The Role of Tax Incentives in Encouraging Social Investment
The Role of Tax Incentives in Encouraging Social Investment
The Role of Tax Incentives in Encouraging Social Investment is published by the City of London and Big Society Capital. The report was prepared for the publishers by Worthstone with assistance from Wragge & Co LLP.

This report is intended as a basis for discussion only. While every effort has been made to ensure the accuracy and completeness of the material in this report, Worthstone and Wragge & Co LLP, and the publishers, the City of London and Big Society Capital, give no warranty in that regard and accept no liability for any loss or damage incurred through the use of, or reliance upon, this report or the information contained herein.

Copyright March 2013. All rights reserved.
© City of London
PO Box 270
Guildhall
London EC2P 2EJ

www.cityoflondon.gov.uk/business/economic-research-and-information

Worthstone is the original independent specialist to be focused exclusively on delivering social investment support to the wealth advice community. We were established to help to bring the social investment sector to maturity within the UK by introducing the mechanism through which this emerging asset class can be incorporated within mainstream financial planning and wealth advice.

Wragge & Co LLP is a UK-headquartered international law firm providing a full service to clients worldwide. We are one of the leading UK advisers on venture capital schemes (VCT, EIS and SEIS) and are committed to our Corporate Responsibility Programme across four focus areas: community investment, supporting our people, engaging with our external partners and addressing our impact on the environment.
Table of Contents

Foreword – City of London .................................................................................................................. iii
Foreword – Big Society Capital ........................................................................................................ iv
Executive summary .......................................................................................................................... vi
Purpose of this report ....................................................................................................................... 1
Context of this report ......................................................................................................................... 1
Report outline ................................................................................................................................... 2

1. Should there be a tax incentive for social investment? ................................................................. 3
   1.1 Definitions of social sector organisations and social investment ........................................... 3
   1.2 Are social enterprises deserving of a tax relief? .................................................................... 4
   1.3 The need for high risk capital for social investment ............................................................... 7
   1.4 Gaps in existing tax incentive schemes for social enterprises ............................................. 9
   1.5 Evidence of wealthy individuals’ appetite for social investment ....................................... 11
   1.6 Conclusion to Part 1 ............................................................................................................. 19

2. How much capital for social investment could be raised with the introduction of a tax relief for social investment? ................................................................. 20
   2.1 A step-by-step approach to estimating the potential effect of a tax relief ...................... 22
   2.2 Risk factors affecting take-up of social investment ............................................................ 27
   2.3 Conclusion on potential social investment raised .................................................................. 27
   2.4 Stress testing against EIS and VCT performance ................................................................. 28

3. What are the likely impacts of developing a tax incentive? ....................................................... 31
   3.1 Risk assessment of tax relief .............................................................................................. 31
   3.2 Retail Distribution Review and the Financial Services Bill ................................................ 33
   3.3 The important role of Independent Financial Advisors (IFAs) ......................................... 33

4. How could a social investment tax incentive be developed? .................................................... 34
   4.1 Practical approach .............................................................................................................. 34
   4.2 The overarching objective: to include social enterprises in tax relief ................................ 34
   4.3 Guiding principles ............................................................................................................. 34
   4.4 Tax relief over the life cycle of an investment ..................................................................... 37
   4.5 Expanded definition of investee organisations within a tax incentive for social investment ................................................................................................................. 38
   4.6 Conclusion to Part 4 ........................................................................................................... 40

5. Conclusion ...................................................................................................................................... 41

Appendix: Adapted EIS & VCT for Social Investment ........................................................................ 43
Bibliography ......................................................................................................................................... 49
Foreword – City of London

The City of London Corporation is committed to promoting the social investment agenda, and so is delighted to have co-commissioned with Big Society Capital this research report, which investigates the rationale for and potential implications of introducing a tax relief for social investment. Both of our organisations are committed to seeing the social investment market flourish, by ensuring that the required capital reaches those organisations which support families, communities, and our society’s broader needs and interests.

Social sector organisations face many simultaneous challenges: a changing public sector landscape, a difficult economic environment, and increasing strain on the grant and donations framework that has helped to support the development of the sector. The increased emphasis on revenue and investment-based finance is in part a response to such challenges, but also reflects the growth and increasing maturity of this market. Demand for organisations that can provide effective social outcomes continues to rise significantly, such that it is predicted that over £1bn of social investment will be needed by 2016.

Meeting these and other opportunities requires a commitment from a range of investors who are responsive to the financial and social returns attached to a social investment opportunity. Tax reliefs have been a highly effective policy lever in attracting mainstream venture capital and have raised close to £800m in 2010/11 alone. However, the lack of share capital in organisations whose primary purpose is their social mission, means that such tax reliefs are generally not available for social sector organisations. This limits the investor base and acts as a significant constraint on the growth of the sector, at a time when demand for its services is rising substantially.

This report is therefore timely in presenting a detailed analysis of the ways in which tax reliefs could support new investment into this market – and how existing tax reliefs could be adapted to apply to social investment. If even a proportion of the estimated likely impact of creating such a relief for social investment materialises - around £500m of social investment over five years – this would provide a solid underpinning for the continued growth of the sector.

This report offers a framework for considering why such a relief could be implemented and would require relatively little adaptation to existing regimes. It recognises the distinctive nature of the social investment sector: while it uses the same routes to market as its mainstream counterparts, it intends primarily to support the creation of social outcomes, alongside a financial return. This is exactly the sort of market mechanism which could be effective in supporting the social investment market at this critical time in its development.

Mark Boleat
Chair, Policy and Resources Committee, City of London
March 2013
Foreword – Big Society Capital

The social investment market in the UK is clearly changing rapidly.

We have recently seen social investment products begin to proliferate. Perhaps the most talked about type of social investment, Social Impact Bonds, have now been commissioned across the country from a variety of organisations, including national government departments such as the Department for Work and Pensions, local authorities such as Essex County Council and even private organisations have been proposed, such as the Council of Voluntary Adoption Agencies. The first Charity Bond was issued by national charity Scope in May last year.

We at Big Society Capital have also seen an increase in interest from existing and new social investment finance intermediaries in helping build new structures to finance social sector organisations. And our announced investment commitments of £56m into 20 organisations since launch demonstrate the potential.

However, as reforms to public services such as probation services gather pace, and some social sector organisations consider reducing their reliance on grants through developing innovative revenue raising models, the need for new social investment is only forecast to increase. Indeed, a previous report commissioned by BSC identified a possible demand of £1bn for social investment by 2016. BSC will certainly play its part to help build the market but the needs far outstrip our independent means.

As Big Society Capital nears its first birthday, our mind has turned to where then the investors will come from to satisfy this demand. I believe that this report - The Role of Tax Incentives in Encouraging Social Investment - provides us with important evidence as to why individuals may present such a welcome opportunity. What’s more is that it describes how social investments may fit neatly within the motivations of many of these wealthy individuals and help them achieve their own financial and social goals.

What is fundamental, however, to taking advantage of this opportunity, for both the social investment community and individuals, is the right tax incentive. This report helpfully details not only the significant potential size but the options for incremental reform to existing incentives that can effectively target the areas of most need among the social sector organisations - risk capital.

I therefore commend this report to the relevant authorities as informative reading to how they can best help social organisations deliver on their valuable social missions. I will also be making sure that Big Society Capital continues to do all it can to help develop the environment for such individuals and social sector organisations to work together through the social investment market.

Nick O'Donohoe
Chief Executive Officer, Big Society Capital
March 2013
Executive summary

This report was commissioned by City of London Corporation and Big Society Capital to investigate the basis for and potential implications of introducing a tax relief for social investment. It looks at the rationale for such a relief, and draws on the evidence of an unmet appetite amongst wealthy individuals to include social investment in their portfolio. It then uses existing survey data to calculate the likely amount of capital that might be raised through such a tax relief. The final part of the report identifies key principles for developing such a tax relief, and looks at the changes that would be required to existing mainstream venture capital tax reliefs to allow for social investment.

Are social sector organisations worth investing in?

In developing the rationale for a tax relief for social investment, it is necessary to ask whether the investee organisations – social sector organisations (SSOs) - are worth investing in. Evidence from social enterprise and business survey data shows improvement in the performance of the sector, leading to greater sustainability, in spite of facing challenging economic times. For example, the 2012 RBS SE 100 Index, which tracked the activity of 365 social enterprises, found that in 2012 the combined turnover of the 100 fastest growing enterprises (the SE100), was £319.4m – an 85% higher turnover than the 2011 SE100 enterprises (£172.7m).\(^1\) Furthermore, these SE100 organisations grew on average by 60% – greater than the 48% growth experienced by the 100 fastest growing FTSE companies that year.\(^2\)

Although social enterprises make up only 7% of the Small and Medium-sized Enterprise (SME) population,\(^3\) the evidence suggests that these organisations are filling a gap in market needs in terms of their service provision. Social enterprises are more likely than SMEs to be involved in activities concerning community development or mutual aid, culture and leisure, economic well-being, accommodation and training.\(^4\) The social sector as a whole most likely provides over 5% of all jobs in the UK, making it a larger employer than the ICT or even the financial and insurance services industries.\(^5\) Nonetheless, this report does not assess the relative economic benefit of encouraging social sector organisations compared with commercial enterprises. Instead, it suggests that SSOs as a group are showing themselves to be increasingly sustainable and deserving of a well-designed tax relief to incentivise investment in the sector, and should not be excluded from such incentives.

---

1. The RBS SE100 Data Report 2012 (December 2012) Summary: Charting the growth and impact of the UK’s top social businesses, [http://se100.net/2012-results-and-analysis/](http://se100.net/2012-results-and-analysis/)
What type of capital needs to be incentivised?

Social sector organisations (SSOs) are seeking “long-term patient capital” in the form of equity-like⁶ or unsecured debt products. Demand for social investment in 2015 is estimated at £750m, comprising equity-like demand of £112m and the rest in unsecured debt.⁷ At present, there is a gap between supply and demand of appropriate capital; high risk capital is in short supply, yet this is the type of capital most required by SSOs. Furthermore, because these organisations adopt certain legal structures in order to protect their social mission, the form in which capital can be provided is largely restricted to unsecured debt or equity-like financing. Organisations can use equity-like capital - where risk is shared with the investor and investee, and returns to investors are made on the basis of improved revenue generated by the investment. There is little scope for traditional equity-like capital in this sector. It is this factor that means existing tax reliefs are difficult to apply to social investment.

Who should a tax incentive be aimed at and why?

The challenge now is to find new financiers to take over the role of government, foundations and trusts, who have provided around £500m of social investment over the previous eight years. Research from Ipsos MORI⁸ into wealthy investors (those with £50,000+ of investable wealth) has shown there is an unmet appetite amongst different types of wealthy investor. High net worth individuals (HNWIs) - those with greater than £100,000 of investable wealth - were found to hold social and ethical values. They want their money to ‘do good’ as well as to produce a return, to use their wealth to reflect their values, and are likely to be engaged in community activities.

For those HNWIs more ‘actively interested’ in social investment, a tax incentive was found to be influential in encouraging these investors to make a commitment to social investment, though it was not a primary motivation.

Wealthy individuals who had a ‘passive interest’ in making social investments identified six ‘top motivations’ from a list. The primary motivation was the creation of appropriate tax incentives. The only other motivation on the list which is open to influence, was for the social investment industry to produce evidence that social outcomes are achieved.

The lack of a tax incentive is therefore a barrier to those wishing to make social investments, given that there are tax incentives for venture capital and charitable giving. This suggests that a tax relief would likely be effective in encouraging social investment amongst different categories of wealthy individuals.

---

⁶ Equity-like capital is capital which is unsecured, acts as a form of risk capital and, in the social sector, is usually linked to providing an investor with a share of the increase in revenues, not in profits. It has been used by SSOs who cannot or choose not to offer share capital and is attractive to many social investors.


In the absence of such a tax relief, grant finance or first loss investment appears to be needed to provide the incentive for high net worth individuals to invest (as was offered in the Big Venture Challenge competition run by UnLtd in 2012). Part of developing the maturity of the social investment market requires it to wean itself off grants and subsidies of this nature and move towards mainstream financial mechanisms. The provision of tax reliefs will be an essential element of that transition.

Therefore, the statistical evidence from the Ipsos MORI research suggests that the ‘sweet spot’ of untapped potential lies with those wealthy and in particular, high net worth individuals (investable assets in excess of £100,000) who could be incentivised to provide equity, equity-like or certain unsecured debt instruments to social enterprises. This matches the type of risk capital that investees seek. The rationale behind this is that these individuals have sufficient wealth to be able to focus beyond purely financial returns, to encompass a social return, they have a route to market via Independent Financial Advisors (IFAs), and they have an identified, but as yet untapped, appetite for social investment.

**How much capital for social investment could be raised?**

This report presents a forecast of the amount of high risk social investment that could be generated from high net worth individuals if such a tax relief was provided. The forecast is for £165m over a three year period and £480m over a five year period. These forecasts are informed by the average amount of investment that could be forthcoming from a representative proportion of the known number of wealthy individuals that have said they would be very or fairly likely to invest in equity-like social investment. However, the response to a tax incentive is very sensitive to the level of relief offered, so this needs to be factored into any predictions on likely take-up.

In the past, a tax relief has been very effective at providing incentives for wealthy individuals to provide venture capital to mainstream SMEs through the Enterprise Investment Scheme (EIS) and the Venture Capital Trust (VCT). The forecast in this report appears relatively conservative when compared with the over £800m raised in 2010/11 by these main venture capital tax reliefs, EIS and VCT. The forecast allows for time to educate HNWIs and their financial advisors about social investment and how social impact is generated, measured and reported.

What is important here is not the absolute level of accuracy of the forecast, but that the potential for such sums is sound. Furthermore, the likelihood of raising the predicted demand for risk capital without a tax incentive is remote, given the importance placed on it by a range of wealthy investors.

**What are the likely impacts of developing this tax incentive?**

The introduction of such a tax relief would complement many other policy levers operating in this sector – namely, the investment readiness and incubator programmes, initiatives to open up access to public service markets, laws to embed social value in commissioning, and the localism agenda. Improving the tax environment will, in itself, act as a catalyst for further organisational development.

---

The Ipsos MORI research shows little evidence of charitable donations from wealthy individuals being made instead to social investment (‘cannibalisation’), as investors were found to have different mindsets towards investment and philanthropy. No more than a quarter of potential investors regard social investment in the same category as their philanthropic activity, although this proportion may be higher if the social enterprise is itself a charity. Indeed, the existence of a tax incentive which differs from Gift Aid should make such ‘switching’ less likely, provided the incentive is not as generous.

**Financial planners/advisors and social investment**

Tax advice is a key aspect of the services that financial planners and accountants offer. An appropriate tax incentive would therefore become integrated into the decision-making process for wealthy individuals’ tax planning.

The view that there is a tax relief barrier has been reinforced by research into the response of financial planners to social investment. A tax incentive based on adapting existing regimes would overcome a major barrier for financial planners, as they are familiar with these schemes. The financial planner/advisor will be a key route to market for social investment, and they will need to establish the suitability of a social investment, given the client has expressed non-financial as well as financial motives. There is a group of financial planners that view the growing area of social investment as a good opportunity to present to their clients.

**How could a tax incentive for social investment be developed?**

This report does not intend to be prescriptive about the structure of a social investment tax relief. Instead, it identifies three principles which, it is reasoned, would need to underpin a new tax regime for social investment: a tight definition of eligibility, a focus on risk-bearing capital, and a focus on individuals as investors.

Tax relief schemes which operate for mainstream SME investment provide a good base from which to create a specific social investment tax relief. Adapting the eligibility criteria of qualifying organisations to allow for those with express primary social purpose, but which do not have equity stakes, would open up the fiscal benefits to social enterprises. Furthermore, the forms of capital on which tax relief could be eligible would need altering to allow for risk capital provided in equity, equity-like or unsecured debt-based form, as long as it was genuinely taking comparable high risk to equity stakes. There are a number of technical changes to EIS and VCT which would enable socially-motivated organisations to access these existing schemes, and these changes are detailed in the Appendix to this report. By making such alterations to EIS and VCT, all legal forms of SMEs would then be able to attract individual investors with some form of risk capital tax relief.

---


11 The Seed Enterprise Investment Scheme (SEIS) is also part of the existing tax relief system. It therefore may be preferable to similarly amend the SEIS. This would complement the portfolio of existing tax reliefs, in the same way that tax reliefs are available to SMEs (under EIS, VCT and SEIS). This would therefore further assist with providing SSOs the same level of access to required capital as SMEs. This would also help maintain consistency with governing legislation.
However, definitional issues will be important if a distinctive social enterprise tax relief is established, particularly if there are differences in the level or timing of relief offered. An investee organisation will need to demonstrate the key characteristics and governance structures of a social enterprise, which operates primarily to deliver social outcomes. Qualifying investee organisations will need to show investors how they measure and report on the social impact generated.

The UK as a key player

In many areas relating to the development of a social investment market, the UK has led the way internationally. The development of a dedicated wholesale fund, Big Society Capital, alongside the creation of investment products, such as the Social Impact Bond and Charity Bonds, place the UK as a world leader in this area.

Conclusion

The introduction of a social investment tax relief in the near future would provide an important signal to investors to engage in this sector - a sector which offers economic and social potential but is currently heavily constrained by under capitalisation. There is considerable merit in treating both the EIS and VCT schemes together and amending the regulations to allow for social investment within both schemes, as they are underpinned by the same Income Tax Act and share many common features. Judging by the success of these two schemes in incentivising mainstream capital, a tax relief for social investors could be a real ‘game changer’ in the longer term in attracting new, required capital into the sector, and providing a vital missing ‘piece’ of the social investment market’s infrastructure.
Purpose of this report

This report has been commissioned by City of London Corporation and Big Society Capital in order to examine fully the case for providing incentives for wealthy individuals to make social investments through tax reliefs. It builds on existing research by interrogating the evidence of wealthy individuals’ appetite for such investment. On this basis, the report estimates the potential impacts of creating such a relief in terms of risk capital raised. As well as examining the case for a tax relief, the report aims to provide practical guidance on how the relief could be created by adapting existing structures.

Context of this report

The context of this report is framed by a series of critical issues listed below:

- Whether social enterprises are deserving of offering a tax relief to their investors;
- The current and forecasted capital requirements of social sector organisations (SSOs);\(^\text{12}\)
- Wealthy individuals’ stated appetite for social investment\(^\text{13}\) and their access to social investment products;
- Definitions, characteristics and legal structures of social investment recipients;
- The state of the market for social enterprise investment;
- The existing risk capital tax reliefs and the difficulty in applying these to social enterprise investment;
- Any likely impact or unintended consequences of introducing such a tax scheme - e.g. cannibalisation of charitable contributions, seepage to other sectors, effect of organisation’s ‘shoehorning’ themselves into a tax efficient legal form.

Other issues which are relevant to this debate but are not directly addressed in this report include:

- Economic impact and public benefit of social investment – including potential employment multiplier effects.\(^\text{14}\) Further research has been commissioned to examine the economic impact of social investment to date, and this will inform the likely cost benefit analysis of revising such a scheme;
- Alternative ways of providing a tax relief to social enterprises e.g. through the provision of corporation tax relief to such qualifying organisations. However, this report concentrates on individual income tax relief to investors, because the evidence suggests there is an unmet appetite for social investment amongst this group;

---

\(^\text{12}\) SSOs incorporate all voluntary, community and social enterprise organisations.

\(^\text{13}\) These are substantiated through the use of recent surveys, data sets, reports and analyses which are listed in footnotes throughout this report.

\(^\text{14}\) University of Durham Policy Research Group (October 2011) – Op Cit. The report suggests that Social Enterprises (SEs) are more likely to be an employer than ‘Other Civil Society Organisations’ (CSOs). Only 28% of SEs had no employees, compared with 60% of CSOs, and they are over-represented in each of the small, medium and large categories, compared to SMEs and CSOs. See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32229/12-566-business-support-for-social-enterprises-longitudinal.pdf
• Other levers, apart from tax relief, that could be and are used to support market growth, which complement any changes to the tax regime. These include transformation in public service delivery, provision of investment readiness support and enterprise loan guarantee schemes, regulatory structures to enable Independent Financial Advisors (IFAs) to assess the suitability of social investment products to potential investors, as well as consistent approaches to measurement of social outcomes.

**Report outline**

**Part 1** of the report considers the rationale and evidence for a tax incentive for investors in social enterprises. It also addresses the definitional issues around social investment as they would apply to a tax relief and identifies the expressed but currently largely unmet, appetite amongst wealthy individuals to include social investment in their portfolios.\(^{15}\)

**Part 2** of the report provides an estimate of the size of capital that could be raised from wealthy investors if existing equity-based tax reliefs were adapted to provide a tax incentive applicable for social investment. These figures are then ‘stress tested’ against levels of capital generated by the two main existing regimes (EIS and VCT).

**Part 3** of the report provides an analysis of the potential impacts or unintended consequences of developing a tax incentive for social investment, and looks at the implications for financial planners, given changes faced in this industry.

**Part 4** of the report considers the practical issues for adapting the Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT) to incentivise individuals most effectively to invest in social enterprises.

**Annexes** (available separately online) to the report provide further detailed references to data sets used, specifics of current and proposed tax reliefs and additional relevant information.

---

1. Should there be a tax incentive for social investment?

This part of the report examines the case for a tax incentive for social investment through the following key dimensions:

- Definitions of social sector organisations (SSOs) and social investment;
- Whether SSOs are deserving of a tax relief;
- The potential for growth and capital requirements for SSOs;
- Gaps in existing tax reliefs;
- Evidence of wealthy individuals’ appetite to invest in SSOs.

1.1 Definitions of social sector organisations and social investment

Definitions of social sector organisations (SSOs) are many and varied. They do not restrict themselves to one specific legal form but are more commonly defined by their key characteristics. These can be identified as organisations which:

- Operate primarily for their mission, using the market mechanism to deliver their goods and services;
- Reinvest the majority of their profits into the business rather than distributing these to investors;
- Create an asset lock or commitment through their Articles of Association or governing documents to ensure that the social mission is protected at sale of the business;
- Reflect their mission in their governance structures;
- Measure and report on their social outcomes, as indicative of their commitment to make social benefit its primary objective.

Investment in this context is considered as:

“...any form of repayable finance with the expectation on the part of the investee and investor that the finance will be returned.”

Social investment is intended to create social as well as financial benefit, irrespective of who provides the finance.

1.1.1 The impact of SSOs’ legal structure on the form of investment

For tax purposes, however, it is appropriate to concentrate on the legal form of a social enterprise, as this is the key determinant of what type of capital can be raised and therefore strongly influences whether a fiscal relief will be appropriate for investors (see Table 1).

16 http://www.bigsocietycapital.com/what-social-investment
Table 1: The various legal forms that SSOs adopt and the form in which funding can be made

<table>
<thead>
<tr>
<th>Legal structure of a social sector organisation</th>
<th>Form(s) of funding open to SSO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company Limited by Guarantee (CLG) with charitable status with no revenue generating facility</td>
<td>Donations, grants</td>
</tr>
<tr>
<td>Company Limited By Guarantee (CLG) acting as a trading arm of a parent company with charitable status</td>
<td>Debt including unsecured debt, equity-like capital*</td>
</tr>
<tr>
<td>Company Limited by Shares (CLS) either acting as a trading arm of a charity or with an embedded social mission within the Articles of Association</td>
<td>Debt including unsecured debt, equity- like capital, equity</td>
</tr>
<tr>
<td>Community Interest Companies (CICs) established as Companies Limited by Guarantee</td>
<td>Debt including unsecured debt, equity-like capital</td>
</tr>
<tr>
<td>Community Interest Companies established as Companies Limited by Shares</td>
<td>Debt including unsecured debt, equity-like capital and equity</td>
</tr>
<tr>
<td>Industrial Provident Societies (Community Benefit companies with or without ‘charitable exemption’ status)</td>
<td>Debt including unsecured debt, equity-like capital, equity</td>
</tr>
</tbody>
</table>

*Equity-like capital is capital which is unsecured, acts as a form of risk capital and, in the social sector, is usually linked to providing an investor with a share of the increase in revenues, not in profits. It has been used by SSOs who cannot or choose not to offer share capital and is attractive to many social investors, as this allows surplus to be reinvested back into the SSO for achieving its social mission. This is important for social investors who invest for social as well as financial returns.

Those organisations which provide equity are able to access risk capital schemes which are equity-based, such as the Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT). However, those organisations which can only offer unsecured debt or equity-like capital are limited to attracting investors through Community Investment Tax Relief (CITR). This provides relief on debt lending into disadvantaged areas when implemented through an intermediary body, known as a Community Development Finance Institution (CDFI).

1.2 Are social enterprises deserving of a tax relief?

Are these organisations viable and sustainable, or would a tax relief be providing an ‘artificial prop’ to the sector?
1.2.1 SSOs’ contribution to a reconfigured economy

The economic and social context facing the country is challenging. Britain is recovering from arguably the most damaging financial crisis in a generation. Public finances are going through a significant consolidation, with public spending as a proportion of GDP due to fall from over 47% in 2008/09 to less than 40% in 2017/18.\(^\text{17}\) The economy is shifting in structure from the public to the private – and, now, to the social – sectors of the economy. The welfare system and public services are undergoing ambitious reform, including the roll-out of payment-by-results, aimed at improving outcomes at lower costs. Meanwhile, many social problems such as recidivism or troubled families remain firmly ingrained, and trends such as demographic ageing are raising levels of social need in certain areas.

Against this backdrop, the estimated 900,000 social sector organisations in the UK already make a tremendous contribution to community and public life and to tackling growing social needs. They are also a conduit for the nearly 20 million UK adults who volunteer every year.\(^\text{18}\)

1.2.2 Comparative size and contribution of SSOs

The social sector can also contribute to the rebalancing of the economy. It is larger than often realised, with employment in the charity sector alone standing at 765,000\(^\text{19}\) and the social enterprise sector a further 800,000.\(^\text{20}\) This means that the social sector most likely provides over 5% of all jobs in the UK, making it a larger employer than the ICT or even the financial and insurance services industries.\(^\text{21}\) Looking beyond the UK, the social economy comprises 10% of all EU GDP and accounts for 6% of all employment (11 million employees).\(^\text{22}\)

Social sector organisations have a vital role to play in any reform agenda. In particular, they hold the key to success in the following market opportunities:

- Charities and social enterprises are often better placed than mainstream private sector organisations to deliver the social result required, providing they can access the right sort of capital and secure a place in the contract chain. They have an in-depth understanding of their client groups’ needs and increasingly are using innovative methods to address these;
- For public sector ‘spin-outs’, charities and social enterprises are the natural legal form to adopt – safeguarding the assets, intellectual property and ethos of public services while providing operational independence. It is no coincidence that all 46 of the NHS spin-outs established under the Right to Request initiative are Community Interest Companies (CICs) – and these organisations now provide nearly £1bn of services to the NHS per annum; and

---

\(^{17}\) HM Treasury (December 2012) The Autumn Statement 2012, [http://www.hm-treasury.gov.uk/as2012_index.htm](http://www.hm-treasury.gov.uk/as2012_index.htm)


\(^{19}\) Ibid.

\(^{20}\) BIS (April 2011) – Op Cit.


Following the development of the Community Rights that came into law during 2012\textsuperscript{23} to advance localism, newly-formed charities and community groups will have a pivotal role to play in identifying and meeting local needs.

1.2.3 Resilience and scale of SSOs

Parts of the social sector have shown significant resilience during the recession, with, for example, the median annual turnover of social enterprises rising from £175,000 in 2009 to £240,000 in 2011.\textsuperscript{24} There is evidence to suggest that social enterprises are improving on their own performance year on year - the combined turnover of the top 100 fastest growing social enterprises in 2012 was 85% higher than the turnover of the social enterprises in the top 100 in 2011.\textsuperscript{25}

Many SSOs are already at significant scale and providing vital services, with just some examples given in Table 2 below.

Table 2: Examples of large-scale social sector organisations providing vital services

<table>
<thead>
<tr>
<th>Social sector organisation</th>
<th>Annual turnover (£m)</th>
<th>Activity/Service</th>
<th>Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>mencap</td>
<td>£193m</td>
<td>Services and information for people with disabilities</td>
<td>Charity</td>
</tr>
<tr>
<td>ageUK</td>
<td>£156m</td>
<td>Care services, information, products, training and research</td>
<td>Charity with a social enterprise arm</td>
</tr>
<tr>
<td>Plymouth Community CARE</td>
<td>£90m</td>
<td>Community health care services (NHS spin-out)</td>
<td>Community Interest Company (CIC)</td>
</tr>
<tr>
<td>CRCL</td>
<td>£81m</td>
<td>Drug recovery and criminal rehabilitation interventions</td>
<td>Charity</td>
</tr>
<tr>
<td>Greenwich Leisure</td>
<td>£76m</td>
<td>Community leisure and fitness facilities</td>
<td>Social enterprise</td>
</tr>
</tbody>
</table>

In terms of growth comparisons, social enterprises are outstripping mainstream Small and Medium-sized Enterprises (SMEs). A 2011 survey by Social Enterprise UK (SEUK) found that whilst 58% of social enterprises reported growth in the last year, only 28% of SMEs did so. Similarly, around a third (34%) of SMEs said their turnover growth had decreased in the last 12 months, compared to only a fifth (20%) of social enterprises.\textsuperscript{26} In the SEUK survey, 44% of social enterprises identified a lack of

\textsuperscript{23}https://www.gov.uk/government/policies/giving-people-more-power-over-what-happens-in-their-neighbourhood
\textsuperscript{25}The RBS SE100 Data Report 2012 (December 2012) – Op Cit; See also http://www.socialenterprise.org.uk/news/recession-busting-top-100-social-enterprises-grow
\textsuperscript{26}Social Enterprise UK (2011) – Op Cit.
available and affordable finance as the single largest barrier to their sustainability. Of those social enterprises who had access to finance, 45% identified this as the most important enabler for their growth. Annex 1 (available separately online) sets out in more detail some of the differences in sectors between social enterprises and SMEs, and demonstrates how social enterprises are often ‘filling the gaps’ left by mainstream organisations, through the market mechanism.

Such research demonstrates that social enterprises are becoming increasingly sustainable in their own right, providing financial as well as public benefit. However, this status is at risk of being undermined if the capital required for their sustainability and growth is not secured.

The European Commission has recognised the social investment sector as a potentially much needed source for growth. It has created the Social Business Initiative[27] to ensure this potential is not lost. A critical component of this initiative is the requirement to provide SSOs with access to appropriate finance.

1.3 The need for high risk capital for social investment

1.3.1 Current and forecasted demand for capital

Three recent reports[28] stress SSOs’ need for “long-term patient capital” in equity, equity-like capital or unsecured loans, which “self-liquidate” at exit. Research by ClearlySo & New Philanthropy Capital (NPC) for Big Lottery Fund found that of the 1,255 SSOs surveyed, 85% were charities and over 50% were or will be seeking growth and risk capital appropriate for their legal structure and form. The dominant purpose for the capital was for working capital to secure contracts and growth capital for scale-up, innovation and improving capacity. Research undertaken by BIS in 2010[29] similarly identifies this appetite for finance from SSOs, with 63% of social enterprises found to be seeking long-term loans. Boston Consulting Group (BCG) forecasts that, by 2015, 38% of a total demand for social investment of £1bn will be required in the form of unsecured lending, with 15% sought in equity-like capital.[30]

The forecasted pace of growth, at around 38% per annum for the next five years, whilst dramatic for the sector, is equivalent to approximately 1% of the market for small business loans. The BCG report identified community organisations and initiatives, disability, ageing, housing and, increasingly over the next five years, employment, as sectors likely to face the greatest demand for capital.

---

29 Government estimates from BIS (April 2011) – Op Cit.
30 BCG & BSC (September 2012) – Op Cit.
1.3.2 Thin trading reserves of SSOs

Much of the social investment sector is undercapitalised; the median level of free trading reserves for operating charities with over £10,000 income is 1.1 months’ worth of expenditure.\(^{31}\) This illustrates the fragility of the balance sheets on which many SSOs trade.

1.3.3 Supply of capital

However, in terms of supply of capital, £165m was lent by social investors to SSOs in 2011, of which c. £8m took the form of quasi-equity and £18m was provided as unsecured lending. The majority of the capital available to supply social enterprises is low risk, asset-backed loan finance. This appears not to be appropriate for many SSOs with limited assets, nor will it be demanded by them.

1.3.4 Big Society Capital’s role as wholesaler and co-financier

Big Society Capital (BSC) was launched in April 2012 as a wholesale provider of finance, with an aim to grow the market for social investors by providing investment to social finance intermediaries on a co-financing basis. Currently BSC managed to match its capital invested with co-financing on a 1:1 basis, though the aim is to raise the co-financing element to 3:1 or above. Moreover, only a small proportion of existing co-financing flowed from institutional or individual investors. BSC aims to commit to investments of £75m to £100m in 2013 and therefore sources of co-finance are critical.

1.3.5 Financing gap

The emerging constraint is where the provision of capital into the market will come from – particularly high risk capital. To date, this has been provided by foundations, trusts and government, but cultural, legal and financial reasons will mean that new investors will need to be encouraged to enter this field to meet predicted demand.\(^{32}\) Part 2 of this report will demonstrate that there is willingness from wealthy individuals, and in particular, high net worth individuals, to invest in higher risk social investment; and that some encouragement from a tax incentive is likely to increase the amount invested significantly.

The social investment sector now faces a funding gap similar to the Macmillan Gap of the 1930s. This recognised the challenge faced by small businesses in obtaining risky, patient capital and led to the formation of the Industrial and Commercial Finance Corporation.\(^{33}\) Much later, tax reliefs were introduced to incentivise capital into these higher risk ventures to support growth.

---

\(^{31}\) NCVO (March 2012) – Op Cit.


1.4 Gaps in existing tax incentive schemes for social enterprises

There is a ‘mismatch’ between the structural requirements of investees (qualifying holdings) under existing tax reliefs and the legal forms adopted by the majority of SSOs (as described above in section 1.1). This creates a disadvantage for social investment, as social enterprises (typically, a subset of SMEs) aim to attract capital from individual wealthy investors, because they are not generally able to offer investors the same types of incentives to invest as mainstream SMEs.

This section (1.4) highlights why existing tax reliefs are predominantly inappropriate or inapplicable for attracting individual or institutional investors to provide capital for SSOs. It focuses on the two key reliefs for risk capital – EIS and VCT, and outlines issues around Community Investment Tax Relief (CITR).

1.4.1 Venture capital schemes: Enterprise Investment Scheme (EIS) & Venture Capital Trust (VCT)

The Income Tax Act 2007 defines the legislative base for both EIS scheme (Part Five of the Act) and VCT scheme (Part Six of the Act). These are parallel schemes with common barriers for application to social enterprise investment. It therefore makes sense to consider both these schemes simultaneously when considering how to create a regime which is fair in incentivising individuals to provide risk capital to social enterprises. Both these schemes are focused on encouraging individual investors to provide risk capital to smaller unquoted trading companies. These schemes are not open to corporations. EIS incentivises direct investment by an individual who purchases new full risk shares into a company, whereas VCT provides a fund structure in which individuals buy shares. The capital is then invested into qualifying companies (holdings). The Seed Enterprise Investment Scheme (SEIS) works on the same principles as EIS, with even higher rates of relief, but is designed to incentivise investment into higher risk start-up companies.34

1.4.2 Suitability for social enterprise financing

The Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) are difficult for charities and social enterprises to use. This is due to both being share relief schemes, whilst the majority of social sector organisations are not limited by shares, but limited by guarantee. Moreover, an organisation which establishes a trading arm that is structured to offer share capital, is not eligible for either EIS or VCT - the relief must be offered on investment into the parent company, which needs to offer share capital. This is the case by definition for the 169,000 charities, some of which might seek to raise capital, and two thirds of the 6,000 Community Interest Companies (CICs), which are established as CLGs.35 Subsequently, would-be social investors wanting to use EIS and VCT to provide some relief on risk-bearing investments have almost no opportunity to do so. In comparison, over £500m and £300m of investments into SMEs were placed via EIS and VCT respectively in 2010/11.

35 76% of the 5316 CICs registered by year end 2012 were structured as CLGs; see http://www.bis.gov.uk/assets/cicregulator/docs/quarterly-reports/11-p119c-community-interest-companies-operational-report-first-quarter-2011-2012
Box 1 identifies key points that make these reliefs hard for social enterprises and charities to use.

**Box 1: Difficulties in applying existing venture capital tax reliefs to social enterprises**

<table>
<thead>
<tr>
<th><strong>Only investment in companies with a share capital</strong></th>
<th>The rules require investment into the parent company. They also require an investment into a company with a share capital. But in the case of charities, the parent entity is most likely to be structured as a trust, or a company limited by guarantee (CLG).</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Group structures</strong></td>
<td>Many not-for-profit organisations have subsidiaries which are CLGs, but the EIS and VCT tax rules require that all subsidiaries are companies with a share capital. Whilst independent structures can be created which could be eligible under VCT rules, they are costly and complex to operate and therefore out of reach for most organisations.</td>
</tr>
<tr>
<td><strong>Control</strong></td>
<td>The EIS/VCT rules require investment into a company which is not controlled by another company. Many charities will have trading subsidiaries which require investment, but this type of investment is not permitted under the rules.</td>
</tr>
<tr>
<td><strong>Trading requirements</strong></td>
<td>The trade must be conducted on an entirely commercial basis with a view to the realisation of profits. Not all social enterprises will meet this requirement, but nevertheless their activities, which create social impact, still require capital investment.</td>
</tr>
<tr>
<td><strong>Requirement to invest in shares (VCT specific issue)</strong></td>
<td>A VCT must ensure that at least 70% (by value) of its investments are so-called “qualifying holdings”. Of those qualifying holdings, at least 70% (by value) must be in ordinary shares which satisfy certain criteria. This means that whenever a VCT invests in a company, it is likely to invest at least 70% of that investment into ordinary shares. However that distorts the economics of the investment (the shares may not be worth that amount) and creates real issues around how the VCT will achieve an “exit” for those shares.</td>
</tr>
<tr>
<td><strong>No tax relief on debt (EIS specific issue)</strong></td>
<td>EIS investors only enjoy tax relief on investments by way of ordinary shares, not on debt. Yet, the social investment sector provides much of the risk capital in the form of unsecured debt or equity-like capital. These investment forms might be deemed less risky when provided in a package alongside equity, but where they provide the only type of investment, the debt bears all the high risk that equity would take in a mainstream equivalent package.</td>
</tr>
<tr>
<td><strong>Exits (EIS specific issue)</strong></td>
<td>As an EIS investor will only invest in shares, without an obvious exit route for those shares (e.g. by way of a trade sale or IPO). The lack of liquidity in the nascent social investment market adds to the risk as investors face additional difficulty in realising their returns.</td>
</tr>
<tr>
<td><strong>Complexity</strong></td>
<td>The rules relating to each of these schemes are complex. The issues described in this Box and section 1.4 are technical ‘traps’ – the social enterprise looking to raise funds will often have difficulty navigating their way through without expert help. In addition, professional advice from experts in this area is expensive.</td>
</tr>
</tbody>
</table>
and typically well beyond the means of a social enterprise, who most likely is trying to ensure every pound of funding goes towards maximising social impact.

Basing tax reliefs for investments in social enterprises on the existing EIS and VCT schemes may help to overcome such issues – this possibility is explored in detail in the Appendix to this report.

### 1.4.3 Community Investment Tax Relief (CITR)

Community Investment Tax Relief (CITR) is not widely known among individual investors or the financial advisor community. The constraints placed on its application have restricted the capital attracted to a relatively small amount - around £70m in total over 10 years as of January 2012. The majority of this investment has been raised in the form of deposits placed in one social bank. Investment raised using CITR has been constrained by a series of issues: the low investment caps faced by the issuing Community Development Finance Institutions (CDFIs), exclusions from investable products (including in areas where social enterprises are particularly active e.g. in social housing and financial exclusion), and the rigorous monitoring and reporting obligations placed on accredited CDFIs. However, CITR is the only scheme which can offer tax relief for debt-lending alone into organisations that do not need to have equity, and has therefore been the dominant option for SSOs to date.

### 1.4.4 CITR needs to be made more attractive

This report focuses on how adaptations to both the EIS and VCT could release the potential to incentivise individuals to take-up social investment opportunities. These two schemes have had significantly greater take-up in the mainstream field - they have had a combined effect of over £800m in 2010/11 compared to c. £7m per annum from CITR. However, the weak take-up of the CITR, given the high propensity for debt financing of social enterprises, suggests that the potential for this scheme is not being maximised. As the National Council for Voluntary Organisations (NCVO) recommends, CITR should be seen as complementary to any alterations in EIS and VCT, and changes to one scheme do not entirely render changes to the other unnecessary.

### 1.5 Evidence of wealthy individuals’ appetite for social investment

Before calculating if a revision to existing tax reliefs could incentivise wealthy individuals to make social investments, there is a need to consider the behavioural issues which influence their investment decisions (see also Annex 6, available separately online). Research undertaken by Ipsos MORI in 2011 identified the need for a change in mind-set by those who wish to engage with social investment.

---

36 Suggested alterations to CITR have been the subject of consultations in 2012 and are not re-addressed here.  
38 Ibid.  
Namely, for investors to realise that social investment needs to be treated differently to existing forms of investment, and thought of as a new ‘wealth pot’. Figure 1 illustrates the transition mindset required to consider social investment in a portfolio of investments.

These findings have implications for the development of appropriate tax incentives for social investment; an incentive will be most effective if consideration has been given to the different motivational triggers for each of the components of a portfolio. Philanthropic and commercial forms of investment are incentivised by Gift Aid tax and EIS/VCT reliefs respectively. Social investment bridges these two motivations, but has no specific tax relief and only a weak ability to apply existing reliefs to its portion of any portfolio.

**Box 2: International precedent for tax incentives into social and environmental initiatives aimed at individual investors**

If it is worth noting here that there is some precedent for a tax relief scheme for social investment aimed at individual investors. In 1995 the Netherlands implemented its Green Fund Scheme (GFS). Through the Scheme, individuals who choose to buy bonds or shares in the ‘Green Fund’ accept a lower interest rate than the market rate, in return for a 2.5% tax advantage. The advantage has two components. First, individual investors are exempt from paying capital gains tax (typically 1.2%) on up to €55,000 invested per person per annum in specific investments such as green business, social, cultural and seed capital funds. Second, investors receive a 1.3% reduction on income tax payments on their green capital. On average individuals invest €30,000 into green funds or bonds.40

Overall the Scheme is considered a success, with the Dutch population contributing over €6.8bn over the period 1995–2008, financing 5,000 projects. This figure is noteworthy considering only 1.4% of the Dutch population participate in the GFS programme.41

---


1.5.1 Survey findings on attitudes towards social investment

In 2011, Ipsos Mori\textsuperscript{43} carried out a survey to throw light on investor attitudes towards social investment. The survey used a dataset of 505 individuals with investable wealth of £50,000 or greater. Two methods were used to identify differences in the population surveyed: regression analysis and cluster analysis.

First, the survey results were analysed using regression to identify whether there were differences in the attitudes and characteristics of those who were interested in social investment, according to their level of investable wealth.

Second, cluster analysis was applied to categorise investors according to their motivations for making social investment. This analysis identified three groups. Each of these groups responded differently to social investment opportunities. The groups were labelled as ‘Active Interest’, ‘Passive Interest’ or ‘No Interest’ based on their likely response to social investment opportunities. The motivations were based on a framework of self-described goals, impulses and habits (see also Annex 6, available separately online). Furthermore, the analysis ranked in importance the triggers or barriers identified by an investor to ‘nudge’ them from a state of interest to actual engagement with social investment. These three sets of data are summarised in Table 3 and Table 4.\textsuperscript{44}

\textsuperscript{42} Source: Ibid.

\textsuperscript{43} Fairbanking Foundation, Ipsos MORI & NESTA (April 2011) – Op Cit.

\textsuperscript{44} See Ibid for full analysis, ranking and weighting of each of the triggers and barriers.
Table 3: Breakdown of 505 individual respondents to Ipsos MORI survey with investable wealth assets of more than £50,000

<table>
<thead>
<tr>
<th>Respondent profile by interest in social investment</th>
<th>Respondent profile breakdown by assets (%)</th>
<th>Key triggers &amp; barriers to investment (ranked)(^4)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>‘Wealthy’ individuals with investable assets £50 – 100k</td>
<td>1. Engagement with the social enterprise/charity</td>
</tr>
<tr>
<td>Active Interest</td>
<td></td>
<td>2. Early adopter</td>
</tr>
<tr>
<td></td>
<td>High Net Worth Individuals (HNWIs) with investable assets £100k+</td>
<td>3. Recycling social investment pot is positive</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5. Economic environment leads to need for social enterprise</td>
</tr>
<tr>
<td></td>
<td></td>
<td>6. Social investment encourages business-like behaviour</td>
</tr>
<tr>
<td></td>
<td></td>
<td>N.B. Triggers/barriers ranked 4(^{th}) and 7(^{th}) differed between the &lt;£100k and &gt;£100k asset investor group - see Table 4 below.</td>
</tr>
<tr>
<td>Passive Interest</td>
<td>40%</td>
<td>1. Need tax incentives</td>
</tr>
<tr>
<td></td>
<td>38%</td>
<td>2. Need case studies</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3. Need a return even if it is for a social purpose</td>
</tr>
<tr>
<td></td>
<td></td>
<td>4. Economic environment means social investment is important</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5. Need for assurance about professional fund management</td>
</tr>
<tr>
<td></td>
<td></td>
<td>6. Need to know money will only be used for social purpose</td>
</tr>
<tr>
<td>No Interest</td>
<td>27%</td>
<td>1. Social needs should be met by government</td>
</tr>
<tr>
<td></td>
<td>25%</td>
<td></td>
</tr>
</tbody>
</table>

\(^4\) Details on how the triggers and barriers were identified and ranked – see Fairbanking Foundation, Ipsos MORI & NESTA (April 2011) – Op Cit.
2. Need a return on investments
3. Need for assurance about professional fund management
4. Social investment will make charities more efficient
5. Need to know which charities/social enterprises are being supported
6. Need to know money will only be used for social purpose

Points to note:

a) It is possible that the sample survey contains some bias towards those with a potential interest in social investment; however, this risk has been mitigated by the fact that very few participants in the survey had prior knowledge of social investment.

b) Unlike for the Active Interest Group of investors, a breakdown of investors into those with £50,000 - £100,000 and £100,000+ investable assets, was unavailable for the Passive Interest Group which forms the basis of the forecast presented in Part 2 of this report. Therefore for the purpose of the forecast, the Passive Interest Group is taken to represent high net worth individuals (£100,000+ investable wealth). This is taken to be a reasonable assumption as HNWI have more disposable income and as a result are arguably more likely to make social investments, even more so with a tax incentive.
<table>
<thead>
<tr>
<th>Identified motivations towards social investment (statistically significant)</th>
<th>‘Wealthy’ individuals with investable assets £50 – 100k</th>
<th>High Net Worth Individuals with investable assets £100k+</th>
</tr>
</thead>
<tbody>
<tr>
<td>This group was found to be influenced by complex motivations, including:</td>
<td></td>
<td>“Social/ethical values” were an influential motivator for this group, meaning they were more likely to:</td>
</tr>
<tr>
<td>• Age, in combination with children at home;</td>
<td>• Want their money to do some good as well as produce a return;</td>
<td></td>
</tr>
<tr>
<td>• A higher level of overall financial satisfaction exploring new investments;</td>
<td>• Have an investment portfolio that reflected their ethical values;</td>
<td></td>
</tr>
<tr>
<td>• A goal to have financial security in retirement.</td>
<td>• Be involved in community activities.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Key triggers &amp; barriers to investment (ranked)⁴⁶</th>
<th>Triggers 1,2,3,5 and 6 as above in Table 3 (same as Active Interest individuals with investable assets £100k+):</th>
<th>Triggers 1,2,3,5 and 6 as above in Table 3 (same as Active Interest individuals with investable assets £50 -100k):</th>
</tr>
</thead>
<tbody>
<tr>
<td>4. Choice of charity/social investment is important;</td>
<td>4. Produce evidence of social outcomes;</td>
<td>7. Tax incentives could make a real difference.</td>
</tr>
<tr>
<td>7. Be sure that social good will result.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 4 illustrates that there is a statistically significant difference in the motivations to social investment between those with £50,000 – £100,000 and those with greater than £100,000 of investable assets. It also shows that within the Active Interest Group, there are differences in the identified triggers/barriers to investment between the two investor asset groups (<£100k and >£100k).

⁴⁶ Details on how the triggers and barriers were identified and ranked – see Fairbanking Foundation, Ipsos MORI & NESTA (April 2011) – Op Cit.
1.5.2 Key differences in motivations across wealth levels (Active Interest Group)

Individuals in the Active Interest Group with investable assets of between £50,000 and £100,000 displayed a complex variety of attitudes and characteristics.

In contrast, for those ‘actively interested’ high net worth individuals (investable wealth of over £100,000), the research evidence suggests that by far the largest determining motivation was for their social and ethical values to be reflected in their investment portfolio.

This is important when determining the policy objective of encouraging social investment; it is likely that a tax relief will be most effective as a motivation to HNWIs, rather than those in the lower wealth bracket.

1.5.3 Role of tax incentives in encouraging social investment

The Ipsos MORI research identified four reasons as to why a tax incentive may be a motivation for actively interested HNWI (those with greater than £100,000 of investable assets):

1. ‘Jump start’ – This would give an official endorsement to the activity. It is an effective way of ‘nudging’ those interested in social investment as they are encouraged to consider such an investment as an appropriate action;
2. Public awareness – The act of providing a tax incentive would create significant public awareness. The government would be providing a clear ‘signal’ that it considered social investment to be sufficiently important to provide an incentive, in the same way as it offers incentives under mainstream tax reliefs;
3. Sharing the benefit – It would give a sense that the social investor was sharing not just the cost with the government but also some of the benefit, by providing finance for services to meet growing social needs; and
4. Financial off-set – It will have broad appeal to those that want to pay less tax and expect the government to encourage this economically and socially useful type of investment (in the same way as with EIS or VCT tax relief schemes).

The research also found that wealthy individuals categorised as having a ‘passive interest’ in social investment, identified ‘the need for tax incentives’ as their primary motivation for social investment (see Table 3). Notably, of the six motivations for the Passive Interest Group, only two are open to influence; the need for tax incentives (ranked 1st) and the need to know investments will be used for social good (ranked 6th).

1.5.4 Evidence of unmet appetite for social investment

The analysis of the Ipsos MORI research undertaken in this section (1.5) has a number of implications for incentivising investment from wealthy individuals in social sector organisations.

---

47 Fairbanking Foundation, Ipsos MORI & NESTA (April 2011) – Op Cit.
Incentivise ‘passive’ wealthy investors, particularly HNWIs in the Passive Investor Group. The ‘sweet spot’ identified by the analysis of the Ipsos MORI research is to incentivise those ‘passively interested’ individuals, who identify that a tax relief would be the single largest trigger to engage in social investment. This group represented 35% of the total sample population, a substantial proportion of the potential investors. In particular, high net worth individuals in the Passive Investor Group (representing 37% of the Passive Investor Group as a whole – see Table 3) would be worth incentivising, as they have the most expendable capital for investment. Though a tax incentive would not be enough in isolation, as the Passive Investor Group also cares about evidence of the social return, it would also appear to be a very strong influencer. Without it, they are unlikely to engage with social investment.

Help to engage high net worth individuals in the Active Interest Group. This group lists tax incentives as within their top seven triggers, but is primarily motivated by the chance to engage with a social mission in some way (e.g. as a mentor, director, volunteer etc.). It is in fact desirable that tax incentives, though identified as a motivation for social investment, are not a primary motivation for the actively interested group of HNWI. It would be expected that this group would be primarily motivated by social or business-related factors (as was found to be the case). The other triggers identified by this group are broadly within the individual investors’ own ability to determine, and therefore do not pose significant barriers in themselves to social investment.

Though ‘actively interested’ HNWI investors are the most likely to make an investment, it remains possible that without a tax incentive, they may not invest because it seems an inefficient use of capital compared with high risk venture investment. In addition, social investments may never be presented to this investor group, if financial planners/wealth managers are not able to present these investments in the context of a tax continuum. Nonetheless, the expectation remains that these investors are the most likely to invest regardless of whether or not a tax incentive exists.

The exception to this is the need to produce evidence of social outcomes. Clearly, the ‘passive interest’ investors expecting social as well as financial returns, want to be able to assess the ‘impact risk’, and seek evidence that such outcomes have been achieved. This is a key policy initiative within the social investment sector and considerable progress has been made over the last year as Big Society Capital has worked with partners to take forward this work. The Inspiring Impact programme for example, is also seeking to address how social sector organisations can best measure and express their impact to investors.

Although the social investment market has received an increasingly high profile, the amount of investment by individuals is small to date. Based on the challenges described here, it would seem important to provide a tax incentive for the sector; in the first instance, to those wealthy individuals with an unmet appetite to invest and for whom tax would provide such an incentive (i.e. the Passive Interest Group, and those HNWIs in the Active Interest Group). Building on from this, in a period of three years.

---


to five years, arguably the market would have moved to a new level of development in terms of regulation, accounting, performance measurement and infrastructure, to consider how tax incentives might engage less wealthy individual investors in social investment.

1.6 Conclusion to Part 1

Various policy levers are helping the social investment sector to secure a greater market share and to compete at scale with mainstream counterparts. However, as with any sector, access to capital is critical to its survival. This first part of the report has restated the estimated annual growth in demand of 38%, rising to a level of £1bn of social investment over the next five years. This growth is likely to be driven by SSOs securing an increased share of a growing market for providing social outcomes.

The forecasted demand for capital can be broken down into approximately £400m - £600m of unsecured debt and c. £150m of equity-like capital by 2015. 50 Less than £300m will be demanded in the form of secured lending. As unsecured lending is in desperately short supply, new ways of providing this capital need to be developed if the sector is to realise its potential.

This part of the report addressed the key characteristics which identify the social investment sector. The statistics relating to recent performance of social enterprises suggest that the sector is on its way to proving itself a 'good bet', as it meets social needs with increasing economic sustainability. It has also been highlighted how the tax reliefs which currently operate - EIS and VCT - do not incentivise the provision of 'social venture capital'. This is primarily because the legal structures that determine a qualifying investment prohibit most SSOs from eligibility. Lastly, this part of the report has drawn on existing research to demonstrate that wealthy individuals appear to have an unmet appetite to include social investment in their portfolio of holdings. Furthermore, the evidence suggests they could be incentivised to invest socially if a tax relief was included in an offer to attract them.

---

50 BCG & BSC (September 2012) – Op Cit.
2. How much capital for social investment could be raised with the introduction of a tax relief for social investment?

Part 1 of this report identified actively interested high net worth individuals as most likely to be motivated towards social investment, because of their social and ethical values. It also identified whether this group is likely to be triggered by a tax relief, and found that, though there is potential for this, it is more likely that passively interested wealthy individuals (£50,000+ investable wealth) will be motivated to make social investments through a tax incentive. Overall this group represents 35% of the total sample population. HNWIs in the Passive Interest Group are of particular interest and represent 37% of this investor group.

In this second part of the report, further survey data provided by Ipsos MORI\(^51\) is used to identify the percentage of wealthy individuals who, when offered a specific high risk social investment proposition, responded that they would be likely to invest. These data points provide the target group. This is then 'multiplied up' to create a target population size, using data from the ONS Wealth and Asset survey.\(^52\) A conversion rate is then applied to allow for the gap between stated intention and action. Multiplying this by a conservative average investment size, (which could be run under different scenarios), provides an estimate of total capital that could be raised. Trend rates and patterns of current EIS/VCT profiles provide a guide to likely distribution of this finance over a five year period (the average investment period) and the figures are then 'stress tested' against mainstream subscription levels.

Figure 2 illustrates the step-by-step approach adopted in this report to estimate the amount of capital that could be generated over a five year period through a tax relief on investment into social enterprises.

Note that numbers have been rounded in certain instances for convenience.

\(^{51}\) Fairbanking Foundation, Ipsos MORI & NESTA (April 2011) – Op Cit.
<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>Result</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 1 &amp; 2</td>
<td><strong>Step 1 – Motivation</strong> – what % of HNWIs are interested in social investment and primarily motivated / held-back by tax regime</td>
<td></td>
<td>Ipsos MORI 2011 Survey</td>
</tr>
<tr>
<td>Step 2</td>
<td><strong>Step 2 – Product</strong> – what % of HNWIs are likely/very likely to consider ‘higher-risk’ social investments</td>
<td>c. 7.5% of households with investible assets &gt;£100k</td>
<td></td>
</tr>
<tr>
<td>Step 3</td>
<td><strong>Target group</strong> – what % of HNWIs are both primarily motivated/held-back by tax regime AND likely/very likely to consider ‘higher-risk’ social investments (intersection of Step 1 and 2)</td>
<td>c. 225,000 households</td>
<td>ONS, Wealth and Assets Survey, 2010</td>
</tr>
<tr>
<td>Step 4</td>
<td><strong>Number in target group</strong> - of HNWIs implied by Step 3</td>
<td></td>
<td>Ipsos MORI 2011 Survey + internal assumptions</td>
</tr>
<tr>
<td>Step 5</td>
<td><strong>Conversion rate</strong> - % of HNWI in target group who go on to make one social investment over a five year period (low/base/high cases)</td>
<td>c. 38% of ‘very likely’ and c. 19% of ‘fairly likely’</td>
<td></td>
</tr>
<tr>
<td>Step 6</td>
<td><strong>Average £ amount of investment</strong> - average size of individual social investment</td>
<td>£10,000</td>
<td>Based on EIS/VCT minimum</td>
</tr>
<tr>
<td>Step 7</td>
<td><strong>Total £ raised over five years and spread across five years</strong></td>
<td>c. £480m total over five years c. £35m in first year growing to £180m in fifth year</td>
<td>Based on EIS/VCT profile</td>
</tr>
</tbody>
</table>
2.1 A step-by-step approach to estimating the potential effect of a tax relief

2.1.1 Steps 1 & 2

Following the evidence explored in Part 1, it would be rational to assume a tax incentive would only significantly influence the Passive Interest Group of wealthy individuals to make social investments, as this group identified tax as their primary trigger/barrier to investment. The Active Interest Group has been discounted in developing a forecast for the effects of a social investment tax relief, as it is assumed they are sufficiently motivated without a change in the tax regime, whilst it is acknowledged (as in section 1.5.4) that this group of investors may eventually be triggered to invest by a tax incentive. Of course the ‘No Interest Group’ is disregarded in this forecast.

Subsequently, it can be said that 37% of the total sample population of high net worth individuals with wealth over £100,000 were interested in social investment and primarily motivated/held-back by the existing tax regime (Step 1) (see also Table 3). The 2011 Ipsos MORI survey presented a ‘high risk’ social investment product (a Social Investment Fund, or ‘SIF’) to those potential investors who had a good understanding of the relative risk to capital. Another larger group of investors were interested in other social investment products with a lower risk profile (e.g. property funds). However, these lower risk products have been discounted from the forecast in this report, as they are currently more easily available than high risk social investment products.

The potential investors were asked “How likely you would be to invest in the product, assuming any further investigation satisfied you?”. Their responses were as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Very likely</strong></td>
<td>3%</td>
</tr>
<tr>
<td><strong>Fairly likely</strong></td>
<td>22%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>25%</strong></td>
</tr>
</tbody>
</table>

Therefore, a total of 25% of all potential investors would be very or fairly likely to invest in such a product as a Social Investment Fund (Step 2).
2.1.2 Step 3

The target population is the Passive Interest Group with wealth of £100,000 or more (HNWI), who said they would be very or fairly likely to invest in a SIF. Again, those in the Active Investor Group are discounted (both the <£100k and >£100k asset groups) as a tax incentive was not a primary motivation for investment, as with all in the No Interest Group. Table 5 sets out the Ipsos MORI findings connecting Steps 1 and 2.

Table 5: Household interest in investing in a Social Investment Fund according to motivation grouping (Active, Passive or No Interest)

<table>
<thead>
<tr>
<th>% of total population over £100k*</th>
<th>Active Interest</th>
<th>Passive Interest</th>
<th>No Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very likely to invest in SIF</td>
<td>2.3%</td>
<td>1.0%</td>
<td>Less than 0.3%</td>
</tr>
<tr>
<td>Fairly likely to invest in SIF</td>
<td>11.8%</td>
<td>6.5%</td>
<td>3.3%</td>
</tr>
<tr>
<td>Total</td>
<td>14.1%</td>
<td>7.5%</td>
<td>3.6%</td>
</tr>
</tbody>
</table>

*Based on survey of 306 respondents with investable asset of £50k or more.

As shown in Table 5, a total of 7.5% of the total population of investors with over £100,000 of investable wealth will be passive investors (and likely triggered by a tax incentive) and very or fairly likely to invest (Step 3).

2.1.3 Step 4

According to the latest data available from the ONS Wealth and Assets Survey (WAS), 11.7% of all households in the UK have financial assets in excess of £100,000. This represents c. three million households (see Annex 2, available separately online, for full wealth breakdown by band).

In line with Table 5 above, the target population of passive investors will be 7.5% of approximately three million – which rounds to 225,000 investors/households (Step 4). This comprises 29,250 investors who are ‘very likely’ to invest (the 1% in Table 5), and 195,000 investors who are ‘fairly likely’ to invest (the 6.5% in Table 5).
2.1.4 Step 5

The Ipsos MORI research helps to better understand the potential for a tax incentive to influence wealthy individuals to commit to a social investment. When asked whether “a tax relief or tax incentive would encourage me to make an investment”, 38% strongly agreed with this statement. This ‘strongly agree’ population is spread fairly evenly across all interest levels (active, passive and no interest). Therefore, the 38% ratio provides a useful ‘conversion factor’ to define those investors that will actually invest (having previously stated an intention to do so).

The 38% conversion factor for the ‘very likely’ group has been adopted and as a precaution, has been halved (i.e. to 19%) for the ‘fairly likely’ group.

\[
\begin{array}{|c|c|c|}
\hline
\text{Step 5} & \text{Conversion rate} & \text{c. 38% of ‘very likely’} \\
\hline
& \% of HNWI in target group who go on to make one social investment over a five year period \text{(low/base/high cases)} & \text{c. 19% of ‘fairly likely’} \\
\hline
\end{array}
\]

This generates a total number of investors of **48,000** (rounded from 48,200) (Step 5):

- **Very likely**: 29,250 x 0.38 = 11,115 (rounded to 11,000)
- **Fairly likely**: 195,000 x 0.19 = 37,050 (rounded to 37,000)
- **Total** = 48,200 (rounded to 48,000).

Box 3: Different scenarios for different potential tax reliefs

It is not possible to determine from existing research what proportion of investors will invest only if there is a tax incentive (i.e. the marginal investment generated), primarily because the existing number of individual social investors into high risk investment is low. However, it is clear that the number will be very sensitive to the way in which the tax incentive is structured. The scenarios in Table 6 below are based on the experience with the VCT scheme, to illustrate this point. The scenarios are structured around a base of 48,000 investors, as calculated in Step 5 (rounded figure).

These relative numbers of investors in Table 6 are based on the change in investment that resulted from changing the tax relief from 20% to 40%, and then to 30% in a four year period. An extra 10% of tax relief from 20% to 30% generated 2.5 times the amount of VCT investment (see Annex 4, available separately online, for VCT annual percentage change). Therefore, the high and low cases reflect a change in 2.5 times the number of investors in either direction (each rounded). Principles for the tax relief are described later in the report and these will be critical to generating the number of investors.

The VCT evidence shows the difficulty of determining the level of tax incentive which will generate the desired positive response i.e. if it is not sufficiently attractive, there will be significantly less engagement from investors.
Table 6: Scenarios for different levels of tax relief

<table>
<thead>
<tr>
<th>Scenarios</th>
<th>Tax regime</th>
<th>No. of investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low case</td>
<td>Marginally lower tax relief</td>
<td>19,000</td>
</tr>
<tr>
<td>Base case</td>
<td>Same tax relief</td>
<td>48,000</td>
</tr>
<tr>
<td>High case</td>
<td>Marginally higher tax relief</td>
<td>120,000</td>
</tr>
</tbody>
</table>

2.1.5 Step 6

An average investment size of only £10,000 has been assumed. This is significantly less than the average EIS subscription since launch, which is around £20,000 per investment. Furthermore, no multiple or re-investments per household have been assumed.

Table 7: Amount of new high risk social investment that could potentially be raised from wealthy individuals if a tax incentive was introduced

<table>
<thead>
<tr>
<th>Total social investment raised (£ million)</th>
<th>LOW</th>
<th>BASE</th>
<th>HIGH</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>19,000 investors</td>
<td>48,000 investors</td>
<td>120,000 investors</td>
</tr>
<tr>
<td>LOW</td>
<td>£5,000 average invested</td>
<td>£95m</td>
<td>£240m</td>
</tr>
<tr>
<td>BASE</td>
<td>£10,000 average invested</td>
<td>£190m</td>
<td>£480m</td>
</tr>
<tr>
<td>HIGH</td>
<td>£20,000 average invested</td>
<td>£380m</td>
<td>£960m</td>
</tr>
</tbody>
</table>

Table 7 generates base case scenarios of £190m, £480m and £1,200m according to the level of the tax incentive. This step does not incorporate a time period – this is addressed in Step 7. Table 7 shows a maximum of 120,000 investors, representing c. 4.0% of wealthy individuals having made a commitment.

There are two points of interest to note about Table 7, which are not evident at the outset. First, it may be better to describe the number of investments rather than investors, as some investors will develop a portfolio of social investments over time. The average number of holdings is considered in the following step (Step 7).

Second, if a tax incentive is successful, it is expected to generate a higher proportion of the amount invested from the wealthiest households. Venture Capital Trusts for example in 2009/10 generated 54% of the total invested from investments exceeding £50,000, from 17% of the investors. This is not to suggest that the amounts would be

Average £amount of investment - average size of individual social investment

£10,000

-
similar. However, it is likely that a high proportion of the total available for social investment would come from those with investable assets exceeding £400,000. This group represents c. 15% of those with investable assets exceeding £100,000, but if the average amount invested was £40,000 over time from this group, it would represent 50% of the amount raised in the base scenario.

2.1.6 Step 7

A back-ended profile is applied based on the profile of EIS/VCT uptake when the schemes began in the early 1990s.

2.1.7 Five year forecast

Table 8: Forecast of high risk social investment over a five year period (using a BASE case of 48,000 investors and £10,000 of average investment)

<table>
<thead>
<tr>
<th></th>
<th>2014/15</th>
<th>2015/16</th>
<th>2016/17</th>
<th>2017/18</th>
<th>2018/19</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of new investors (Base case)</td>
<td>3,500</td>
<td>5,000</td>
<td>8,500</td>
<td>13,000</td>
<td>18,000</td>
<td>48,000</td>
</tr>
<tr>
<td>Amount of investment</td>
<td>£35m</td>
<td>£50m</td>
<td>£85m</td>
<td>£130m</td>
<td>£180m</td>
<td>£480m</td>
</tr>
<tr>
<td>Cumulative investment</td>
<td>£35m</td>
<td>£85m</td>
<td>£170m</td>
<td>£300m</td>
<td>£480m</td>
<td>N/A</td>
</tr>
</tbody>
</table>

The forecast in Table 8 provides a profile of the number of investors and investments over a five year period. It assumes that there are two schemes operating similar to EIS and VCT that encourage social investment. It shows 48,000 investors committing to make an investment over the five year period. The number of investors is c. 7.5% of those that stated they were very or fairly likely to invest. As social investment becomes more of a mainstream activity, it would be expected that the proportion of individuals thinking about investing would rise. It is also likely that investors would begin to have an allocation of their wealth for social enterprises, which is distinct from their allocations for commercial investment or philanthropy. This would lead to growth of multiple holdings (which is not considered in the above simple forecast).

2.1.8 Caveats to the forecast

There are caveats to the forecast; it is reliant on the responses of 505 affluent and wealthy individuals as indicative of the broader population of wealthy individual investors. It also was not possible to develop an accurate picture of the conversion rate from individuals’ expressed intentions to their actions.
It is also important to note that this report takes a conservative approach to the forecast using the data that is available, and has been deliberately simple in the calculations, to avoid making unnecessary and unjustified estimates. In particular, those active investors that could be ‘triggered’ into making a social investment and the prospect of multiple investor holdings have been ignored for the purposes of estimation in order to err on the side of caution.

As is often the case with forecasting, the accuracy of the forecast presented in this section will depend on a number of factors, such as how many social enterprises are ready for investment, the level of the tax incentive, the continuing establishment of infrastructure, intermediaries and advisors engaging together for the investors, etc. Indeed, an early setback could reduce the speed of growth; alternatively, high profile successes could accelerate it. However, from this data it is possible to conclude that the level of available capital to be raised is sufficient to have an important potential effect on the social investment market, at this nascent stage of its development.

### 2.2 Risk factors affecting take-up of social investment

There are many factors other than the tax incentive itself that could lead the investor numbers to be greater or lower than the numbers shown here, including:

<table>
<thead>
<tr>
<th>Social enterprise readiness</th>
<th>The degree to which social enterprises have developed in order to receive investment from private individuals.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial advisors</td>
<td>Procedure and expertise will need to be developed to incorporate social investment into the advice being offered.</td>
</tr>
<tr>
<td>Regulation</td>
<td>It could take time for the financial regulators to construct policy that allows social investment to be recommended as suitable for investors that have social objectives as part of how they want to deploy their wealth.</td>
</tr>
<tr>
<td>Risk</td>
<td>The market could be negatively impacted by early investments that perform worse (both in terms of financial and social returns) than anticipated, or if there is concern over whether a social impact is being generated. A reputational problem in the early stages could have a disproportionate effect.</td>
</tr>
<tr>
<td>Development of an asset class</td>
<td>As familiarity with social investment grows, the perception of social investment as an asset class would alter along with the receptiveness of the different investor interest groups. As discussed earlier in this report, the effect of a tax incentive would be to move more of the Passive Interest Group to become very or fairly likely to invest and to increase the probability that the Active Interest Group will make a commitment to social investment.</td>
</tr>
</tbody>
</table>

### 2.3 Conclusion on potential social investment raised

Substantial amounts of investment could become available through tax incentivised schemes for social enterprises. The somewhat cautious forecast provided in this report is for £165m over three years and £480m over five years, generated from wealthy individuals who are offered a suitable tax incentive. Much larger sums would be available if the tax incentive was substantial, since it is known that the amount will be heavily influenced by the level of the tax incentive. This level of
investment would involve the development of social investments with an appealing combination of social and financial benefits, together with the growth of the advisory system to draw potential social investors’ attention to these investments.

The forecasting in this section is based on the assumption that the tax relief would be offered at the point of investment, which is in line with the existing schemes operating for mainstream venture capital. In the following section, the findings are ‘stress tested’ against existing schemes, and in Part 3, potential unintended consequence of introducing such a scheme are addressed.

2.4 Stress testing against EIS and VCT performance

Section 2.1 estimated the amount of social investment that could potentially be raised from wealthy individuals, if an appropriate tax relief were available. This section ‘stress tests’ these estimates against the actual figures raised by EIS and VCTs (see Annex 4, available separately online, for additional information).

2.4.1 EIS subscriptions

The EIS has raised c. £8.7bn in the 18 tax years since it commenced and has assisted 18,696 companies. The amount invested is primarily from larger investments in the range of £20,000 to £300,000, with c. 70% of the total amount invested coming from investments in this range in 2010/11. The current steady state for EIS is around £600m with c. 2,000 companies raising funds in a year from c. 30,000 subscriptions.53 (Note: some investors will have more than one subscription per annum).

2.4.2 VCT subscriptions

The VCT scheme has raised c. £4.7bn and the number of VCTs has grown from managing 12 funds in the first year of the scheme (1995/96) to 124 funds in 2011/12. It took 12 years for the number of VCTs managing funds to reach 120. The last six years of the VCT scheme have generated an average of £278m per annum.

2.4.3 Comparison with social investment estimates

In the first three fully operational years of EIS and VCT, the schemes raised £188m and £520m respectively, totalling £708m. Based on these figures for comparison, if similar schemes were introduced for social investment, it could be inferred that an EIS-type scheme could generate £100m to £180m, and a VCT-type scheme could generate £300m to £520m in the first three years; producing a total range of £400m to £700m. However, social investment is an emerging and developing sector and even the lower figure may be too optimistic. The figure of £170m is used as 23% of the amount raised in the early years of the EIS and VCT schemes. The forecast numbers for social investment appear modest in this context.

Figure 3 and Figure 4 show the amount of funds raised by the EIS (introduced 1993) and by the VCT (introduced 1995) respectively.

Figure 3: Chart showing EIS funds raised and number of companies

At most, companies have up to three years after shares are issued to submit an EIS1 compliance statement. Therefore, with the likelihood of sizeable revisions due to claims not yet received: data for 2010/11 are provisional, and claims for 2011/12 and 2012/13 are currently excluded. A further review of data capture procedures has led to small revisions to published statistics in most years.

2.4.4 Impact of income tax on take-up of VCTs

Investors are very sensitive to the rate of income tax relief. This is illustrated in the graph for VCTs (Figure 4) by the strong growth when the government re-ignited VCTs by doubling the income tax relief from 20% to 40% in 2004/05. The scheme was very successful and the relief was reduced to 30% in 2006/07. The introduction of the 50% income tax band had a significant effect on the amount invested in VCTs from its introduction in 2009/10. Annex 4 (available separately online) shows the percentage changes in the amount invested in VCTs each year from the previous year. The amount invested is sensitive to the absolute and the relative rate of the tax relief, for example, when the marginal rate of tax went to 50% in 2009/10; this had the effect of encouraging VCT investment. The point is that incentives need to be established in the context of other reliefs, in order for their effect to be well predicted.
2.4.5 Conclusion from stress tests

Based on the success of the EIS and VCT schemes it is realistic to envisage c. £480m being invested in social investment over a five year period, if similar schemes were available, as presented in the forecast (section 2.1). For example, EIS, with 30,000 investors and in one year, secures a greater amount than the amount forecasted in this report as achievable with a base case of 48,000 investors over a five year period, if a tax relief were adopted for social investment. The forecast in this report therefore feels a relatively conservative estimate and within the bounds of possibility.

However, there is some risk of overestimation when making comparisons across sectors. EIS and VCT schemes were seeking to stimulate growth in SME business financing - a sector already understood by potential investors, even if it was lacking in capital. It may take time for the social investment sector to have sufficient social enterprises that are ready for investment, and for an understanding of social investment to spread amongst suitable investors. Nonetheless, if alterations are made to both the EIS and VCT schemes as suggested in Part 4, this could reduce the time lag and speed-up the knowledge process, as investors and advisors are already familiar with this tax mechanism.

Source: Pricewaterhousecoopers, Allenbridge, Trustnet, Investegate and London Stock Exchange - VCT information and news announcements.
3. What are the likely impacts of developing a tax incentive?

This part of the report briefly considers both the potential risks of developing a tax incentive and how to deal with these, and the potential impacts in terms of recent regulatory changes and financial advisors.

3.1 Risk assessment of tax relief

Creating a fair tax relief which is applicable for social investment may not in itself release the estimated capital, if further barriers, such as inadequate demand or undue restrictions in the wider regulatory environment, remain. These are not the subject of detailed analysis in this report. However, this section considers unintended consequences that adapting such a tax relief for social investment might bring (see Table 9).

Table 9: Assessment of risks posed to realising the potential capital flow

<table>
<thead>
<tr>
<th>Risk</th>
<th>Rating</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social sector organisations unwilling or unready to take on social investment</td>
<td>Low</td>
<td>• Numerous ‘investment readiness’ programmes;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Growing body of research pin-pointing scale of potential demand.54</td>
</tr>
<tr>
<td>Insufficient product design</td>
<td>Low/Moderate</td>
<td>• 2012 saw several new products emerge, including a charity bond55 and new social entrepreneur funds;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Going forward, Big Society Capital has an explicit mandate to support intermediaries that design, manufacture and distribute investment products.</td>
</tr>
<tr>
<td>Inadequate product distribution</td>
<td>Low/Moderate</td>
<td>• A key route to the target group of investors is the IFA or advisory channel. “Availability of tax incentives” is a key consideration of IFAs in discussing social investment products;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Product distribution would further improve if (i) the Financial Conduct Authority continues to stress the suitability of social investments to the IFA community56 and (ii) private wealth management institutions place social investment products on their own distribution platforms.</td>
</tr>
</tbody>
</table>

54 See for example BCG & BSC (September 2012) – Op Cit.
<table>
<thead>
<tr>
<th>Risk</th>
<th>Rating</th>
<th>Explanation</th>
</tr>
</thead>
</table>
| Regulatory barriers faced by investors                              | Low/Moderate    | • The Red Tape Challenge looking into civil society has begun to address some regulatory barriers facing social investment;  
• The application of financial promotion rules to social investment is the most significant area for further reform.                                                                                                                                                                                                                                    |
| Further motivational barriers faced by investors                    | Low/Moderate    | • Tax incentives are an important but not sole motivation for social investment – another key consideration is demonstration of social impact through case studies;  
• The social investment industry has already begun developing such cases through a taxonomy for social impact reporting.                                                                                                                                                                                                                     |
| Cannibalising either existing SME investment OR charitable giving    | Low/Moderate    | • Qualitative research shows that wealthy individuals eventually think of social investment as third ‘pot’, separate from financial and philanthropic objectives for their wealth. (See Annex 3 (available separately online) for examples of investors’ attitudes to dividing their wealth across different ‘pots’). |
| Regulatory barriers faced by investees                              | Moderate        | • At present CICs are severely capped in the amount of share dividend and/or performance-related interest that can be paid-out;  
• A proactive response from the CIC regulator to the on-going consultation on CIC caps is vital to optimise the benefit from any tax change.                                                                                                                                                                                                 |
| Seepage of tax relief to organisations that are not creating social benefit | Low             | • Reverse problem; currently, CLGs and their subsidiaries are excluded from venture capital reliefs which are open to other SMEs;  
• Additional definitional issues should identify organisations creating value e.g. (i) the type of investors – individuals not corporations, (ii) the types of social investment capital that is used by social enterprises, and (iii) the nature and form of the social enterprises that will be eligible under the tax incentive (see Table 1). |

59 Fairbanking Foundation, Ipsos MORI & NESTA (February 2011) – Op Cit.
3.2 Retail Distribution Review and the Financial Services Bill

A number of recent influences have bearing on the way social investment products may be taken to potential clients. First, the introduction of the Retail Distribution Review from January 2013 fundamentally alters the level of services and the way in which IFAs will be paid for providing product advice to clients. This reinforces the second factor, namely, the inclusion in the remit of IFAs to consider the ‘suitability’ of social investment products for clients. Third, the recent adoption of an amendment to the Financial Services Bill by the House of Lords, places obligations on the regulatory body to take into account different motivations of investors, and to identify a responsible officer for social investment considerations. These factors indicate that at present there is momentum around the social investment sector. Introducing a tax relief for the sector would therefore provide timely support.

3.3 The important role of Independent Financial Advisors (IFAs)

Financial advisers have a significant bearing on the success of the social investment sector. If tax incentives drive client demand, this will influence advisors’ level of engagement. The growth of socially-motivated investment is leading the industry to establish technical and advisory procedures which the new regulatory body is committed to taking into consideration. Adapting existing tax regimes such as EIS and VCT, will help ensure that the IFAs become engaged in helping distribute these opportunities to appropriately screened clients.

Research published by JP Morgan in August 2012 projected that 81% of £50,000+ household income earners will seek professional advice to varying degrees. Financial planners are also under considerable regulatory pressure to ensure that the investments of their clients are appropriate.

Investment opportunities are often only provided to sophisticated investors (such as HNWIs) through their IFAs. For this reason, a tax relief for social investment will, by default, be largely taken up by such HNWIs (at least in the beginning). However, research from NESTA and Worthstone suggests that IFAs are most driven by client demand for impact investment products. This puts the onus back on HNWI clients to show sufficient awareness of social investment products, for an advisor to discuss such opportunities with them.

---

61 NESTA & Worthstone (June 2012) – Op Cit.
4. How could a social investment tax incentive be developed?

4.1 Practical approach

This final part of the report looks at the practical application of a tax relief for social investment, using existing tax reliefs as a starting point. Details of all four existing tax relief schemes which operate for mainstream venture capital are summarised in Annex 5 (available separately online); namely, the Venture Capital Trust (VCT) scheme, the Enterprise Investment Scheme (EIS), the Seed Enterprise Investment Scheme (SEIS) and Community Investment Tax Relief (CITR).

This part has been prepared by building on the significant body of previous work into an appropriate social investment tax relief, notably the NCVO Tax Commission of 2012.\textsuperscript{62}

4.2 The overarching objective: to include social enterprises in tax relief

The overarching objective of tax reform must be to develop \textit{appropriate tax incentives for social investment} vis-à-vis other investment opportunities. This is not an argument for social investment to be given preferential treatment, but merely fair treatment, in the minds of investors when they make their investment decisions amongst an array of investment products, many of which already have tax incentives attached to them. The proposals set out in this report flow from this objective. This does not imply that a social investment tax relief cannot be distinctive from other mainstream venture capital reliefs, and it would serve as a positive signal if it were to be clearly identified as such. In fact, these altered existing regimes have been given specific names for this purpose (see the Appendix to this report), but they are strongly based on existing schemes for both practical and cost reasons.

4.3 Guiding principles

This report recommends three principles to underpin a new tax regime for social investment: a tight definition of eligibility, a focus on risk-bearing capital, and a focus on individuals as investors. These three principles are derived from the discussion in Part 1 and 2 of this report and expanded on below.

1) \textbf{A tight restriction to regulated social sector organisations (RSSOs).}\ All regulated social sector organisations are by definition, driven by making a social impact, and have clear missions to increase their social impact amongst disadvantaged individuals, communities and society at large. Restricting eligibility of any extended relief to these organisations is the best way of protecting against abuse (see section 1.1).\textsuperscript{63}

2) \textbf{A focus on patient, risk-bearing capital.}\ The type of capital currently in shortest supply for RSSOs is risk-bearing capital to help them grow, diversify or invest in their own capability.

\textsuperscript{62} NCVO (January 2012) – Op Cit.
\textsuperscript{63} This report has not suggested broadening the eligible organisations to include private companies that have implemented strict governance and other requirements to evidence and lock in their social mission and activities (such as the requirements in the BSC Governance Agreement - see Annex 8, available separately online), however this could be a consideration for future reform.
3) A focus on individuals as investors. This is the right investor group to target; individuals, particularly HNWIs, have demonstrated an interest in social investment, and cumulatively they have large amounts of investible capital. They are also the target recipients of existing tax reliefs for providing high risk capital.

It is possible to ‘sketch-out’ the specific features of a tax relief for social investment by thinking about eligibility, the relief itself, and administrative features. Some key features within these components are set out in Table 10 below. Note that the three central elements of a tax incentive for social investment are described in greatest detail in Terms1.1, 1.2 and 1.3 in Table 10.

Table 10: Design features of a tax regime to level tax incentives for social investment

<table>
<thead>
<tr>
<th>No.</th>
<th>Term</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Eligibility</td>
<td></td>
</tr>
<tr>
<td>1.1</td>
<td>Investors eligible</td>
<td>All individuals, subject to existing legal and regulatory restrictions on financial promotions. Wealthy individuals would however be expected to have the greatest take-up. Corporations and institutions would not be eligible.</td>
</tr>
<tr>
<td>1.2</td>
<td>Investments eligible</td>
<td>• Equity (as currently provided); and • <strong>Equity-like risk capital</strong>, meaning unsecured debt with equity-characteristics, which can include (i) performance-related interest (such as described in CIC Regulations),64 (ii) contracts such as revenue participation agreements65 and ‘at risk’ outcome payments, and (iii) debt unsecured by assets. The term of the investments would be comparable to the existing schemes, emphasising the long-term nature of the investments.</td>
</tr>
<tr>
<td>1.3</td>
<td>Underlying investee organisations eligible</td>
<td>• Charities (regulated by the Charity Commission); • Community Interest Companies (CICs) (regulated by the CIC regulator as part of BIS); and • Community Benefit Societies (registered</td>
</tr>
</tbody>
</table>

---

65 See the revenue participation agreement between CAF Venturesome and Charity Technology Trust in NCVO (January 2012) – Op Cit, p.13.
Together, these are Regulated Social Sector Organisations (RSSOs).

The activities that these organisations are able to conduct would be broad and incorporate all the different types of activities that RSSOS conducts to promote social impact, particularly with respect to transforming public services, including to improve healthcare, education, social care, financial inclusion and increase community ownership of local assets.

The size of the organisations can be the same as the size covered by existing reliefs – that is, it is not targeting the biggest organisations that may already be able to access finance.

The form of organisations would take into account the various structures around the investee organisations, such that trading subsidiaries of parent RSSOs (even with majority share ownership) would be included.

<table>
<thead>
<tr>
<th>Table</th>
<th>Title</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.4</td>
<td>Eligible investment process</td>
<td>Investment would be permitted directly or through an intermediary organisation (as currently provided).</td>
</tr>
<tr>
<td>2</td>
<td>Relief</td>
<td></td>
</tr>
<tr>
<td>2.1</td>
<td>Type and level of tax relief (%, amount)</td>
<td>Rates comparable to existing schemes for individual investors, including:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Full income tax relief at point of investment;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Dividend; and</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Loss or gains on point on sale.</td>
</tr>
<tr>
<td>2.2</td>
<td>Timing tax relief is granted</td>
<td>Comparable to existing schemes for individual investors – point of investment relief is most relevant.</td>
</tr>
<tr>
<td>2.3</td>
<td>Caps on relief</td>
<td>Comparable to existing schemes for individual investors.</td>
</tr>
<tr>
<td>3</td>
<td>Administration</td>
<td></td>
</tr>
<tr>
<td>3.1</td>
<td>Process</td>
<td>Comparable to existing schemes for individual investors. However, the</td>
</tr>
</tbody>
</table>
additional regulatory requirements of RSSOs would be taken into account to ensure that there is not duplication of procedures for RSSOs.

| 3.2 | Enforcement | Comparable to existing schemes for individual investors, requiring almost no additional resources and relative ease of policing. |

The Appendix provides comprehensive details on the changes required to existing EIS and VCT regulations to make them fit for the purpose of social investment. The EIS is compared with a new Social Impact Investment (SII) and the VCT with a Social Impact Investment Trust (SIIT).

### 4.4 Tax relief over the life cycle of an investment

There are several different stages in the life cycle of an investment at which a tax relief can operate and which affect the behaviour of an investor. These are:

- **When the investment is made.** This plays to present-bias, and is highly sensitive to the rate of actual relief offered. Some mental calculation about the purpose of the capital and the opportunity cost if the rate offered is lower than other tax reliefs, could influence take-up. Capital gains tax (CGT) deferral can also play to present-bias. Whilst offering CGT deferral on loans would be a clear differentiator, the concept is not in itself unusual, as it is present in the EIS.

- **When the investment is held.** Dividends or interest gained whilst holding may be subject to relief. This could be applied in social investment using a VCT type structure.

- **When the investment is sold for a gain.** This relief would be less of a motivation as there is usually lower than expected and actual capital gains. It may be better to create a differentiation by not having this relief for a gain. It is offered for future benefit rather than present gain.

- **When the investment is sold for a loss or written off, or the investor dies.** A relief could offer the opportunity to offset this loss against other taxable gains. This would provide a differentiator as much loss relief is currently being reduced. It could offer peace of mind, especially for first time social investors. Holding on to a perceived loss is not unlikely, and reflects the high value an investor might put on such a holding, beyond its monetary value. In the case

---

66 The Seed Enterprise Investment Scheme (SEIS) is also part of the existing tax relief system. It therefore may be preferable to similarly amend the SEIS. This would complement the portfolio of existing tax reliefs, in the same way that tax reliefs are available to SMEs (under EIS, VCT and SEIS). This would therefore further assist with providing SSOs the same level of access to required capital as SMEs. This would also help maintain consistency with governing legislation.

67 Academic research into behaviour change is referenced in the ‘Further reading’ section of the Bibliography to this report.
of an investor dying, there could be an offset of the holding against inheritance tax.

Each of these time points have different trade-offs in terms of cost benefit analysis, but offer considerable flexibility in how a social investment tax relief may best be incentivised and implemented.

Additional considerations as to how the tax relief could be structured are:

- **Offering choice to investors on the tax relief they prefer.** This could widen the range and motivations of investors, from ‘risk takers’ through to those who seek peace of mind. Decisions may be affected by emotional aspects of social investment. There could even be a voluntary tax (i.e. a ‘Starbucks tax’) for such investment.

- **Temporary tax relief.** The aim here is to stimulate interest using tax as a ‘lightning rod’, by offering higher reliefs during the first tax year of the scheme, which tapers over time. This could eliminate other liabilities that would occur later in the lifecycle, such as CGT. However there are obvious negative implications of establishing temporary short lived incentives in a fragile sector at an early stage of development.

### 4.5 Expanded definition of investee organisations within a tax incentive for social investment

It will be a challenge to define precisely the nature of a tax incentive for social investment so that it is appropriately targeted. The definition should be sufficiently flexible to cover the various types of social enterprise that require social investment, but also be sufficiently specific to prevent other non-socially focused organisations access to another tax incentive (and a large untargeted liability to the government). Achieving this balance is critical to the success of the tax incentive. This report has already considered the first two concepts of eligibility referred to above (type of investors and type of social investment).

The most public discussion thus far has certainly surrounded how to define the **nature of the organisations** that are seeking social investment (refer back to section 1.1).

In section 4.3, a guiding principle is that the tax relief is restricted to RSSOs. This ensures that the tax incentive is as targeted as possible, and clearly focuses on organisations with a social purpose. However, in doing so, it potentially misses out a number of organisations set up as private companies that are also clearly socially motivated. Understanding how to set up such a balance could be helpful in the long-run for the development of social investment.

Therefore, in order to understand the nature, or distinct characteristics of the socially-motivated organisation, three key components must be considered: the social impact (or public benefit) that the organisation is trying to achieve, the governance of the organisation, and how the organisation reports social impact.
4.5.1 Defining the social impact of social enterprises

Clearly identifying the social benefit expected from the social enterprise is very important to the definition and requires consideration of social impact. The vast range of charities (some 169,000 in all) and companies with the aim of creating social benefits, with varying aims and objectives, means the potential range of social or public goods, is enormous. The categories of ‘public benefit’ listed by the Charity Commission is the only defined list that appears to be sufficiently definitive for the purpose of a tax incentive. The public benefit has to relate to the objectives of the charity and must be identifiable.

4.5.2 Governance of a social enterprise

The governance structure of a social enterprise can have the effect of ‘locking in’ the social impact in the mission of the social enterprise, and therefore could be used to identify which social enterprises fall within the scope of a tax incentive.

Restricting an incentive to RSSOs will miss out those organisations in the legal form of private limited companies that have strong governance structures and which have a clear primary purpose to achieve a social impact. Research indicates this comprises a significant percentage of all social enterprises. In addition, these private companies are generally some of the most ready to receive investment given their legal structures permit it, particularly equity investments into companies limited by shares.

In order to address this need, Big Society Capital has developed a model governance agreement to be used by for-profit SSOs. In addition to the public benefit requirement, it contains four further constitutional requirements. These are in relation to:

- **Distribution of profits after tax** (should be used for social objectives);
- **Constitutional arrangements/contractual lock** on the provision of public benefit, dividend and surplus distribution policy and disposal of assets;
- **Remuneration arrangements** should be reasonable, comparable to other SSOs, and subject to disclosure; and
- **In the event of change of ownership**, efforts should be made to preserve the social mission.

This approach, taken by Big Society Capital, demonstrates that solutions are possible to clearly describe the relevant organisations and some are already emerging in the social investment market (see Annex 8 for more detail).

4.5.3 Reporting of social impact

Reporting of the social impact (or public benefit) of RSSOs is often used as another way of ensuring that the core mission of the organisation is maintained, and

---

68 For more information on what constitutes ‘public benefit’, see Annex 7 (available separately online); see also http://www.charitycommission.gov.uk/Library/guidance/publicbenefittext_1.pdf.
70 See Annex 8 (available separately online).
therefore could be used to identify those organisations within the scope of the tax incentive. Rigorous reporting obligations, perhaps based on the Charities Trustees Annual Report as a model, could be used to ensure the social investment received by the investee organisations is used appropriately for public benefit.

4.6 Conclusion to Part 4

This final part of the report has briefly illustrated that it is certainly possible to construct plausible, clear limits around private organisations that are not RSSOs and that should be within the scope of the tax incentive. This would have the effect of capturing the many innovative social enterprises that do not currently fit within the strict confines of RSSOs. Policymakers should consider this as an option for future reform of the tax relief after an initial introduction in accordance with the earlier sections of Part 4.
5. Conclusion

This report has identified a rationale for the creation of a tax relief to incentivise individuals to provide much needed risk capital to the social investment sector. It is estimated that an adjustment of the existing mainstream venture capital tax reliefs could generate capital of close to £500m over five years. This estimation is based on evidence of an appetite of wealthy individuals, particularly HNWIs, to invest in social outcomes, on the take-up of comparable existing mainstream regimes offering, and through extrapolation of the distribution of wealth of HNWIs taken from ONS Wealth and Asset Survey findings. Both the government and philanthropists have played a significant role in building up the market for social investment, but the baton now needs to be passed on to other potential investors. This will provide a stepping stone for scaling-up and an opportunity for larger-sized investments, which will be more attractive to financial institutions.

The rationale for such a tax relief for individual investors lies in three key arguments. These are based on the evidence of an unmet appetite to invest for social purpose, as described in the report. First, there is the argument for ensuring high risk capital reaches social as well as mainstream enterprises – currently much social investment falls outside the remit of existing tax regimes as it is neither philanthropy nor commercially-based investment. Second, the rationale for introducing a tax relief to individuals is based on the need to meet forthcoming demand for high risk capital, estimated at around £1bn over the next five years. Lastly, the opportunity cost of not meeting society and government’s growing need for services through a shortage of investment is measured in terms of the lost economic and social benefit.

The intention of a tax relief would be to see greater social investment from wealthy individuals into distinctive schemes for public benefit. The relief would need to provide sufficient incentive, but not be so complex or different that financial advisors and investors do not engage. To implement such a scheme, there is a need to create a framework which defines the types of investee organisations it seeks to encourage investment into. One key aim would be to address the current gap in incentivising all finance (including unsecured debt-based capital used to take high risk) provided by individuals into social enterprises. Such a scheme would need to determine when in the life cycle of the investment the tax relief is offered, at what rate, and whether these rates should alter across different forms of capital provided. Though this report does not provide such details, it does set out the case for the benefits of introducing such a scheme.

It clearly makes sense to treat both EIS and VCTs together as they operate as parallel schemes. Both schemes offer opportunities to invest across the range of different investment processes – VCT indirectly and EIS directly. In addition, both EIS and VCT are governed by the same legislation – the Income Tax Act 2007 – and are consistent in their eligibility and management. Developing a tax incentive for social investment by adapting these two schemes together would therefore provide consistency of approach and ease of policing for the government.

However, there are also differences in the schemes which are recognised; for example, EIS has a greater annual personal allowance than VCT (£1m as opposed to £200,000 respectively), and has already provided considerable capital into green initiatives and community programmes. Nonetheless, it is suggested in this report
that both EIS and VCT are adapted together, to maximise the potential effectiveness from implementing a tax relief scheme for social investment.

Introducing such a scheme for social investment is likely to provide a signal that social investment can be a suitable element of an investment portfolio. This is necessary because the potential of the sector will not be met without the high risk capital it requires, in spite of plentiful public signals about the merits of social enterprises contributing more fully to society’s needs.

Financial advisors can play a key role in assessing the suitability of these opportunities and offering them, where appropriate, to their HNWI clients, and the inclusion of a tax break alongside those offered to other mainstream investments, will be critical in converting these individuals’ interest into social investment.

The timing of introducing such a scheme seems ripe; there is a confluence of factors, including Parliament’s recognition of the concept of investing for different motivations beyond pure maximisation of financial returns. These include: a newly-created competency for social investment by a reconfigured financial regulator, (the Financial Standards Authority, soon to be the Financial Conduct Authority), and the radical change in the mechanism for providing financial advice to HNWIs under the Retail Distribution Review. The government faces an ever-growing need for more effective social outcomes which will reduce future government spending commitments, while it scans the opportunities to generate growth within the economy. The social investment sector has the potential to be a major contributor on all these counts, but it needs capital to deliver.

Tax incentives for social investment would complement the many other policy levers which are shaping the growth of this sector. These include the recently enacted Public Services (Social Value) Act in public procurement and the Localism Act’s support for communities, the creation of Big Society Capital and the various incubator and investment readiness schemes. All of these initiatives need appropriate capital on stream to ensure that these organisations can deliver their social outcomes. A tax relief is one of the most direct and effective mechanisms available to help to secure this.
Appendix: Adapted EIS & VCT for Social Investment

For individuals looking to invest directly into a social enterprise, it will be more straightforward to begin with a form of tax relief which in this report, will be called Social Impact Investment (or “SII”) and is based on that available under EIS and VCT.

For individuals looking to invest into a fund which, in turn, invests in social enterprises, a new type of venture capital trust – a Social Impact Investment Trust (or “SIIT”) - could be established.

The benefits of doing this would be:

- To allow investors to spread the SII portfolio;
- To offer tax reliefs immediately (rather than when the money is invested into a Social Impact Investment Scheme (SIIS))

The existing limits on investments under EIS (£1m per individual per tax year, and a rolling 12 month limit per company of £5m) could apply equally to investments qualifying for SII relief. Similarly, the existing limits on investments under the VCT regime (£200,000 per individual per tax year, and a rolling 12 month limit per company of £5m) could apply equally to SIITs.

The following tables compare SIIS with the existing EIS regime (Table 11), and then compare SIIT with the existing regime for VCTs (Table 12). Certain amendments to the EIS and VCT regimes have been based on information from each other scheme to aid consistency as well.

Please note that the below tables are not final recommendations as to the precise nature of the amendments required to be made to existing schemes to implement the SIIS and SIIT, but are suggestions of how such current schemes may be amended to help address some of the common problems faced by RSSOs in these schemes in order to provide useful information for future discussion.

Table 11: Social Impact Investment Scheme (SIIS) – Comparison with EIS

<table>
<thead>
<tr>
<th></th>
<th>EIS</th>
<th>SIIS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Form of the enterprise</td>
<td>The investee enterprise must be a company with a share capital</td>
<td>The investee enterprise may be a Regulated Social Sector Organisation (“RSSO”) (as defined in the report)</td>
</tr>
<tr>
<td>in which the investment is made (“Investee Enterprise”)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unquoted status</td>
<td>The investee enterprise must be unquoted</td>
<td>Same</td>
</tr>
</tbody>
</table>

Table 12: Social Impact Investment Trust (SIIT) – Comparison with VCT

<table>
<thead>
<tr>
<th></th>
<th>EIS</th>
<th>SIIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Form of the enterprise</td>
<td>The investee enterprise must be a company with a share capital</td>
<td>The investee enterprise may be a Regulated Social Sector Organisation (“RSSO”) (as defined in the report)</td>
</tr>
<tr>
<td>in which the investment is made (“Investee Enterprise”)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unquoted status</td>
<td>The investee enterprise must be unquoted</td>
<td>Same</td>
</tr>
<tr>
<td>EIS</td>
<td>SIIS</td>
<td></td>
</tr>
<tr>
<td>-------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td>Size</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td><strong>Size</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investee enterprise must have equivalent of no more than 250 full time employees.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross assets of investee enterprise (and subsidiaries) cannot exceed £15m before investment, and £16m immediately afterwards</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Control</td>
<td>Same – unless the ultimate parent company or controller is also (and remains) a RSSO</td>
<td></td>
</tr>
<tr>
<td><strong>Control</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The investee enterprise must not be controlled by another company (or by a company and its “connected persons”)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Group structure</td>
<td>Group structure should also be permitted to include companies without a share capital and other entities typically used by social sector</td>
<td></td>
</tr>
<tr>
<td><strong>Group structure</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subsidiaries must be qualifying subsidiaries (defined as the parent company owning over 50% of the ordinary share capital)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Activities</td>
<td>The activities of the investee enterprise must fall within certain defined activities (see report), and thus be a RSSO.</td>
<td></td>
</tr>
<tr>
<td><strong>Activities</strong></td>
<td>Definition of “trading” should not apply to the investee enterprise. Instead, if an entity falls within that definition, an investment into that enterprise should qualify for investment under SIIS – irrespective of whether or not the enterprise “trades” for realisation of profits rather than for realisation of financial and social returns</td>
<td></td>
</tr>
<tr>
<td>It must carry out or be preparing to carry out a qualifying trade</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The trade must be conducted on a commercial basis with a view to the realisation of profits. Most trades qualify, but some do not – termed ‘excluded activities’</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Location</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td><strong>Location</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>It must have a permanent establishment in the UK</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
When the money must be employed

The money raised must be employed in a qualifying trade within two years

The money raised must be employed in pursuit of the objects of the investee enterprise within two years

Nature of the investment

Each investment must be in ordinary shares meeting certain requirements

Investments may be in any proportion of equity or equity-like risk capital (e.g. shares, debt with equity characteristics or unsecured debt)\textsuperscript{71}

How long must the investment be held?

Shares must be held for a minimum of three years

Loans should have a minimum term of five years, but allow for voluntary repayment, or early repayment on customary events of default\textsuperscript{72}

Tax avoidance/abuse

Securities issued in connection with “disqualifying arrangements” will not be qualifying holdings.

Same

Perhaps a more general anti-avoidance rule may be introduced

<table>
<thead>
<tr>
<th>Table 12: Social Impact Investment Trusts – Comparison with VCTs</th>
</tr>
</thead>
<tbody>
<tr>
<td>**</td>
</tr>
<tr>
<td>---</td>
</tr>
<tr>
<td>The fund</td>
</tr>
<tr>
<td>Must the fund be listed on a recognised Stock Exchange?</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

\textsuperscript{71} However the nature level of the tax relief may vary dependent on whether the investment is by way of capital or unsecured debt.

\textsuperscript{72} Taken from VCT scheme.
<table>
<thead>
<tr>
<th><strong>Is the fund exempt from corporation tax on any capital gains arising on disposal of their investments?</strong></th>
<th><strong>VCT</strong></th>
<th><strong>SIIT</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

| **What are the limits on how much the fund must invest in so-called “qualifying holdings”?** | **VCTs must invest at least 70%, by value, of the fund in “qualifying holdings”** | Same as for VCTs, except definition of “qualifying holdings” will be any investment in a RSSO |

| **What proportion of the fund must be invested by way of shares?** | At least 70% of the VCTs’ qualifying holdings must be in ordinary shares meeting certain requirements (“eligible shares”) | No minimum requirement. The SIIT’s qualifying holdings may be held in any proportion of equity or equity-like risk capital (e.g. shares, debt with equity characteristics or unsecured debt) |

<table>
<thead>
<tr>
<th><strong>The enterprises in which the fund can invest (the “Investee Enterprise”)</strong></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Form of the Investee Enterprise</strong></td>
<td>The investee enterprise must be a company with a share capital</td>
<td>The investee enterprise may be a company with a share capital, or other legal forms of RSSOs</td>
</tr>
<tr>
<td><strong>Unquoted status</strong></td>
<td>The investee enterprise must be unquoted</td>
<td>Same</td>
</tr>
<tr>
<td><strong>Size</strong></td>
<td>Investee enterprise must have equivalent of no more than 250 full time employees Gross assets of investee enterprise (and subsidiaries) cannot exceed £15m before investment, and £16m immediately afterwards</td>
<td>Same</td>
</tr>
<tr>
<td><strong>Control</strong></td>
<td>The investee enterprise must not be controlled by another company (or by a company and its “connected persons”)</td>
<td>Same – unless the ultimate parent company or controller is also (and remains) a RSSO</td>
</tr>
<tr>
<td></td>
<td>VCT</td>
<td>SIIT</td>
</tr>
<tr>
<td>--------------------------</td>
<td>----------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Group structure</strong></td>
<td>Subsidiaries must be qualifying subsidiaries (defined as the parent company owning over 50% of the ordinary share capital)</td>
<td>Group structure should also be permitted to include companies without a share capital and other entities typically used in RSSOs</td>
</tr>
<tr>
<td><strong>Activities</strong></td>
<td>It must carry out or be preparing to carry out a qualifying trade</td>
<td>The activities of the investee enterprise must fall within certain defined activities (see main report), and thus be a RSSO. Definition of “trading” should not apply to the investee enterprise. Instead, if an entity falls within that definition, an investment into that enterprise should qualify for investment by a SIIT – irrespective of whether or not the enterprise “trades” for realisation of profits rather than for realisation of financial and social returns</td>
</tr>
<tr>
<td></td>
<td>The trade must be conducted on a commercial basis with a view to the realisation of profits. Most trades qualify, but some do not – termed ‘excluded activities’</td>
<td></td>
</tr>
<tr>
<td><strong>Location</strong></td>
<td>It must have a permanent establishment in the UK</td>
<td>Same</td>
</tr>
<tr>
<td><strong>When the money must be employed</strong></td>
<td>The money raised must be employed in a qualifying trade within two years</td>
<td>Substantially the same. The money raised must be employed in pursuit of the objects of the investee enterprise within two years</td>
</tr>
<tr>
<td><strong>Nature of the investment</strong></td>
<td>At least 10% of each investment must be in eligible shares – but the VCT must hold 70% of its “qualifying holdings” in eligible shares, so in practice this proportion is much higher</td>
<td>Investments may be in any proportion of equity or equity-like risk capital (e.g. shares, debt with equity characteristics or unsecured debt)</td>
</tr>
<tr>
<td>How long must the investment be held?</td>
<td>VCT</td>
<td>SIIT</td>
</tr>
<tr>
<td>--------------------------------------</td>
<td>-----</td>
<td>------</td>
</tr>
<tr>
<td>Loans only qualify if the term is a minimum of five years (although early voluntary repayment is permissible, as is repayment on certain customary events of default)</td>
<td>Same</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tax avoidance/abuse</th>
<th>VCT</th>
<th>SIIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities issued in connection with “disqualifying arrangements” will not be qualifying holdings</td>
<td>Same</td>
<td>Perhaps a more general anti-avoidance rule may be introduced</td>
</tr>
</tbody>
</table>
Bibliography

Accenture (February 2011) Carbon Capital: Financing the low carbon economy
http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture_Barclays_Carbon_Capital.pdf;

Baker Tilly (October 2012) A Guide to AIM Tax Benefits

Big Society Capital (September 2012) For-Profit Social Sector Organisations Governance Agreement
http://bigsocietycapitalblog.files.wordpress.com/2012/09/governance_agreement1.pdf

Big Society Capital, Bates Wells & Braithwaite, & Worthstone (March 2012) Advising Clients on Social Investments and Deciding on Suitability: The report of an expert working group

Boston Consulting Group & Big Society Capital (September 2012) The First Billion: A forecast of social investment demand

Charity Commission (December 2011) Charities and Public Benefit: The Charity Commission’s general guidance on public benefit
http://www.charitycommission.gov.uk/Library/guidance/publicbenefittext_1.pdf

ClearlySo, New Philanthropy Capital & Big Lottery Fund (July 2012) Investment Readiness in the UK

Coopey, R. (1994) The First Venture Capitalist: Financing development in Britain after 1945, London School of Economics,

Delta (March 2010) Hidden Social Enterprises: Why we need to look at the numbers

Department for Business, Innovation & Skills (2009) Community Interest Company Guidance, Chapter Seven
www.bis.gov.uk/cicregulator/guidance

Department for Business, Innovation & Skills (BIS) (April 2011) Small Business Survey 2010
Fairbanking Foundation, Ipsos MORI & NESTA (April 2011) Investing for the Good of Society: Why and how wealthy individuals respond

HM Treasury (December 2012) The Autumn Statement 2012,
http://www.hm-treasury.gov.uk/as2012_index.htm

Insight at Pacific Community Ventures & The Initiative for Responsible Investment at Harvard University (January 2011) Impact Investing: A framework for policy design and analysis, Case study 7: Green Funds Scheme

JP Morgan Asset Management (August 2012) Winning Propositions: The consumer market post-RDR; Matching your fee-based services to customer needs
http://am.jpmorgan.co.uk/adviser/_documents/jpm-winning-propositions.pdf


National Council for Voluntary Organisations (March 2012) UK Civil Society Almanac 2012
http://www.ncvo-vol.org.uk/almanac

NESTA & New Philanthropy Capital (April 2011) Understanding the Demand For and Supply of Social Finance

NESTA & Worthstone (June 2012) Financial Planners as Catalysts for Social Investment

NL Agency Ministry of Housing, Spatial Planning and the Environment (September 2010) The Green Funds Scheme: A success story in the making

Office for National Statistics (December 2012) Financial Wealth section of the Wealth and Assets Survey (WAS)


RBS SE100 Data Report 2012 (December 2012) Summary: Charting the growth and impact of the UK’s top social businesses,
http://se100.net/2012-results-and-analysis/


UnLtd Big Venture Challenge (November 2012) *Attracting Early Stage Social Investment*