Consultation response

Social Investment Tax Relief: call for evidence

July 2019

Summary of recommendations

In this submission we have sought to respond with evidence-based answers wherever possible. In this submission we make the following policy recommendations:

Question 14

- Remove the rules under Section 257MJ of the Income Tax Act 2007 that make investments supporting activities that HMRC would not consider to be a 'trade' ineligible for SITR (see 14.18 to 14.21 below)
- Make the community ownership and leasing of assets eligible for SITR (14.24 to 14.30 below)
- Remove renewable energy generation and export from the excluded activities list for SITR (see 14.31 to 14.36 below)
- Remove production of primary agricultural products from the excluded activities list for SITR (see 14.37 to 14.39 below)
- Make property development by an asset locked community benefit society eligible for SITR (see (14.40 to 14.42 below)
- Establish criteria and a checking process that allows certain co-operative societies to benefit from SITR (see 14.43 to 14.51 below)
- Create a 50 percent tax relief for seed social investments equivalent to SEIS ('Seed SITR) (see 14.52 to 14.53 below)
- Remove the seven year age limit for businesses offering SITR to investors (see 14.54 to 14.55 below)
- Develop a scheme whereby social investors can 'gift' the value of their SITR to the business they are investing in (see 14.56 to 14.57 below)

Question 5

- Set a clear policy objective for SITR to enable more social investment on the part of engaged stakeholder/beneficiary communities

Question 6

- Create a Social Entrepreneurs' Relief by removing the 'no employee investors requirement' from SITR

Question 8

- Increase the lifetime limit to that set for EIS

1 *Question 1 If you are a social enterprise, are you interested in or planning to scale up? How do you intend to achieve this and how much do you hope to raise in investment?*

1.1 We would like to offer government the evidence we gathered during the 2016 'Co-op Census', which asked co-operatives questions about their objectives for the future. Of the 413 individual co-ops that responded to this question, 66 percent indicated that they had growth ambitions.[1]

2 *Question 2 Other than individual investors, what sources of finance do trading social enterprises seek and acquire?*

2.1 Evidence suggests that for co-operatives, including community benefit societies operating a co-operative model of ownership and control, members drawn from communities of place and interest are the most significant source of finance. Members finance their co-operatives and community businesses through member share capital (most notably Community Shares), by buying bonds, making loans to the business, paying subscriptions and making donations. Most of these transactions should be considered by government as finance from 'individual investors', albeit investors that are 'inside' the social enterprise. Evidence suggests that other than this, the most significant sources of finance for co-operatives and community businesses are grants and debt from institutions, with things like factoring, supplier credit and member donations also playing a role.[2]

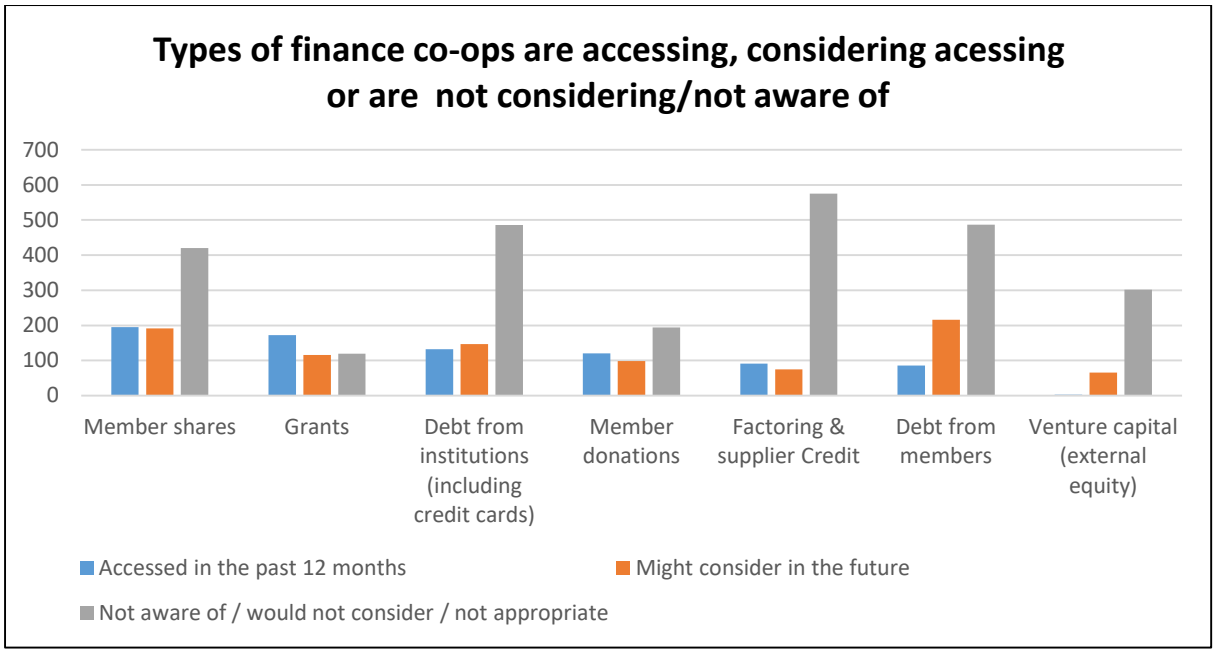
2.2 We would also like to draw government's attention to the small but strategically promising role that institutional equity investment is starting to play.

Co-op Census (2016) data

2.3 We would like to offer government the evidence we gathered during the 2016 'Co-op Census', which asked co-operatives questions about sources of finance. The Census data contains the responses of 498 individual, validated co-operatives, the vast majority of which are community businesses, worker co-operatives or co-operatives serving multiple stakeholders, making them very relevant to considerations of social enterprise.

2.4 The Co-op Census tells us that the most common sources of finance for co-operatives were forms of member capital contribution. Member shares (such as Community Shares) were the most commonly reported source of finance overall, which government should certainly consider as a kind of 'individual investor' source. But donations from members and debt raised from members (for example through loans to the co-operative or 'member bonds') were also present in the sample. Grants and debt from institutions like banks were very significant sources of finance for the responding co-operatives. 'Non-traditional' financing such as factoring and supplier credit was also present in the sample.

2.5 Significantly, and as expected given the form and function of co-operatives, the Co-op Census tells us that only a small minority of co-operatives consider raising equity investment from 'external' sources (non-members) and far fewer still actually do it.



Data from Co-op Census (2016)

2.6 So, to answer government's question directly, other than individual investors who are overwhelmingly members contributing equity (most notably Community Shares) and debt, the Co-op Census (2016) data tells us that the most significant sources of finance are grants and debt from institutions, with things like factoring, supplier credit and member donations also playing a role.

Institutional investment and financial support

2.7 We would also like government to consider the growing role of institutional investors in co-operatives and community businesses.

2.8 Co-operatives UK is one such institutional investor. We have been funded by Power to Change to make match-investments in community businesses through the Community Shares Booster Programme. This is a funding scheme to support community share offers. It will invest equity up to £100,000 to match Community Shares in societies that can demonstrate higher than average levels of community impact, innovation and engagement.

2.9 Co-operatives UK has also begun making equity investments in emergent 'platform co-operatives' (co-operatively owned and run social tech/tech for good platforms), with the financial backing of the Open Societies Foundation.

2.10 Community Development Finance Institutions, such as Co-operative and Community Finance can also play a role in this space. Co-operative and Community Finance made new loans to co-operative and community businesses totalling £893,000 in 2017 [3]

3 Question 3 How difficult or easy is SITR to access for social enterprises?

3.1 For the majority of social enterprises, accessing SITR would be very difficult because they would need to issue debt or equity securities to investors, which is neither necessary nor appropriate for most of them. The majority of social enterprises, including co-operatives and community businesses, are very small or micro-businesses.[4] [5] Furthermore a significant

minority operate business models that do not support the servicing of bonds or dividends, for example by relying heavily on grants and other non-trading income.[6] While government research in 2017 found that 39 percent of social enterprises with growth expectation planned to approach external finance providers, the same research also found that the main sources of finance sought by social enterprises were bank overdrafts, credit cards and loans.[7]

3.2 Raising capital from investors can be complex, costly, time consuming and daunting. If not done appropriately it also carries a risk that the social purpose and impact of the enterprise could be undermined.

3.3 Within the social economy, and even more so within the population of SITR-eligible organisations, the pool of likely businesses for whom it is necessary and appropriate to issue debt or equity securities to investors is limited to the following:

- community benefit societies using a 'community co-operative' model of ownership and control for revenue generating assets and enterprise, making use of Community Shares and potentially community debt instruments
- Public Service Mutuals
- Other comparatively large community interest companies, charities or community benefit societies

3.4 This is backed up by the data on actual SITR use complied by Big Society Capital.[8]

4 Question 4 What are the factors that lead to a successful trading social enterprise?

4.1 To some extent, the factors are little different from businesses in general. Success depends on the following:

- An effective, efficient value creation model - using inputs efficiently to produce commercial value and social impacts, in a way that is 'competitive' in the relevant markets
- Having the right capital and investment in that capital – including investment in people as individuals and as a team, knowledge, equipment, space, infrastructure, social capital
- Maximising the value-added in relationships with, and participation of, workers, customers, beneficiaries and the community at large
- Having effective systems for decision making, trouble shooting, organisational learning and renewal

4.2 Or course, to deliver on a social mission through the operation of a successful business model, social enterprises tend to approach these factors differently from 'for-profit-only' businesses, in varied ways. And where the social enterprise is also a co-operative, distinct approaches to social value creation, capital, investment, stakeholder relationships and governance are fundamental components.

Success factors	Co-operative difference
An effective, efficient value creation model	Focus on 'member value' - the shared economic, social, cultural and environmental benefits created for those who form the co-operative Successful creation shared social value is heavily dependent on the participation the beneficiaries – for example as workers, as community investors, volunteers, customers and non-transactional beneficiaries Social value creation is enhanced by the beneficiaries sharing democratic ownership and control of the business as members Where a co-operative model is used by people to co-create their own value in areas such as land management, housing and local services, the traditional model of competition for consumers does not apply neatly
Having the right capital and investment in that capital	Co-operatives are an efficient means of pooling economic and social capital to achieve common purposes, especially the community co-operative model using Community Shares
Maximising the value-added in relationships with, and participation of, workers, customers, beneficiaries and the community at large	Depending on the purpose of the co-operative, the workers, customers/users or the community will be, through their membership, both the primary agents and the beneficiaries This helps create a strong culture of solidarity, responsibility and trust, boost discretionary effort and improve communication and information flows Empowerment through shared ownership and control helps to develop people's individual and collective capabilities
Having effective systems for decision making, trouble shooting, organisational learning and so on	Successful co-operative governance ensures that members - the beneficiaries - exercise ultimate control, thus helping to retain focus on social purpose, hold senior decision-makers to account and to inform an effective value creation process

4.3 There can be significant added economic and social value in the community ownership and control of assets and enterprise. The participative, empowering relationship a beneficiary community has with an asset in a co-operative model can play a major role in unlocking that asset's value. In our view, where the community ownership of assets has under-performed, community equity has played a small role in the overall mix.[9] Co-operative relationships between a beneficiary community and an asset/enterprise; as investors, owners, members and customers/users; is key to the potential of the community ownership model which government has recently commitment to support in its Civil Society Strategy.[10]

5 *Question 5 Do you think social enterprises need private investment and for what purposes?*

5.1 We are not entirely sure what is meant by 'private investment' in this context. Does it mean not public sector investment? Or private equity perhaps?

5.2 In the Co-op Census (2016) challenges relating to finance (access, cost and suitability) were the second most commonly identified barrier to success. The most commonly identified barrier to success was competitive pressures.[11] Thus we believe co-operatives, like most businesses, do experience a need for greater investment in productivity enhancements.

5.3 That said, the potential for the types of investment that could be supported by SITR should not be overstated. A significant number of co-operatives do not operate in capital intensive industries and can meet their capital needs through the contributions of members, bank lending and through retained earnings. However, over time some co-operatives do develop capital needs that their retained earnings and borrowing cannot meet and at this point they may well require further investment.

Community investment vs 'private investment'

5.4 Furthermore, there are co-operatives that have bigger capital requirements early on. For example those seeking to utilise powerful digital platforms, grow large memberships quickly or make extensive use of land and premises, must fill a significant finance gap at the beginning. For some community or consumer co-operatives, the co-operative model can itself be a vehicle for raising finance by crowdfunding it from a larger pool of members. This is even the case when a lot of capital is needed from the beginning. The key finance model here is Community Shares, which has developed into a £100 million market since 2009 and has led to broad community ownership of land, property and even renewable energy plant.

5.5 But it is questionable whether this capital raising route is best described as 'private investment' (though we are not entirely sure what is meant by this). This is social investment on the part of an engaged stakeholder/beneficiary community (a public), rather than privately-placed equity investments. This model of social investment has proven especially successful in raising patient, mission-aligned equity, from stakeholders who prize the community benefit produced by the enterprise very highly. This is a demonstrably successful approach, to not only driving the right kind of investment into social enterprise, but also driving broad community participation in social enterprise at the same time.

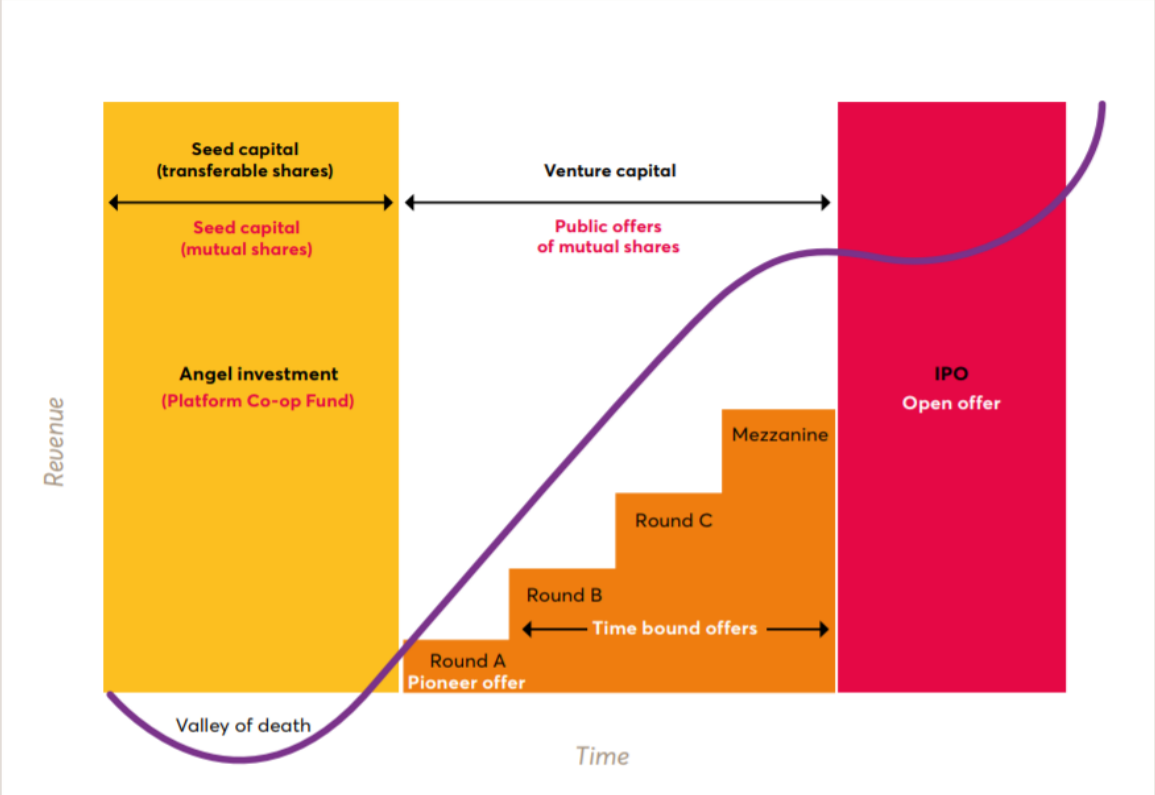
Recommendation: Set a clear policy objective for SITR to enable more social investment on the part of engaged stakeholder/beneficiary communities.

External investment in co-operative societies

5.6 However, for many other co-operatives, and especially for workers' co-operatives, such capital needs could only be met by accessing 'external' private investment. Recent research by Nesta and Co-operatives UK has mapped the investment needs and possible solutions for the UK's nascent platform co-operative sector and a new structured approach to equity investment is likely to be an important part of the mix [12](see below). We anticipate

that this new financing cycle will include a mix of private equity, often from institutions, and equity investments from public of mission-aligned social investors.

Figure 2: Possible start-up finance cycle for platform co-ops



From Simon Borkin (2019) 'Platform co-operatives: solving the capital conundrum'

6 *Question 6 Is tax the most appropriate government lever for supporting funding for social enterprises?*

6.1 This depends on specifics such as the where a business is in the life cycle, what activities it undertakes and what the related capital needs are. A tax relief such as SITR is a very appropriate lever for incentivising the allocation of investment towards social enterprises that:

- have a business model that is likely to generate a revenue over the long term
- need to raise capital from investors and use a structure that is suited to doing so, such as a community benefit society taking a co-operative approach and using Community Shares
- offer investment prospects that are less attractive in narrow commercial terms than those offered by non-social enterprises undertaking similar actives

Co-operative and Community ISAs

6.2 We also see significant new opportunities for people to opt for some of their savings to be invested in co-operative societies and community benefit societies with tax benefits. This follows very welcome action in 2016 to make bonds issued by co-operative and community

benefit societies eligible for the Innovative Finance ISA. To unlock this opportunity government could help to convene co-operative and community benefit societies, crowdfunding websites and socially-purposed financial institutions such as credit unions, to explore the potential of developing 'Co-operative and Community ISAs'. Such a development could be especially useful for co-operative societies that are more likely to use debt issues to mission-aligned external investors.

Enterprise-focused tax incentives

6.3 We also ask government to consider the potential for using the tax lever not to incentivise the behaviours of external investors, which is only really useful for some particular subsets of social enterprise, but to incentivise the behaviours of social enterprises themselves.

6.4 A new tax incentive could encourage some of the profits created by co-operatives and social enterprises to be pooled in independent, mission and asset locked funds, to be put to work at greater scale for greater impact, to fund enterprise development services and to provide more accessible finance for other co-operatives and social enterprises. Government could offer a corporation tax relief on profits paid into such institutions. This approach has proven to be very successful in supporting co-operative development where it has been introduced.[13]

6.5 Crucially, the targeting and eligibility criteria for such a relief would regulate the institutions receiving the profits, rather than the enterprise, so this could be used to incentivise the behaviour of any business that chose to use its profits in this way, regardless of legal form or corporate purpose. Eligible receivers would need to be mission and asset locked social enterprises in their own right, committed to using funds to support things like co-operative development, with an appropriate degree of operational independence from the businesses that provide these funds.

6.6 Separately, and again taking what works for co-operatives elsewhere in the world, a corporation tax relief on profits paid into the non-distributable ('asset locked') reserves of a co-operative or social enterprise would be very instrumental in supporting self-financed enterprise growth.[14] Crucially, this approach to growth is very appropriate for most new co-operatives and other social enterprises.

Social Entrepreneurs' Relief

6.7 While over time and with the right targeting, SITR will increase the allocation of investment to social enterprises in need of capital, this will not in itself incentivise social entrepreneurship. Entrepreneurs' Relief in theory provides a tax relief for entrepreneurs exiting their company with capital gain. But it operates in a way that is unsuitable for most forms of social entrepreneurship, where capital gain on disposal of shares is either impossible (a community benefit society, community interest company limited by guarantee) or is possible (community interest company limited by shares) but can become an inappropriately significant motivation.

6.8 Government should consider the merits of a Social Entrepreneurs' Relief that provides a tax-advantaged return on investment for employees of social enterprises who hold shares or have otherwise invested in the business. This could be achieved by removing the 'The no employee investors requirement' from SITR (ITA2007 257BA).

Recommendation: Create a Social Entrepreneurs' Relief by removing the 'the no employee investors requirement' from SITR

Non-tax support for start-ups

6.9 The success of our Community Shares Booster programme suggests that were the British Business Bank or Big Society Capital to provide match equity investments alongside community investors, they could make Community Shares and community business a more widely viable model, especially in contexts of socio-economic deprivation.

6.10 Evidence provided elsewhere in this response suggests that government should also make sure its interventions in start-up and growth finance, such as the New Enterprise Allowance and Start-Up Loans respond to the particular needs of social enterprises. While there are no specific barriers to using these funding sources to help establish co-operatives, both the financing and the accompanying enterprise advice have been designed with for-profit-only lone entrepreneurship in mind. For example, Start-up Loans are made to individuals not corporations and business partners must apply for and be approved for loans separately. And looking at the makeup of Start-up Loan Providers, only 8 out of 31 appear likely to offer pre-application support or mentoring on co-operative options.[15]

6.11 Furthermore, to support more social and co-operative entrepreneurship at the smaller scale and outside of the community business space, evidence suggests a greater focus on business development grants, especially repayable grants and ultra-soft loans, perhaps on a match-funded basis, would be more instrumental. Crucially, these types of financial support could be provided by institutions funded by the pooled profits of other social enterprises (see 6.4 above).

7 Question 7 What criteria would be best measure of success for SITR?

7.1 Success should be measured by the extent to which SITR addresses the market failure it was created in response to. As stated in the consultation document, SITR was created because insufficient investment is allocated to social enterprises, because in narrow commercial terms these businesses very often must offer less attractive investment prospects than non-social enterprises, due to the primacy of their social purpose and their organisational and legal structures.

7.2 So, SITR should be judged as successful by the extent to which it incentivises investment that generates a social as well as a financial return, where the capital might otherwise have been allocated to ventures that are a more attractive prospect in narrow commercial terms, or not invested at all. On this last point, we believe one measure of success should be the extent to which SITR enables a 'democratisation' of social investment among people who might otherwise not invest at all. This democratisation would certainly align SITR with the policy objectives set out in government's Civil Society Strategy.[16]

7.3 Key indicators of success might include:

- Increase in the volume and scale of social investments supported by SITR
- Qualitative and quantitative evidence of increased social returns on investment supported by SITR

- Increased participation in social investment by people from outside the traditional investor demographics of wealth, status and background, supported by SITR
- Increased volume and value of assets and enterprises in community ownership, delivering community benefits supported by SITR

7.4 We urge government to be realistic and patient when setting aspirations for indicators such as these. As stated, the population of SITR-eligible enterprises that might realistically issue debt and equity instruments to investors is small and growing only steadily. And this is further limited by the current restrictions within SITR on 'trade' and excluded activity.

8 Question 8 Is the SITR limit of £1.5 million appropriate?

8.1 The lifetime limit of £1.5 million is inappropriate and undermines the ability of SITR to meet its policy objectives. The disparity with the value of reliefs available for non-social investments via SEIS, EIS and VCT further intensifies the market failure SITR was intended to address, by disincentivising the allocation of capital to investments that generate social return but are less attractive in narrow commercial terms.

Recommendation: Increase the lifetime limit to that set for EIS

10 Question 10 Would you invest in social enterprise without tax relief?

10.1 We would like to draw government's attention to data that sheds some light on the impact of tax reliefs on the behaviours of community businesses and their investors.

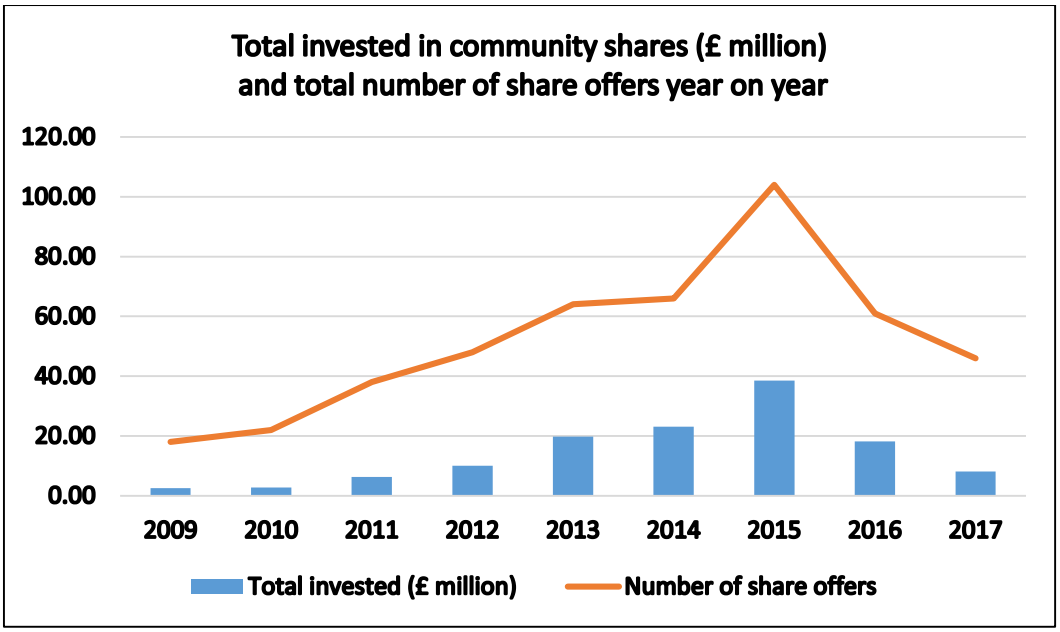
Community Shares Unit data

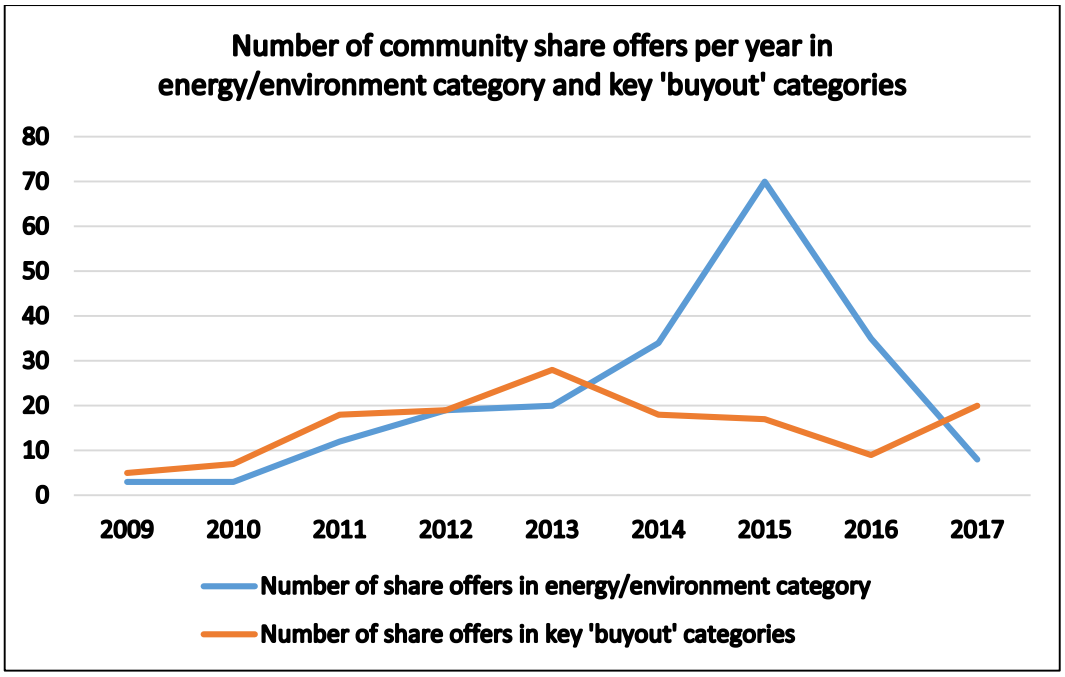
10.2 With Locality and a small team of experts, Co-operatives UK runs the Community Shares Unit, which among other things collates data on community share offers. Trends in recent years are useful indicators of how recent changes in tax relief eligibility have impacted on activity.

10.3 The two biggest changes in tax relief support for Community Shares in recent years have been:

- a loss of EIS for energy generation from October 2015 (and exclusion from expanded SITR)
- a loss of EIS for 'community buyouts'/'community rescues' of businesses and assets from November 2015 (and similar exclusions in the expanded SITR)

10.4 How did these withdrawals of tax relief impact Community Shares activity? Total annual investment in Community Shares has declined from a £38.5 million peak in 2015, to just £8.1 million in 2017. In line with this, the total number of share offers each year declined from a 2015 peak of 104 to just 46 in 2017.[17]





10.5 The number of community share offers in categories key to the ‘community buyout’/‘community rescue’ of businesses and business assets (community retail and pubs) peaked in 2013. The biggest drop (47 percent) occurred in 2016, following the withdrawal of EIS for the ‘community buyout’/‘community rescue’ of businesses and business assets in November 2015, though the downward trend began before this tax change and has since begun to pick up.

10.6 The total number of community share offers in the energy and environment category dropped from a peak of 70 in 2015 to 8 in 2017. Taken alongside evidence we gathered in 2014 on the role of EIS in community energy investment (see below) we believe there has been a link between the loss of EIS and the dramatic fall in community energy share offers. However, this trend must also be understood within the context of a potentially much more significant non-tax development: the effective end of predictable, viable electricity generation income for community energy schemes, as a result of the dramatic Feed-in

Tariff reduction from February 2016 onwards. In 2018 a survey by Community Energy England established that the Feed-in Tariff reduction had been the leading cause of stalled community energy projects in 2016-17.[18]

10.7 But evidences leads us to think that the loss of EIS will have contributed to the drop off in renewable energy-related community share activity. Crucially, we believe the loss of EIS may well have *reduced investment* in this part of the community business landscape even in a scenario where the Feed-in Tariff had continued. This evidence comes in the form of community energy investor survey data we gathered in 2014.

Community energy investor survey (2014)

10.8 In 2014 Co-operatives UK sought to understand how the ability to claim EIS had influenced people's decisions to invest in community energy schemes. The results suggested that, all other things being equal, the lack of tax reliefs on investment returns would have significantly reduced levels of social investment in this sector.

10.9 We surveyed the sector and 1,056 individual investor-members of at least 57 independent community energy societies completed an online questionnaire. Of these 883 had benefited from EIS relief. Asked what they would have done if EIS had not been available 37 percent of respondents (who did benefit from EIS) told us they would have invested less. When asked what lower amount they might have invested, the responses averaged out at a 45 percent reduction. A further 38 percent of investors told us that without EIS they would not have invested at all.

10.10 The table below shows the average investment amounts and the total investment represented by each of the three respondent groups mentioned in paragraph. The data suggested that in real monetary terms the absence of EIS would have **resulted in a 59 percent loss** in community investment.

	Investors		Average investment	
Not invested at all	338	38%	£4,303	34%
Invested less	327	37%	£6,101	48%
Invested the same amount	218	25%	£2,385	19%

10.11 In the same survey of community investors we asked what impact a future without any investment tax relief might have on future decisions to invest. The responses were as follows:

- 22% said it would make no difference
- 40% said they would invest less
- 38% said they would be less likely to invest at all

10.12 The results of the survey also showed that EIS had the least impact on the smallest investments. Of those who said they would have invested the same amount even without EIS, 61 percent invested under £2,000. Of those who invested under £500, 52 percent indicated that EIS had no impact. However, the results show the role of EIS on decision

making growing rapidly as the investments increase in size. So by contrast 74 percent of those who invested between £1,000 and £1,499 said that without EIS they would either have invested less or not invested at all.

Conclusion

10.13 The data we have suggests that tax reliefs can contribute to making it more likely that people make social investments, and more likely that they will invest in greater amounts. We believe the most significant impact of tax reliefs on investors is how they encourage them to invest more in a social enterprise than they might do otherwise. As the consultation document rightly says, social investments often offer the prospect of comparatively low financial returns for the level of risk involved. The social return on investment can often make up for this, especially in the context of community investment, where lots of investors have a close communal stake in the social impact that will be generated. But a tax relief can further make up for lower returns and thus incentivise an even greater allocation of capital to social investments.

14 Question 14 As an investor, enterprise or interested party, do you have a view as to why the take up of SITR has been less than expected?

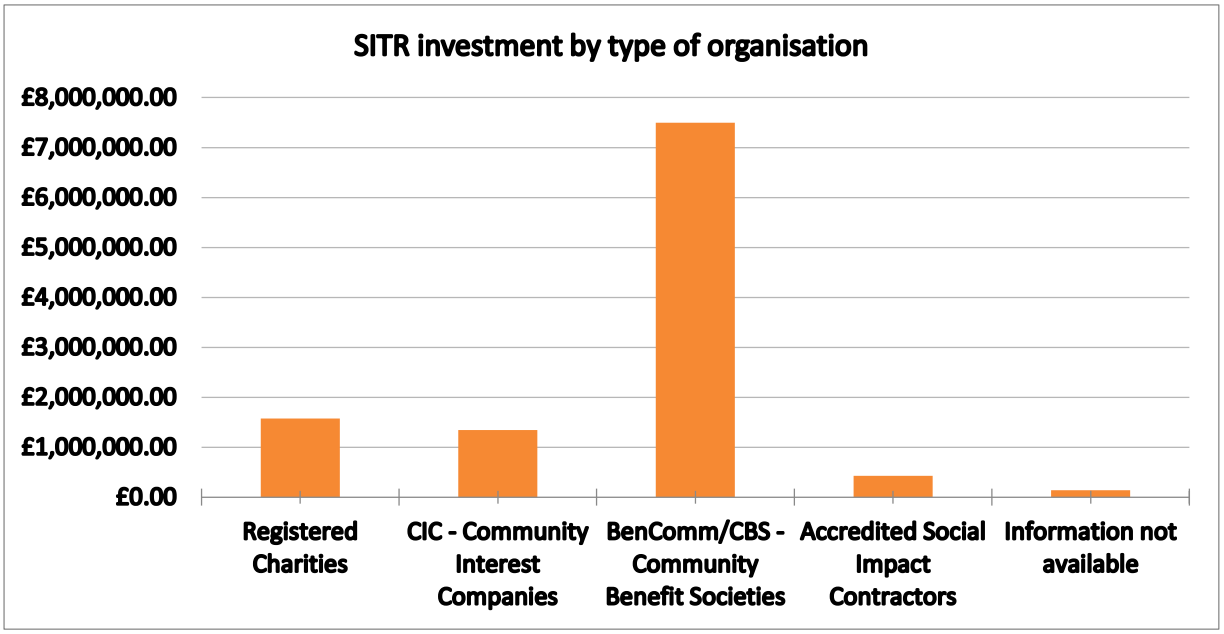
14.1 As we said in response to ***Question 3***, the number of SITR-eligible social enterprises (community benefit society, community interest company, charity) in the UK that are likely or able raise money from investors by issuing debt or equity instruments is quite small. To reiterate, the majority of social enterprises, including co-operatives and community businesses, are very small or micro-businesses.[19] [20] Furthermore a significant minority operate business models that do not support the servicing of bonds or dividends, for example by relying heavily on grants and other non-trading income.[21] While government research in 2017 found that 39 percent of social enterprises with a growth expectation planned to approach external finance providers, the same research also found that the main sources of finance sought by social enterprises were bank overdrafts, credit cards and loans.[22]

14.2 Raising capital from investors can be complex, costly, time consuming and daunting. If not done appropriately it also carries a risk that the social purpose and impact of the enterprise could be undermined.

14.3 Within the social economy, and even more so within the population of SITR-eligible organisations, the pool of businesses for whom it is necessary and appropriate to issue debt or equity securities to investors is largely limited to community benefit societies using a ‘community co-operative’ model, with revenue generating assets and enterprise, using Community Shares and community bonds. This is why, according to Big Society Capital’s SITR open data, community benefit societies account for by far the largest portion of SITR use to date, both in the number of deals and investment amounts.[23]

14.4 Community benefit societies and Community Shares account for **all** of the £4.8 million of equity raised through SITR. And while we really must stress the unmatched success of Community Shares in raising full risk equity finance for social enterprises, community

benefit societies also account for 45 percent of debt raised through SITR and on average have raised debt investment through SITR in larger amounts.[24]



Data from Big Society Capital

14.5 This limitation in the pool of social enterprises likely to use SITR is compounded by the current restrictions within SITR on 'non-trade activity' and other excluded activities. A significant number of community benefit societies using Community Shares undertake activities that are 'excluded' under SITR rules, for example because they develop property, own land and assets that they lease out, or generate and export renewable energy.

14.6 These restrictions stop SITR from supporting investment in a substantial subset of social enterprises that have in recent years made a success of issuing equity and debt to investors.

14.7 What is more, we firmly believe these restrictions undermine the ability of SITR to meet its core policy objective of incentivising more investments that generate a social return but are less attractive in narrow commercial terms.

14.8 Before going on to explain these points in more detail, we believe it is important to set out the key features of Community Shares and the unique share capital and special corporate form that underpins them. And we also believe it is important to specify some distinct developmental challenges experienced by community businesses. Together these factors make these social investments even less attractive *in narrow commercial terms*, further intensifying the market failure that SITR was created to respond to.

Features of Community Shares

14.9 Community Shares use a form of equity unique to co-operative and community benefit societies, called withdrawable share capital. Both the corporate form and the share capital in particular have features that are particularly well-suited to patient, mission-aligned investment in community business, but which can also therefore be less attractive in narrow commercial terms.

14.10 Withdrawable share capital, unique to co-operative and community benefit societies, provides a form of equity for the business under FRS102 accounting standards, yet unlike company equity it can be withdrawn by the shareholder at par value (or under), under conditions controlled by the society, providing a simple non-market exit. Community benefit societies almost always impose a fixed term of a number of years during which withdrawal is prohibited and then limit the total combined amount investors can withdraw each year for longer still.

14.11 These shares also cannot pay a dividend, but instead shareholders can receive a steady (though not guaranteed or fixed) rate of interest to provide a long-term return on investment, that is enough to obtain and retain the capital of patient, mission-aligned members, but no more than this.[25]

14.12 Because of the limitation of withdrawal at par value (or below) and the community benefit society asset lock, Community Shares do not give shareholders a right to the underlying assets of the society. Thus Community Shares, unlike company shares, do not include any possibility for investors to make capital gains from sale of their shares, or sale of the business or it assets. This distinction is especially important when considering how a Community Shares investment offer in property development, for example, might compare with non-social enterprise investment in property development. It is easy to see how the market failure SITR was created in response to would apply.

14.13 Lastly, in a community benefit society shareholders have one vote no matter how many shares they have. Control of the society is democratic rather than being determined by individuals' financial interest in the business.

14.14 All this makes Community Shares perfectly suited to investment in community businesses. But the limited return on investment, which is indeed significantly limited when the absence of any capital gain is taken into account, the fact that withdrawal is not permitted for many years, and the lack of investment-linked control, all makes for a comparatively unattractive investment opportunity in narrow commercial terms.

Challenges for community businesses

14.15 Community businesses raising investment to develop, acquire, or indeed rescue, assets or enterprise come up against particular challenges including: tough and uncertain negotiations with the owners of assets and businesses; competition against larger, better-resourced and better-connected private sector actors looking to acquire sites and assets for private gain; uncertainty about a community's investment appetite and capacity; steep learning curves for community volunteers; and scepticism among key stakeholders unfamiliar with community businesses (be they private, public, civil society).

14.16 Communities cannot escape these difficulties or mitigate uncertainties, risks and losses by running multiple projects in varied locations, as other private sector actors seeking investment can. Most of these community businesses raising investment represent a start up from scratch, with all the uncertainty that inevitably comes from any new venture.

14.17 Furthermore, the majority of community investors start off unfamiliar with investment and business ownership. For them, such activity is part of a journey of self-efficacy and learning and is not perceivably low risk. Perceived risk for community investors must be placed

within the context of people pooling often scarce resources for a social purpose, for low returns with no prospect of capital gain. As the evidence we discussed in our response to ***Question 10*** suggests, a tax relief tends to help encourage their participation.

Non-trade activity

14.18 Section 257MJ of the Income Tax Act 2007 rules that investments supporting activities that HMRC would not consider to be a 'trade' are ineligible for SITR. We believe the importing of the concept of a 'trade' from EIS is problematic and undermines the ability of SITR to meet its core policy objectives.

14.19 We understand and support the rationale behind requiring EIS-eligible investments to be in businesses that carry on a 'trade', as this helps to target EIS in ways that support the underlying policy objectives: incentivising investment in new, risky, innovative, growth-oriented businesses. But we ask government to consider whether this rationale makes sense for SITR, given that SITR has different policy objectives: to incentivise more capital to be allocated to investments that generate a social return but are less attractive in narrow commercial terms.

14.20 When it comes to addressing this market failure, it is to a large extent irrelevant whether the investment will fund a risky trade or not. We offer government the example below to illustrate what we accept is a challenging argument to make.

Investments in land ownership and leasing

Investment A: a 'for-profit-only' venture is raising investment to acquire land in a gentrifying neighbourhood, which it expects to lease to mid-market commercial property developers. Investors are offered the prospect of both strong yields year on year and a significant capital gain when the uplift in asset value is captured on exit.

Investment B: a community benefit society is offering Community Shares and bonds to fund the acquisition of land in the same neighbourhood, which it will keep in community ownership for community benefit in perpetuity, for the sole use of affordable, community-led housing developments for poorer residents. Investors are offered a modest yield year on year, limited liquidity and no possibility of capital gain from any uplift in asset value.

Neither investment is in a 'trade' as HMRC would see it. The market failure SITR is meant to address will result in more capital being allocated to Investment A than Investment B. The significant social return on Investment B will encourage some people to invest, but people of are less likely to invest, or are likely to invest less, in Investment B.

In the current land and property market, the venture behind Investment A is likely to go ahead. But an under-allocation of capital to Investment B does more than reduce its social return, it makes it much less likely that the venture will go ahead at all.

If Investment B could benefit from SITR, then more capital would be allocated to it and the social return on this investment would more likely be realised.

14.21 We also argue that the difference in treatment between charities and non-charitable social enterprises in Section 257MJ is unjustified and somewhat arbitrary. At present a community benefit society with charitable status operating a business model with a degree of 'non-trade' activity could make use of SITR, but a community benefit society without charitable status operating the same business model could not make use of SITR, even though the investment and the returns on that investment would be identical.

Recommendation: Remove the rules under Section 257MJ of the Income Tax Act 2007 that make investments supporting activities that HMRC would not consider to be a 'trade' ineligible for SITR.

14.22 Further to the above, there are a number of 'exclusions' in the STR rules that limit its utility for supporting high-impact social investments, notably: community ownership and leasing activities; property development; agriculture; generating energy like electricity or heat; exporting electricity.

14.23 It is notable these excluded activities mirror those for EIS and, as we understand it, the rationale for the exclusions has been imported from EIS as well: investments in these activities are not risky enough to warrant a tax relief because of prevailing market conditions and/or the existence of other public support. As with non-trading activity, we question whether this rationale makes sense for SITR, given that SITR has different policy objectives: to incentivise more capital to be allocated to investments that generate a social return but are less attractive in narrow commercial terms.

Community ownership and leasing of assets

14.24 Arrangements in which an asset locked community benefit society owns and ultimately controls land, property or facilities for community benefit, which it then rents to third parties, in whole or in part, should be made eligible for SITR.

14.25 These arrangements form a substantial subset of the community ownership sector and deliver significant community benefit. Given the limited returns on investment, the absence of any possibility of capital gain and the lack of investment-linked control (see 14.9 to 14.17 above), the market failure that SITR was created in response to would certainly apply to these business models.

14.26 Often, community ownership and subsequent leasing of an asset is critical to the generation of community benefit. For example, when commercial property is brought into community ownership and control as a way for local people to shape the evolution of their high street.[26] As a recent House of Commons Select Committee report found, commercial landlords can play a significant positive or negative role in high street economies and the benefits derived from local communities playing that role should not be underestimated. [27]

14.27 To take another example, a land trust has used Community Shares to fund the acquisition of agricultural land which is then rented to small, low impact farm businesses, as a means of enabling the development of a viable low impact agricultural industry.

14.28 Lastly, it is very common for assets, such as a village pub listed as an Asset of Community Value under the Localism Act, to be acquired through a 'community buyout' using

Community Shares and ultimately controlled by the community for long-term community benefit, but then rented to a third party to run the business day to day.

14.29 In all these cases the leasing out of community owned assets is a significant part of a value creation model through which community benefit can be realised on a commercial basis.

14.30 To reiterate, the limited returns on investment, absence of any possibility of capital gain and lack of investment-linked control in these asset locked community benefit societies, means the market failure that SITR was created in response to would certainly apply to these community ownership and leasing business models.

Recommendation: make the community ownership and leasing of assets eligible for SITR.

Generating energy and exporting electricity

14.31 Community energy is one of social investment's biggest success stories in terms of the scale of investment, number of enterprises, broadening of investor demography and social impact.

14.32 As well as the environmental benefit from renewable energy generation, community energy schemes have given ordinary people and their local communities a stake and a say in the renewable energy transition. Surpluses have then been reinvested in other interventions such as energy efficiency improvements, education initiatives or low carbon transport. Beyond environmental impact, many community energy schemes use surpluses to reduce fuel poverty. And all represent a revenue-generating model that produces funds that are controlled democratically by communities and committed for communal benefit. [28]

14.33 The rationale for excluding energy generation and export from EIS and SITR has been that other government interventions have created a renewables sector that offers low risk investment opportunities with predictable returns. But since 2015 government has dramatically reduced incentives and subsidies for onshore renewable generation, while also making the planning environment much more hostile. This means that smaller scale, community-led renewable energy schemes are comparatively risky and challenging undertakings.

14.34 More importantly, regardless of whether there is government support for small-scale renewable energy generation, community energy schemes using Community Shares must offer investment opportunities that are less attractive in narrow commercial terms than other renewable energy investment offers (see paragraphs 14.9 to 14.17). Thus the market failure that leads more capital to be allocated to non-social investments applies regardless.

Recommendation: remove renewable energy generation and export from the excluded activities list for SITR.

14.35 We know government grew concerned that the 'community energy carve out' (that allowed community energy schemes to continue benefiting from EIS from 2012 to 2015) came to be misused for contrived tax planning purposes, rather than to support genuine community investment in renewable energy deployment.

14.36 We believe this could be guarded against by restricting SITR eligibility to social enterprises with the following characteristics:

- a community benefit society raising money through a Community Share and/or bond issue
- where there are two classes of membership and shareholding contained in the society's rules, approved by the FCA:
  - community members who live within a defined geographic area with full voting rights and control over ongoing community activities
  - generalist social investors with limited voting rights

Agriculture

14.37 Investments in agricultural social enterprises are ineligible for EIS because of the existence of direct support for farm businesses through the Common Agricultural Policy (CAP). This is understandable as it helps ensure EIS meets its policy objective. We ask government to consider whether the exclusion helps SITR to archive its rather different policy objective.

14.38 There is an ecologically sustainable, vibrant, innovative, and potentially very significant agricultural social enterprise sector in the UK, most notably in 'community agriculture'. [29] More investment could scale up and mainstream many of the solutions that are urgently needed to produce the food we need without inflicting further damage on our natural environment.[30]

14.39 At the very least, we ask that SITR be made available for social enterprises operating on sub 5 hectare sites, because these are not eligible for direct support under the CAP. But we also ask government to consider that, given the choice between an investment in for-profit-only horticultural business (for example) receiving direct support under the CAP and a horticultural social enterprise receiving the same direct support under the CAP, the market failure SITR was created to respond to will lead more capital to be allocated to the former.

Recommendation: Remove production of primary agricultural products from the excluded activities list for SITR

Property development

14.40 The rationale for excluding investments in property development from EIS does not make sense when trying to ensure SITR meets its policy objective. Investments in social enterprises such as community-led housing and social landlords can deliver very significant social returns on investment by reintroducing some urgently needed affordability and long term stability into land and property markets. But because these enterprises are not developing property to be appreciable assets to generate capital gain, investments will always be less attractive in narrow commercial terms that investments in non-social enterprise property developments.

14.41 For example, there are community benefit societies that operate both as land trusts and affordable homes developers, seeking to raise substantial amounts through Community Shares.[31]

14.42 Crucially, where an asset locked community benefit society is concerned, investors are not able to profit in any way from speculative property development. Community investors can only earn a modest rate of interest on their shares, that cannot be increased as a means of distributing profits from the sale of properties, and these shares can only ever be withdrawn from the business up to par value (see 14.9 to 14.14 above). While these community benefit societies are successful in their own contexts, the extent to which their socially-purposed property development can become more mainstream is limited by a market failure that continues to drive more investments into speculative, higher yield developments.

Recommendation: Make property development by an asset locked community benefit society eligible for SITR

Co-operative societies

14.43 We fully understand why government decided to limit eligibility for SITR to charities, community interest companies and community benefit societies, as part of measures to ensure the relief is properly targeted. However, we remain disappointed that no solution as found that would enable these co-operative societies with clear social purposes and non-distributable assets to benefit, given how critical many of these businesses are to growth of a vibrant, commercially successful and democratic social economy.

14.44 As already evidenced, take up of SITR is to a significant degree limited by the small number of eligible businesses that are in a position to issue debt and equity to investors. As a recent report by Social Enterprise UK confirmed, the UK's consumer co-operatives are certainly social enterprises, as are a significant proportion of our financial mutuals, such as credit unions and building societies.[32] The pool of commercial, investment-seeking social enterprises would be significantly enhanced if a solution could be found to include some co-operative societies, and perhaps credit unions and building societies as well.

14.45 Not all co-operative societies can be considered as socially-purposed businesses. For example, farmers' co-operatives tend to operate for the mutual economic benefit of their members without a social purpose. But co-operative societies owned and controlled by customers, service users and communities are very likely to have a social purpose and to meet the other criteria for social enterprise, such as the reinvestment of more than 50 percent of their surpluses in fulfilling that purpose.

14.46 Of these, 3,678 have reported assets under the £15 million threshold for SITR eligibility. This includes smaller consumer co-operatives, housing co-operatives, sports and social clubs, community energy schemes, community pubs and shops - typologies that are well-placed to benefit from SITR-backed investment from members. Almost 1,000 of these have annual turnover in excess of £100,000, which is an amount that can be enough to generate modest long term returns for member share capital. [33]

14.47 Furthermore there are 75 worker owned co-operative societies with assets under £15 million and a turnover in excess of £100,000, at least a substantial portion of which also have clear social purposes and reinvest more than 50 percent of their surpluses in their business or their social missions.[34] Some of these businesses could benefit from raising debt from external social investors. Some might also benefit from issuing equity to a distinct class of 'investor members'.

14.48 The co-operative society legal form can also be ideal for 'platform co-operatives'. This is an exciting area of innovation where co-operatives have the potential to deliver significant social impact. We are running an accelerator programme to support new platform co-operatives and have also begun making equity investments in the sector with the backing of the Open Societies Foundation. This follows a research project and report we have delivered with Nesta, which has identified how the co-operative society legal form and a new class of mutual shares for investor-members could help to develop platform co-operatives.[35] SITR could play a critical role in encouraging the necessary levels of investment in platform co-operatives.

14.49 The ability to use SITR for debt issues would be especially useful for co-operative societies as there are often severely limited in how much equity they can raise from members and 'investor-members'. Debt finance in the form of loan stock, raised from mission-aligned non-member investors, has been especially popular among worker-owned co-operative societies and housing co-operative societies.[36]

14.50 Crucially, co-operative societies are legally prevented from existing to generate returns for investors and the interest they pay on shares must never be more than is necessary to obtain and retain capital.[37] Co-operative society shares cannot pay a dividend. And, where 'common capital' rules are in place, shareholdings carry no right to acquire the underlying assets of the business. Furthermore, all members have one vote, regardless of how much they have invested in the business and the voting rights of external equity investors must be heavily curtailed. All this means that co-operative societies must offer investment prospects that are less attractive in narrow commercial terms than those of for-profit-only companies undertaking similar activities. The market failure that SITR was created to respond to applies.

14.51 The relevant objects and purposes of a co-operative society and the relevant stipulations regarding distribution of surpluses and residual assets, which together can confirm the social purpose of a co-operative society, are easily found in their rules, which are approved and filed by the Financial Conduct Authority (FCA). The FCA has recently made the records for all co-operative societies free to access online. We believe it would be possible and indeed practicable for government and HMRC to establish clear and easily checkable criteria for making some co-operative societies eligible for SITR.

14.52 Government has, after all, created an entire accreditation scheme to award SITR to Social Impact Bond issues by 'for-profit-only' companies limited by shares.

14.53 Allowing some co-operative societies to benefit from SITR would certainly increase the pool of eligible businesses likely to use and benefit the relief.

Recommendation: Establish criteria and a checking process that allows certain co-operative societies to benefit from SITR

Seed SITR

14.54 We believe the lack of a 50 per cent Seed SITR deters some use of SITR. Once SEIS has been used, many social enterprises will find it more straightforward to advance to EIS if possible.

14.55 The inability of a social enterprise to offer a 50 per cent relief for the earliest stage and highest risk investments, further intensifies the market failure SITR was intended to address, by encouraging more of that capital to be allocated to non-social SEIS-backed investment opportunities instead.

Recommendation: Create a 50 percent tax relief for seed social investments equivalent to SEIS ('Seed SITR)

Seven year limit

14.56 Our 'co-op economy' data and experience of supporting hundreds of co-operatives each year, suggests that most co-operatives and other social enterprises develop quite slowly and may not be in a position to issue debt and equity to investors before they reach seven years of age. Thus the age limit further reduces the already small pool of social enterprise likely and able to make use of SITR.

14.57 The seven year age limit for EIS helps to target the relief at new ventures, so directly serves the underlying policy objectives. But the policy objective behind SITR is not to incentivise the allocation of capital to new, high risk ventures. Rather it is to incentivise a greater the allocation of capital to investments that generate a social return but which are less attractive in narrow commercial terms. This market failure applies whatever the age of the social enterprise. Thus the rationale for applying the seven year age limit to SITR is far from clear.

Recommendation: remove the seven year age limit for businesses offering SITR to investors

'*Gifting' SITR*

14.58 Evidence from the Community Shares market also tells us that there often large numbers of community investors making small investments (of £100 for example), who are PAYE and so very unfamiliar with filing forms with HMRC, who do not claim SITR (or EIS) even when they can.

14.59 The impact of SITR is often too small in each individual case to motivate the investor to make a claim. But the combined benefit of these otherwise forgone reliefs for the community business could be considerable. We suggest government could develop what could be described as a 'Gift Aid' scheme for SITR, wherein investors who are not motivated to claim SITR 'gift' its value to the social enterprise instead, to be realised through a reduction in corporation tax.

Recommendation: develop a scheme whereby social investors can 'gift' the value of their SITR to the business they are investing in.

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About Co-operatives UK

Co-operatives UK is the network for Britain's thousands of co-ops. We work to promote, develop and unite member owned businesses across the economy. From high street retailers to community owned pubs, fan owned football clubs to farmer controlled businesses, co-ops are everywhere and together they are worth £36.1 billion to the British economy.

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