

## **Joint consultation response from Co-operatives UK and Locality**

September 2013

# **Social Investment Tax Relief (SITR)**

## **Background**

### *Co-operatives UK*

- 1.1 Co-operatives UK is the national trade body that campaigns for co-operation and works to promote, develop and unite co-operative enterprises. We have a unique role as a trade association for co-operatives. We work to promote co-operative businesses across all sectors of the economy – from retail and finance where co-operatives are most recognised to key growth areas such as renewable energy, agriculture and education. Together the co-operative economy is worth some £35.6 billion, is owned by nearly 13 million adult members in the UK and has grown by nearly 20 per cent since the start of the credit crunch. Co-operatives UK has 75 per cent of the UK co-operative sector in membership.
- 1.2 For more information on Co-operatives UK, please visit: [www.uk.coop](http://www.uk.coop)

### *Locality*

- 1.3 Locality is the leading nationwide network of communities ambitious for change. We have a membership of over 700 community organisations across the UK. Our members are multi-purpose and community-led and they include community enterprises, development trusts, settlements and social action centres. Locality assists people to work together to create and capture local wealth for the benefit of communities – providing tailored support and promoting peer-to-peer exchange.
- 1.4 Locality is running the My Community Rights support service with resources, inspiration and advice on using the Community Rights. It is also the UK expert on asset transfer, managing the Asset Transfer Unit (ATU) and runs the Community Organisers programme mobilising people across England.
- 1.5 Find out more about [Locality](#)

### *Community Shares Unit*

- 1.6 Together, Co-operatives UK and Locality represent a significant proportion of co-operative and community enterprises, which have a wide and varied asset base and deliver a host of valuable services in their localities.

- 1.7 Both organisations are closely involved in a range of activities to support this growing community-led enterprise sector, as part of the wider social enterprise landscape. However, one particular programme considers the areas of social finance, community investment and sustainable enterprise, which forms the basis for this consultation response.
- 1.8 Specifically, Co-operatives UK and Locality are currently delivering a pioneering programme to support the growing community shares market. The Community Shares Unit (CSU) is a joint venture between the two organisations which launched in October 2012 and is funded by the Department for Communities and Local Government (DCLG).
- 1.9 This programme is overseen by a steering group composed of representatives from a range of government departments and agencies including HMT, FCA, HMRC, Charity Commission and DECC.
- 1.10 It aims to support the growth of community shares, which refers to the sale of shares in enterprises which serve a community purpose. Broadly, the CSU's remit is to develop and promote the use of the Industrial and Provident Society (IPS) form as the vehicle for such community investment, given its unique type of share capital.
- 1.11 Since the launch of the Community Shares Programme in 2009 there has been over 130 successful community share offers, raising in excess of £25m from over 20,000 members, with a further 200 newly registered societies engaged in the process of developing investment offers. To date this model has helped finance shops, pubs, buildings, renewable energy schemes and many other local-based ventures.
- 1.12 For more information on community shares, please visit:  
[www.communityshares.org.uk](http://www.communityshares.org.uk)

#### *Community Shares and tax relief*

- 1.13 The majority of these successful community share offers have benefited from Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) tax relief, which has proved to be an important incentive for community investors. The CSU also acknowledges the special support EIS has given to social enterprises, by allowing renewable energy enterprises structured as CICs and IPSs to benefit from both tax relief and FIT payments.
- 1.14 The CSU supports the view that social enterprises should be encouraged to adopt and develop a corporate form that best enables them to function as enterprises, without prejudice towards any particular form. It welcomes tax relief schemes that reward risk taking in enterprise, and investment in activities that have a public, social, or community benefit. The SISR consultation provides the opportunity to address the perverse fiscal incentives that encourage social enterprises to adopt unsuitable or inappropriate legal forms, as well as addressing the inequalities that exist in current venture capital tax relief schemes between social enterprise and private enterprise.

## Summary of our Position

- 1.15 The Social Investment Tax Relief is a welcome proposal, which addresses market constraints faced by enterprises trying to raise capital for activity that has a clear community or social purpose.
- 1.16 The focus of our response is in relation to one of the key market constraints faced by social enterprises, which is under-capitalisation and we strongly believe that a tax relief can be effective in relation to this. However, our concern in relation to the outline proposals that have been published is that the scheme may end up tied down by inappropriate limits and exclusions, or may not dovetail in an open and flexible way with other options for financing, such as the Enterprise Investment Scheme (EIS). In this case, the relief would be a distraction and potentially an added complexity in the field of social investment.
- 1.17 The focus of our comments are therefore on the practical details required to make a success of the underlying proposal, in line with the commitment and recognition given by Government to the importance of scaling up the social investment market to meet wider needs of the society and economy and to innovate in relation to these.

## Consultation Response

### 2 Criteria for the social investment tax relief

#### Question 1:

*Do you agree with the proposed criteria for assessing options for the social enterprise tax relief? Please provide comments as appropriate.*

- 2.1 We broadly agree with the selected criteria acting as the principles to be applied when evaluating proposals. However, their effectiveness will be determined by the actual detail of how they are interpreted and implemented.
- 2.2 Based on subsequent sections of the consultation document, there is concern that these principles may not have been interpreted appropriately in some cases. In particular, the final criteria: *Compliance with State aid rules* suggests that any new relief may need to gain State aid approval from the European Commission. This in itself is a valid statement but subsequent considerations on how SITR will interface with State aid, with regard to the size of investment appear to be misguided from our perspective – which is detailed further in response to **Question 12 and 16**.
- 2.3 Similarly, we would agree that the principle of *Sustainable and not open to abuse* is a valid criterion, but based on subsequent detail in the consultation document, its interpretation over the prospect for creating substantial additional avoidance opportunities and exposing social enterprise to undue risk, may again be out of step with activity on the ground. Our reasoning here is further explained in **Questions 9 and 10**.

- 2.4 All in all, we would welcome more detail as to how these principles will be interpreted and applied in the evaluation process to ensure that they work effectively during the appraisal and subsequent design of the tax relief scheme.

### **3 The investee organisation**

#### Question 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.*

- 3.1 We welcome the proposal to target SITR at social enterprises that operate for a social purpose, enshrined in its legal form. We recognise that such a definition provides a clear and simple boundary that would be relatively straightforward to administer. However, while SITR focuses on three regulated groups of organisation: CICs, Community Benefit Societies and charities, it fails to mention other forms of IPS, specifically bona fide co-operative societies.
- 3.2 We believe there is a strong case for including co-operative societies in the list of regulated organisations eligible for SITR, based on both a principled and practical position.
- 3.3 Taking a principled view, co-operative societies and community benefit societies are registered by the FCA. A bona fide co-operative society must define its community of interest. The FCA also refers to the International Co-operative Alliance's Statement on the Co-operative Identity. This Statement sets out the values and principles underpinning all co-operatives. Principle Seven is Concern for Community, committing all co-operatives to work for the sustainable development of their communities through policies approved by their members.
- 3.4 More practically, the exclusion of IPS co-operatives would be ill-judged if it was based on the perspective that the ability to distribute profits to members denotes private benefit overriding social benefit.
- 3.5 In a co-operative society a dividend is a discretionary allocation of profits paid to members, based on the value of the members' transactions with the co-operative, and not on the amount of capital invested. Essentially, it is a form of re-allocation of profits to the members who helped generate them, and often acts a financially prudent mechanism that also encourages member loyalty.

- 3.6 Where co-operatives have raised investment, for example through a community share offer, only a minority have redistributed profits through a dividend based on members' transactions with the society, and in all cases the level of distribution has not threatened the wider tenets of community purpose, which the society is committed to on registration.
- 3.7 Furthermore, the exclusion of IPS co-operatives could potentially have a perverse incentive for enterprises to register as community benefit societies in order to qualify for tax relief, when the co-operative society form may be more appropriate. Since 2009, over a third of all share offers were launched by IPS co-operative societies, equivalent to over 50 share offers since 2009. Often the decision to take an IPS co-operative form is in recognition that the community benefit may be predominantly bounded to the membership base, but yet a community purpose features strongly.
- 3.8 This position is acknowledged within the EIS and SEIS guidance on renewable energy enterprises, which applies to both co-operative societies and community benefit societies.
- 3.9 An additional safeguard, should it be required, to ensure that there is no establishment of societies for purposes not intended under this tax allowance, could be a stipulation applied in practice that there is a minimum number of members, such as twenty, required in any bona fide co-operative society that is eligible for the relief.
- 3.10 Finally, there are also pragmatic reasons for including co-operative societies with community benefit societies as regulated groups of organisation eligible for SISR. The FCA, in some cases, has no historic record of whether a society is registered as a co-operative society or a community benefit society. As such, in many cases it would not be possible to determine whether a society would be eligible for SISR based on its legal form, and so would hinder the ability for such a definition to provide a clear boundary.
- 3.11 Beyond IPS Co-operatives, we are aware of calls within the wider sector to potentially expand the definition to other legal forms. We do not feel best placed to make the argument in respect to other forms such as CLGs, and recognise that other membership bodies and sector networks have developed cases in this respect and would be a more appropriate point of reference on this matter.
- 3.12 However, our position would be that by expanding the definition to include IPS Co-operatives, it is still possible to align a definition of social enterprise to those legal forms that are regulated with a specific provision for community purpose.

Question 3:

*Is there an alternative definition of social enterprise that would more accurately reflect the types of organisation that should benefit from the relief, and would be workable in legislation? If so, please provide one.*

- 3.13 We believe that for the purposes of government policy, defining social enterprise by legal form is a positive step in that it provides a clear and consistent approach for encapsulating enterprises that operate for a social purpose. Equally, we cannot envisage an alternative definition that would offer a similar level of transparency, consistency and accuracy that would be workable in legislation. It is acknowledged that there will always be enterprises operating at the fringes of what can be considered as offering a social benefit but a definition by legal form would be the optimum approach to determine whether it should be considered a social enterprise in the eyes of policy makers.

Question 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?*

- 3.14 We believe the introduction of SITR will have implications on donation activities but that it would be limiting to consider the impact simply in terms of the pros and cons for charities. Rather there would be more value in exploring the wider relationship between investment and donation across the social enterprise and charitable sectors.
- 3.15 In particular, **Paragraph 3.17** notes that charities and donors already benefit from substantial tax relief on donations in the form of Gift Aid. This tax relief is very important for charities that are reliant on voluntary income as their primary source of revenue. However, it also creates a perverse fiscal incentive for social enterprises to adopt legal forms in order to secure charity status, but which hamper their ability to function as enterprises. Social enterprises, by definition, should be reliant on their trading activities as their primary source of revenue. They should also look to raise equity to finance their start-up and growth.
- 3.16 Gifts, grants and donations are appropriate for social enterprises at the pre-start stage, before they are investment ready. The risks facing pre-starts are unknown, making it difficult to justify taking on equity or debt.

- 3.17 The CSU in particular is aware of almost 200 pre-start societies that are struggling to become investment ready because of the lack of risk capital to meet their development costs. Providing SITR on gifts, grants and donations to pre-start CICs and IPSs would incentivise giving, and provide an appropriate stream of investment for pre-start costs. It would also create a level playing field between charities, CICs and IPSs, and remove any perverse incentive to be a registered charity. SITR on gifts, grants and donations could be structured in an equivalent way to SEIS, available only to newly registered CICs and IPSs at the pre-start stage.
- 3.18 So to respond to the question directly, the risks of donations being displaced by investments would be mitigated if grants, donations and gifts could be eligible for SITR for all forms of social enterprise as per the definition.

Question 5:

*If charities are eligible for the relief, it will be necessary for specific anti-avoidance rules to ensure investments do not receive relief as both investments and donations, including the need to account for donations and investments separately. Do you foresee any practical problems with this? Are there any other specific avoidance risks that would arise from allowing charities to be investee organisations?*

- 3.19 It should be relatively straightforward to distinguish between investments and donations as investment would be subject to a repayment which is a specific characteristic that Gift Aid prohibits.

Question 6:

*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?*

- 3.20 We recognise the value of ensuring consistency with existing tax reliefs. Indeed, the majority of co-operative and community enterprises that we work with on accessing investment would have significantly less employees than the 250 suggested here. However, from our experience of developing the community shares model, we realise the value of equity investment at all growth stages, from pre-start to established businesses. Given that the context for SITR is to stimulate access to finance for social enterprise regardless of growth status, our position would be to ensure that the size requirement should be as flexible and generous as possible.
- 3.21 That said, our proposals with regard to State aid may require SITR to be restricted to SMEs which make the 250 employee cap applicable. More information on this can be found in our responses to **Question 12 and 15**.

Question 7:

*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*

- 3.22 Taking into account our response to **Question 6**, if there are to be limits on the size of the investee organisation then we see the value in restricting size by a number of criteria and not solely by number of employees.
- 3.23 However, turnover may be a more appropriate indicator of scale than gross assets as there is a greater regional disparity concerning asset value. Specifically, community share offers are predominantly used to raise finance to purchase assets such as pubs, renewable energy installations and other buildings – this gives the clearest sense of community ownership. However, we feel that communities would be unfairly penalised if SITR was not eligible for the purchase of an asset being brought into community use, solely because its valuation exceeded the limit due to local market conditions.
- 3.24 In any event, if 250 employees is to be the cut-off for number of staff, in line with EIS, then accordingly EIS provisions on gross assets of £15m could be appropriate for SITR.

Question 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.*

- 3.25 Specifically, **Paragraphs 3.20** and **3.21** suggest whether low-risk property or asset backed investments should be excluded from SITR in line with the practices for EIS and SEIS. However, this does not take into account that investors in social enterprises do not benefit from the prospect of capital gains, relying instead on the trading performance of the enterprise rather than its capital value. There is a strong case for making an exception for social enterprises in SITR, EIS and SEIS where the trading activity is “property based” but are not property companies per se.
- 3.26 The CSU has supported numerous social enterprises that are property based, including initiatives involving heritage buildings, community land trusts and community supported agriculture. Social investors in these types of initiative will not benefit from capital gains and should therefore be included in these tax relief schemes.

## 4 The Investee Organisation

### Question 9:

*Do you agree with these general principles governing the scope of the investment instrument as a means to ensure that the tax relief for social investments is well-targeted and focused on appropriately high risk investments?*

- 4.1 Based on our on-going work supporting community and co-operative enterprise, we do not agree with some of the principles which have defined the scope of the proposed investment instrument.
- 4.2 Our primary challenge relates to the statement in **Paragraph 4.2** which suggests that many social enterprises are unwilling or unable to raise equity finance. Based on our work through the CSU, there is a growing trend which suggests that social enterprise can and do raise equity finance. Over the last five years, the community shares market has grown dramatically from a handful of ventures to over a 130 share offers, raising over £25m across from 20,000 members. Yet despite this promising market growth, the CSU is committed to addressing the lack of understanding of the importance of equity in the capitalisation of social enterprise, and the scope for all social enterprises to adopt, or convert to, legal forms that enable them to issue equity.
- 4.3 For instance, it is not well known that a company limited by guarantee can be converted into a community benefit society, which would enable it to raise equity. Similarly, through working closely with the Charity Commission it is now acknowledged that some charitable community benefit societies may choose to raise capital by issuing withdrawable share capital, and will need to pay interest on this share capital to attract and retain this investment. It has also accepted that some charities, currently registered as companies limited by guarantee, would be better able to meet serve their communities if they were to convert their form from companies limited by guarantee to community benefit societies.
- 4.4 This emphasis on the value of equity investment is part of a wider recognition that all social enterprises benefit from taking a balanced approach to capitalisation by developing an appropriate mix of equity, debt and retained profits. Tax incentives should support and sustain this balanced approach to capitalisation, recognising the greater risks associated with equity investment. It should also recognise the public, social and community benefits associated with social investment.

### Question 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?*

- 4.5 While we agree with some of the criteria, we do have some reservations on the points set out in **Box 4.A**, informed by our response to the previous question. Accordingly we can offer what we could consider a more appropriate approach to ensuring the tax relief has a proportionate level of risk.
- 4.6 In terms of our areas of agreement, we would support the proposal to exclude equity investment from SITR, because SEIS and EIS already cater for equity investment in social enterprises. However EIS and SEIS do treat social enterprise investors less favourably than private enterprise investors (referred to in greater detail in **Question 24**). Similarly we would support the second criteria that SITR should be restricted to unsecured investments.
- 4.7 However, in the **final paragraph in Box 4.A** and similarly in **paragraph 4.15** it is argued that SITR should not be available to social enterprises that already have an “appreciable layer of equity”.
- 4.8 We believe that such a position is flawed as it could result in a perverse incentive to discourage equity investment in social enterprises. Rather than introducing this restriction, we would propose that the investment instrument has no preferential rights over share capital, and that SITR investors face the same market risks as commercial unsecured lenders.

### Question 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?*

- 4.9 We agree that SITR should be restricted to unsecured investments – it is widely understood that this is the area of most acute market failure in regard to the inability for social enterprises to access unsecured lending. From our experience working with community shares, we emphasise how this finance acts as much needed start-up capital that is patient and linked to the performance of the business. However, many enterprises will need to consider other forms of finance in addition to community shares to meet overall funding requirement and unsecured lending may be explored for working capital and other revenue activities.

Question 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?*

- 4.10 In the first instance we would take a view that a social enterprise should be in a position to determine the rate of return as informed by the overall business case and their target investor base. As demonstrated with community shares, the level of interest committed to is often based on what the business plan can support and what is necessary to incentivise investors in the first place, recognising that the primary motivation is for social or community benefit. This process can be regarded as reflecting the ‘inherent profitability’ of the enterprise, rather than any speculative value.
- 4.11 However, we also recognise that there are potential State aid issues around level of return. Specifically, we hold the view, which is shared with many in the social investment sector, that any limit relating to de minimis aid should be applied not to the principle amount of investment but to any perceived rate “subsidy” on the cost of finance as compared to EU Hurdle rates for unsecured lending to SMEs that might be deemed to flow from SITR. We are interested and aware of the dynamics in unsecured lending because it often forms part of the overall funding mix alongside Community Share capital for new start enterprises.
- 4.12 The EU General Block Exemption Regulation (GBER) lists 26 categories of State aid which do not need to be notified to the European Commission. All 26 categories apply to SMEs, and two focus specifically on investment in SMEs. Article 15 provides for SME investment, limiting aid intensity to 20%. Article 28 addresses State aid in the form of risk capital, defined among other things as equity, quasi-equity, seed capital and start-up capital. Investment is limited to €1.5m per enterprise, at least 70% of the investment must be in form of equity or quasi-equity, and at least 50% of the investment must come from private investors. There is also a de minimis limit of €200,000 State aid per enterprise over a three year period.
- 4.13 Taking this view and in order to comply with State aid regulation with respect on investment in SMEs, there would be a requirement to ensure that rate of return did not equate to a level of subsidy that exceeded de minimis with respect to EU Hurdle rates for unsecured lending. However, such a position would provide a clear and justified position as to how Government can ensure that dividends and interest payments are paid at an appropriate rate, and so limit opportunity for manipulation.

Question 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?*

- 4.14 Based on the limited detail offered in the document, we cannot take a view at this stage. Specifically, we feel that the consultation document is somewhat unclear about what exit routes will be available to investors. **Paragraph 4.10** proposes to allow the redemption of investments after a minimum period without stating what this minimum period might be. It also makes references to redeemable share capital.
- 4.15 Company law requires the redemption of redeemable shares to be financed out of retained profit or by the issue of replacement share capital. We propose that SITR investment instrument should only be redeemable out of retained profit, which would enable the investment to be classified as quasi-equity. The benefits of this classification from a State aid perspective are outline in **Question 15**.

Question 14:

*Would the criteria overall result in any damaging, distortive or unintended consequences in the field of private investment into social enterprise? Please give examples where investments would be supported, or where difficulties might arise.*

- 4.16 In regard to damaging consequences, we believe that anti-avoidance / abuse rules will mitigate such a risk. In terms of unintended consequences on private investment into social enterprise, again this will depend on the detailed design of SITR – we have already highlighted potential perverse incentives that may arise based on the current proposal – particularly around diverting private investment away from valuable equity investment due to potential restrictions. However, we believe that these can be avoided through the suggestions we have set out.

Question 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?*

- 4.17 We would challenge the basis on which a maximum €200,000 per investee organisation has been identified. Drawing on the response to **question 12**, the proposed limit on SITR investment appears to be based on the de minimis limit, rather than using Article 15, or more importantly Article 28 of GBER, upon which presumably the EIS investment limit is based. The investment limit for SITR could be set at a much higher level if the investment instrument is structured as quasi-equity. GBER defines quasi-equity as financial instruments “whose return for the holder is predominantly based on the profits or losses of the underlying target undertaking and are unsecured in the event of default.”

- 4.18 Accordingly, based on our response to **question 13**, we believe that classifying SITR as quasi-equity would be appropriate to meet the legal implications of redeemable shares.
- 4.19 The ability to increase the maximum based on this logic would enable SITR to more successfully generate additional social investment. To give an indication of scale from the community shares market, the average share offer is now just over £200,000 and has been increasing steadily – thus to limit tax relief to investments of €200,000 would limit its ability to realise the investment demand at greater levels within the social enterprise sector.

Question 16:

*Is a cap of £1 million of investments per investor per year the right amount?*

- 4.20 We recognise that this cap is in line with the limits to EIS investors and as an overall limit it would be appropriate. However, our view on this matter is that social enterprises should structure their capital so that they are no overly reliant on a single source of external capital. The proposed cap on investors would still allow a single investor to invest up to the limit of investment eligible for tax relief in a single investee organisation. Therefore, it is proposed that SITR should limit the maximum investment by a single investor to no more than 20% of the total investment sought, and thus avoid the risk of dependency on a single investor.

Question 17:

*Should the EIS conditions on how and when the money raised by the investment must be used also apply to the social investment tax relief?*

- 4.21 In terms of *how* the money raised is then subsequently used, we would encourage that SITR should be as inclusive as possible and so avoid the EIS conditions regarding to qualifying trade / activities. In particular, property-based activities should be eligible as per our response to **Question 8**, but also other activities such as social care and agriculture have a valuable social enterprise dimension and should not be excluded in terms of SITR.

Question 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?*

- 4.22 Given our predominant focus on the IPS form for raising investment, our experience of working with CICs is limited and so we do not feel best placed to comment on this, along with questions 19, 20 and 21.

## 5 The Tax Reliefs

### Question 22:

*Would the proposed definitions of connected parties create any specific problems for investments into social enterprises? How might the Government best ensure that all types of investment instrument were captured through rules on financial connections to a company, without being overly restrictive in the case of emergency financing?*

- 5.1 We believe there are both principled and practical reasons to relax rules on financial connections to a company with respect to SITR. Taking the principled view, there needs to be recognition that the social benefit is generally the primary motivation, ahead of any financial motivation, for investing. Consequently the connected party is not likely to receive a disproportionate 'material benefit' from investing.
- 5.2 On a practical basis, when considering the dynamics of community enterprises raising investment through a community share offer, it should be realised that the founding members are regularly investors in their own right. Furthermore, if the wider members of community-owned ventures were also excluded based on their membership then there would be an illogical scenario where the majority of people comprising the natural 'community of interest' would be ineligible to claim SITR. Thus, an appreciation of co-operative enterprise as a member-owned, member-run business needs to be acknowledged when devising rules around connected parties.

### Question 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?*

- 5.3 A five-year period is in line with Venture Capital Trusts which intends to support longer-term investment commitments. In order to most effectively encourage greater levels of social investment across the wider social enterprise sector, a shorter time-scale should be introduced. We feel it would be more appropriate to align with EIS and introduce a three year minimum period. This would more effectively strike the balance between incentivising investors and protecting social enterprises from liquidity issues.

Question 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?*

- 5.4 On the face of it, Capital Gains Tax on disposal would potentially limit the incentive to invest in the first place we understand the proposal to allow investors to benefit from tax relief on capital gains when disposing of qualifying social investments. However, it is unclear how such capital gains will be achievable in asset-locked CICs and IPSs, or how any profit-related bonus could be described as a capital gain.
- 5.5 EIS and SEIS provide Capital Gains Tax exemption to equity investors in private enterprise which is not applicable to equity investors in social enterprise for the reasons described above. To compensate for this disadvantage, and to encourage reinvestment in asset locked entities, we would propose that reinvested profits should be exempt from Corporation Tax, and that earnings on shares in CICs and IPSs should be exempt from Income Tax. Interest on withdrawable share capital is already paid gross to members, and exempting these earnings from income tax altogether would greatly reduce the administrative burden on individuals, especially those on PAYE schemes who would not otherwise need to complete an annual tax return.

Question 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?*

- 5.6 Given the demand for indirect investment vehicles for EIS and other tax reliefs, we would anticipate considerable interest for similar arrangements to offer access to SITR. However, we would not envisage the need to issue new rules to specifically support this as the current regulations would be appropriate.

Question 26:

*What are the advantages and disadvantages of continuing to operate both CITR and a new tax relief for investment in social enterprise?*

- 5.7 There are a number of advantages to operating CITR in tandem with a new tax relief in SITR in that it will improve the promotion of marketing of CITR to investors. While there are areas of commonality, SITR is designed to incentive investment in social enterprise by individuals and is not available to companies, whereas CITR is available to businesses rather individuals – thus there is sufficient disparity between the two.

Question 27:

*Would any of these anti-abuse measures be likely to have unintended adverse consequences? Please also list any further anti-abuse measures that might be needed.*

- 5.8 Taking into account the characteristics of community enterprises raising investment through an IPS, there is potential for both the second and third anti-abuse measures outlined having unintended adverse consequences. In terms of 'preventing an investor from qualifying for relief if the investor is able to exercise control or influence over the enterprise invested in', this refers to the points outlined in **Question 22**, in which community-owned enterprise relies on members of the community participating in the enterprise in multiple ways - as investors, customers, and co-owners. The democratic nature of governance in a community enterprise in which works on one member, one vote, ensures that no one individual has undue influence.
- 5.9 Similarly the rule 'preventing an investor from qualifying for relief if the enterprise provides the investor with any form of financial benefit (other than a normal commercial return on their investment)' has the potential to rule out IPS co-operatives given their ability to distribute through a dividend. As outlined in **Question 2**, such a characteristic does not threaten its status as a legitimate social enterprise and so should be eligible for SITR.

## Annex A

### 6 Call for Evidence

#### Question 28:

*Please provide information on the current size and composition of the social enterprise environment. For example, information on the total number and size of companies of potential eligible Community Interest Companies(CICs), Community Benefit Societies (bencoms) and Charities, levels of employment, amount currently received by private investors (excluding companies), estimates of turnover, and breakdown by type of capital (quasi-equity/equity/debt).*

- 6.1 The information detailed here is based on the work of the Community Shares Unit to capture and track the level of community investment taking place in the UK over the last five years.
- 6.2 This market intelligence is brought together within a Community Shares Directory, accessible at [www.communityshares.org.uk](http://www.communityshares.org.uk) and which informs the guidance and support the CSU provides, and as such underpins our responses to the consultation questions. An explanation of how this data is collected and presented can be found here: <http://www.communityshares.org.uk/further-information-community-shares-directory>
- 6.3 In terms of the composition of the community shares market with respect to potentially eligible organisations as outlined in the consultation document, the key observation is to demonstrate the breakdown by legal form of those registering with an intention to raise investment and subsequently undertaking a share offer. Specifically, out of the 135 share offers by Industrial and Provident Societies, recorded in the last five years by the CSU:
- 40 are co-operatives
  - 95 are community benefit societies
- 6.4 Furthermore, the CSU tracks the registration of new societies which have both launched a share offer and those which have stated an intention to raise finance through a share offer but have yet to launch. Specifically, out of the 405 societies registered and recorded on this basis:
- 255 are community benefit societies
  - 153 are co-operatives
- 6.5 All of which highlights the sizeable number of IPS co-operatives that have raised equity investment as part of the overall market.

6.6 Taking into account both co-operatives and community benefit societies, the key headline figures for community shares are presented below. This provides an overview of the sector over the last five years, in order to reflect the marked increase in share offers around this time.

**Figure 1: Key Stats (2009 to present)**



6.7 The graph overleaf presents these key indicators as an annual breakdown, highlighting the significant increase in both the ‘pipeline’ of new societies registering with the intention to raise finance through community shares, as well as those actually launching and completing share offers.

6.8 In order to give some context to the figures, a comparator is utilised, showing the number of UK listed companies undertaking an Initial Public Offering (IPO) based on Ernst and Young’s IPO monitor. This comparator demonstrates the notable level of activity of community shares compared to other public investment activities. Specifically, as of July 2013 there had been 131 community share offers compared to 108 IPOs of UK listed companies since 2009.

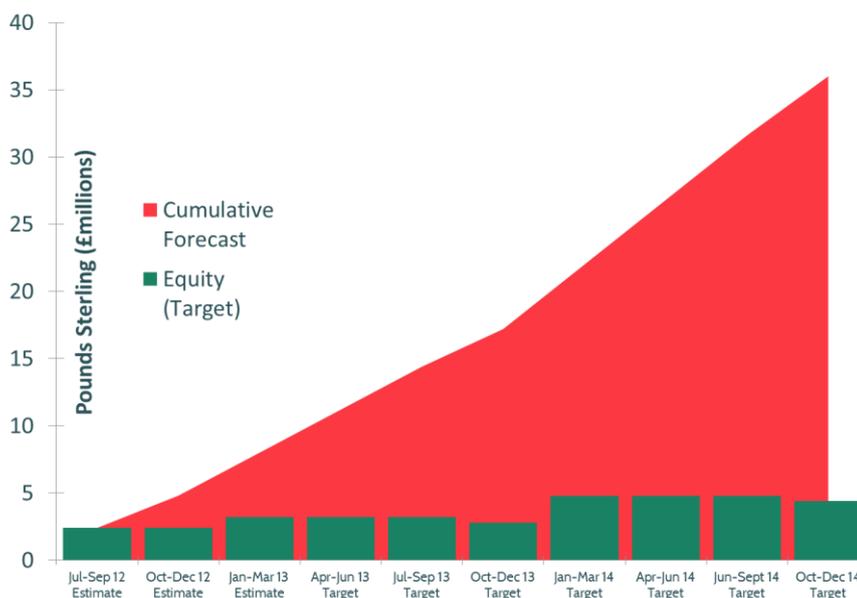
**Figure 2: Community Shares Market Analysis, 2009 to present**



6.9 Of particular note when considering Figure 2 is the sizeable increase in activity in 2013. The figures for the half-year point suggest that the number of registrations and share offers will double that seen in 2012. Such a trend is anticipated to continue over the next period, based primarily on the growing pipeline which of societies registering with the intention of raising finance through community investment.

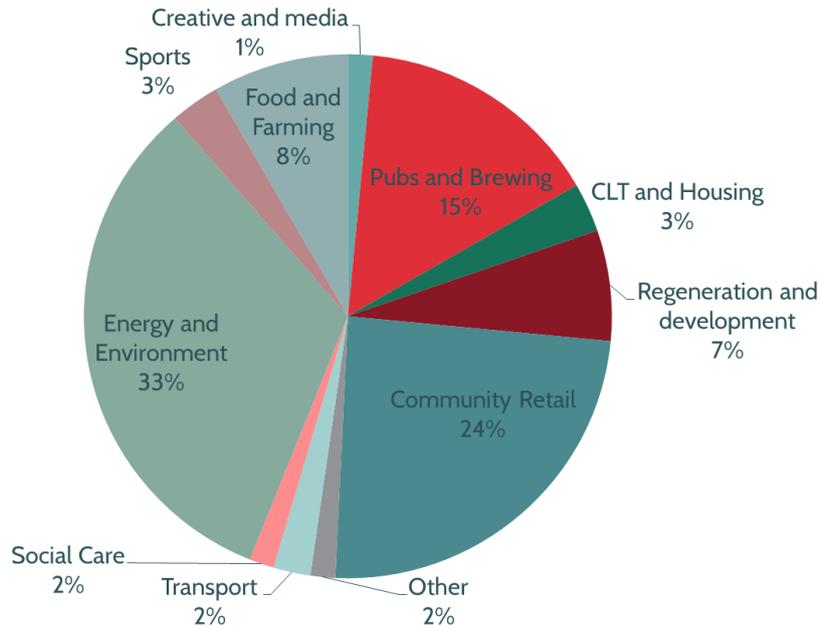
6.10 With this, the CSU has undertaken some forecasting work, highlighted in Figure 3 overleaf. All of which suggests that by the end of 2014, over £35m of equity will have been raised through almost 200 share offers with over 50,000 members participating.

**Figure 3: Forecasts for equity raised by community shares**



6.11 In terms of the diversity of the community shares market, the following figures shows the significant sector and regional distribution of activity in the UK. Again based on registrations, our expectations are that this level of diversity will increase with community enterprises developing share offers in new and emerging sectors such as woodland, heritage and transport.

**Figure 4: Sector distribution of share offers**



**Figure 6: Regional distribution of share offers**

