncomplicated as possible.

In the above cases, a clearer definition of eligible social impact bond delivery organisation is necessary in addition to a potential application to either HRMC or the CIC Regulator. Such a tight definition should include companies limited by shares created solely for the purpose of managing this social impact bond and that will be wound up after completion. It could also include references to the fulfilment of payment-by-results contracts and direct contractual relationships with charities, IPS (BenComs) and CICs as service providers under the contracts.

BSC proposal:
- To provide for a separate registration scheme conducted by HMRC to assess the eligibility of social impact bonds products that are not otherwise within the scope of eligible social sector organisations
- If a separate regime is not possible, to ensure that the regulations relating to CICs are reformed to make them fit for use by social impact bond delivery organisations

Conclusion

This tax relief comes at an opportune time in the development of the social investment market. The 6 June consultation document has many sensible features. We have proposed some alterations in this response and the Annex briefly outlines how these alterations could really extend the reach of the tax relief to many more types of useful social investment products. To ensure that this tax relief achieves maximum impact for the social investment market, HMT, HMRC and all interested parties should check that the final form of this policy intervention is:

- Sufficiently **broad** at it outset to account for diverse range of products, investors and structures that may need to develop but which haven't yet at this nascent stage of the market;[75]
- Sufficiently **material in size** to make a substantial difference to the financing needs of social organisations (rather than be treated as a side option for investment) and to tip the balance in investors mind to take action quickly;[76] and
- **Consistent** with the emerging social investment finance intermediary landscape – the more the tax relief can operate with existing and new intermediaries, the more it will help extend access to frontline social organisations, build on existing practice and enhance the sustainability prospects of the intermediaries themselves.

We believe that adopting recommendations in this consultation response could help ensure that this tax relief has a truly transformative effect on the UK social investment market.

Big Society Capital, August 2013

[75] A comment often made about the introduction of the Community Investment Tax Relief (CITR) was its unexpected low level of use could be partly attributable to unduly prescriptive regulation at its outset

[76] A relief that is particularly complex and time-consuming to implement will unlikely to be interesting to a social organisation if it can only use it to meet 5% of its financing needs. Likewise, an investor will not be interested in investing in a scheme if disproportionate amounts of the investment (for example, 30%) are spent in transaction costs (even given the tax benefit)

ANNEX

SOCIAL INVESTMENT PRODUCTS IN AND OUT OF SCOPE

Below is a short outline of some of the more public transactions in the social investment market that have occurred recently (or hypothetically could occur), measured as against their eligibility under the current proposal and assuming our proposed changes are made. Note that there are likely to be many smaller non-public social investment transactions that would benefit from this tax relief that are not described below.

Type of Investment Product	Example transactions/potential transactions	Current Proposal	BSC Proposal	BSC Response Reference
Equity				
Equity	Social bank equity issue, where the bank is a charity (hypothetical)	N	Y	Part C (Q15)
Equity	Settle Hydro community share issue by IPS (BenCom)	N	Y	Part C (Q8, Q13)
Quasi-equity				
Revenue participation agreement	Charity Technology Trust obtained £50,000 in return for offering a revenue participation right from CTT that entitled the investor to 2% of CTT's gross annual (audited) revenue	Y	Y	N/A
Social impact bond	Peterborough social impact bond issued by social impact bond delivery organisation where investor return when at least 7.5% reduction in reoffending rates	N	Y	Part D (III)
Royalty agreement	Urgent Care Ltd obtained £399,999 investment in exchange for rights to royalty payments on an agreed percentage of annual gross income	N	Y	Part C (Q15)
Performance-related debt				
Social loan	HCT group obtained a part-fixed, part-social loan comprising £3m as traditional fixed rate loan with £2m investment linked to revenue performance	N	Y	Part C (Q13, 15)
SIB-linked bond	Allia's Future for Children Bond (now closed) proposed a product linked to the Essex Social Impact Bond that repaid principal at a fixed coupon rate with additional payments linked to social performance	N	Y	Part C (Q13, 15)
Unsecured debt				
Bond	Scope charity bond offered £2m unsecured loan at 2% p.a. over 3 years	N	Y	Part C (Q11, 13, Q15), Part D (I)
Bond	Golden Lane housing bond offered a £4m unsecured loan at 4% over 5 years	N	Y	Part C (Q11, 13, 15), Part D (I)