



Investing in Social Enterprise: the role of tax incentives

By Vince Heaney

Additional research: Katie Hill

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Foreword

Through practical experiments and rigorous research NESTA is stimulating imaginative solutions to pressing social issues and shaping policy to help the UK meet its national innovation challenges.

Over the last decade, social enterprises have emerged as a powerful new form of business, providing both financial and social dividends in a cost effective way.

But whilst pressure on the public purse increases, NESTA is keen to find ways to support social enterprises so that the barriers to growth can be addressed in order to realise their full potential.

One of the barriers to scale is access to patient, equity-like finance and support that can sustain growth and support ambitious but realistic social entrepreneurs.

Although the sector is growing, the majority of social enterprises are currently illiquid with few external assessments of and platforms for tradable value. As the social enterprise sector emerges as a discernible asset class, riskier and more flexible social investment will be a crucial source of capital.

One way of increasing the amount of investment in social enterprises could be to use the tax framework to create incentives for investment.

We are therefore delighted to have supported this independent review of tax incentives for social investment in the UK. We will continue to help shape the debate and inform the development of the right fiscal conditions to allow social investment to flourish.

Jonathan Kestenbaum
Chief Executive - NESTA

Preface

The CSFI is delighted to be collaborating once more with the National Endowment for Science, Technology and the Arts. Its belief that innovation can solve some of the country's biggest social and economic challenges takes us back to our roots. Last year we published John Kay's radical report on Narrow Banking, which was sponsored by NESTA. This project, on incentives to invest in social enterprise, has drawn us into the realm of the "socially useful", which is also regarded as radical by some in financial services.

This report, by Vince Heaney a former colleague at the Financial Times, fulfils a number of roles. It guides the reader – and we hope some real social entrepreneurs – through the maze of schemes and legal definitions that beset the sector. To be fair, some complexity is inevitable in a range of activities running from charities with trading arms to businesses that deliver a benefit to the local community. And when it comes to tax relief, HMRC can be a bit pedantic about motivation. So, the provision of a manual for those seeking to attract investment on the best possible terms for both the enterprise and the backer is a very welcome service.

Alongside the description comes an incisive piece of analysis that judges the pros and cons of each scheme, exposes the gaps in the current investment regime and suggests the best way forward. The innovation lies in the new forms of fund-raising and the "hybrid" business/charity structures that are emerging to widen the access to capital.

Like any other business, social enterprises will feed the economy by generating revenue to employ people, pay rent and buy supplies. They will also benefit their communities by providing goods and services that are needed but which cannot be created on a fully commercial basis.

We hope that this report will help those involved in such worthwhile activity to find financial backers, and help the would-be investors to find the most effective way to contribute.

Jane Fuller
Co-director, CSFI

Contents

Introduction	4
Glossary	7
PART ONE:	
A survey of tax incentive schemes for investment and their applicability to social enterprise	8
Legal forms:	8
Company Limited by Shares	8
Company Limited by Guarantee.....	9
Limited Liability Partnership.....	10
Industrial and Provident Society.....	10
Community Interest Company.....	11
Charities/Charitable Incorporated Organisations	12
Tax incentive schemes:	14
Enterprise Investment Scheme.....	15
Venture Capital Trust Scheme	20
Corporate Venturing Scheme.....	25
Community Interest Tax Relief.....	27
Gift Aid/Charitable status	33
Other schemes	37
PART TWO:	
Recommendations for improving the flow of investment into social enterprises	42
Specific changes to existing schemes	42
Using the CIC structure to promote investment	44
The social enterprise ‘ecosystem’	46
Conclusion	52
Appendix:	
Table of social enterprise legal forms	53

Introduction

Social enterprise has developed from the need to correct market failures in the provision of socially important goods and services and from the awareness that social problems cannot be adequately solved by traditional not-for-profit and philanthropic approaches.

The UK social enterprise sector is growing. On some estimates there are 62,000 social enterprises, accounting for 5% of all businesses with employees and contributing £24bn per annum to the UK economy. In the post-credit-crisis environment the need for a properly funded social enterprise sector is greater than ever. Following the collapse of the banking system, a desire for a more socially useful pattern to investment is evident from public opinion. At the same time, the sector faces pressure on all its sources of capital: the more restricted availability of credit following the crisis means that competition for private capital is greater, constraints on the government's fiscal position may restrict public funding and the impact of tougher economic conditions on charitable giving could weigh on grant income.

The supply of social risk capital is vital

Social enterprise is not yet a discernible asset class that provides opportunities for liquid investment. The supply of social risk capital into the sector is, therefore, a vital component of continuing growth. The government provides risk capital in the form of loans, grants, quasi-equity and equity through programmes such as the Social Enterprise Investment Fund and the Futurebuilders Fund, while the proposed Social Investment Wholesale Bank would provide the sector with another potential source of capital. But the long-term sustainability of the sector will depend on engaging private sector capital, which is consistent with the objective of spreading the risk of supporting the sector's growth among all its potential beneficiaries.

The government already provides tax incentives for investment in enterprise. The purpose of this report, commissioned by the National Endowment for Science, Technology and the Arts (NESTA), is to examine the role of tax incentives in helping to promote investment in social enterprises. The first part of the report examines the existing incentive schemes, their use by and drawbacks for social enterprises, and proposes options for increasing their applicability. The specific legal form adopted by a social enterprise is crucial to its ability to benefit from different tax incentive schemes. The analysis of the available schemes is, therefore, preceded by a review of legal forms.

In a wider context, combating environmental issues – particularly the impact of climate change – and the need to develop sources of renewable energy are high on the government's agenda of desirable objectives. Enterprises operating in these sectors fulfill a social role in a wider sense (recognised by the “triple bottom line” concept – people, planet, profit) and in numerous instances have been successful in using tax incentive schemes. Their experience, where relevant, is included in the analysis.

A trade-off between tax advantages and access to capital

The picture that emerges is that most of the current tax schemes are designed to give incentives for short to medium-term equity investment, but many social enterprises are not able to issue shares because of their legal structure. Tax reliefs are available on equity investment and there are tax breaks on giving via Gift Aid, but the legal structure required to obtain the latter often prevents the former. This means that many social enterprises face a trade-off between obtaining tax advantages for normal operations and accessing growth capital.

The second part of the report builds on the recommendations made in part one and places the use of incentives in the wider context of the social enterprise sector's infrastructure. Ultimately, a thriving social enterprise sector will depend not only on investors being incentivised to allocate capital to it, but also on having the products, intermediaries and market infrastructure through which they can channel their investments. Through the development of new products and infrastructure, the potential investor base can be broadened to include more of the retail sector as well as institutional investors that do not specialise in social investment.

Definitional issues

Any discussion of social enterprise has to address problems of definition. The UK government defines social enterprises as “businesses with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners.” Under this definition a private limited company that distributes its profits, but has a social mission enshrined in its Memorandum of Association, gifts a proportion of its profits to a foundation and focuses its activities on areas of deprivation, would not be considered a social enterprise.

The conceptual debate will no doubt continue between those who consider “not for personal profit” businesses as the only form of social enterprise and those whose priority is to maximise social impact. The latter feel comfortable including “hybrid” private businesses with a social mission in the definition of social enterprises.

A flexible model is emerging

From a practical viewpoint, there is a wide spectrum of businesses pursuing social objectives. At one end are those focused solely on social returns on investment, while at the other end are private businesses with social missions, which pursue a blend of social and financial returns on investment. What is clear is that more hybrid structures are appearing and that specialist social investors are prepared to provide capital for such businesses. Rather than being hidebound by definitional problems, a flexible model of social enterprise is emerging in the market.

Some social enterprises have business models that will never be scalable or investable, for which a grant-funded charitable structure will remain entirely appropriate. But for many in the middle of the spectrum, which are pursuing blended

Need to become "investment ready"

financial and social returns, attracting investment is both desirable and necessary for growth. From the perspective of the social entrepreneurs running these businesses, there is a need to improve financial literacy and become "investment ready". This will often entail a greater willingness to consider both profit generation and the capability to issue equity.

If the social enterprise sector is to avoid becoming what one commentator calls a "high-octane voluntary and community sector rather than a business sector", policymakers must embrace the idea of delivering social returns within more commercial structures than is encompassed by the current government definition. The second part of this report proposes changes that the government could introduce to broaden the existing CIC legal structure and combine it with tax incentives to provide a powerful impetus to investment in social enterprise.

Glossary

CDFI Community Development Finance Institution

CIC Community Interest Company

CITR Community Interest Tax Relief

CLG Company Limited by Guarantee

CLS Company Limited by Shares

CVS Corporate Venturing Scheme

EFG Enterprise Finance Guarantee

EIS Enterprise Investment Scheme

EMI Enterprise Management Incentives

IPS Industrial and Provident Society

ISA Individual Savings Account

MRI Mission Related Investment

PRI Programme Related Investment

SIPP Self Invested Pension Plan

VC Venture Capital

VCT Venture Capital Trust

PART ONE: A survey of tax incentive schemes for investment and their applicability to social enterprise

Legal forms for Social Enterprises

Ability to attract investment under VC schemes

The structure adopted by a social enterprise plays a crucial role in determining how the enterprise attracts finance. A review of these structures and the issues arising from their use is, therefore, necessary to put the use of tax incentive schemes into context. The material is broadly arranged to run from commercial structures that can be used by businesses with a social mission – companies limited by shares, limited liability partnerships – and then on to structures more exclusively associated with social enterprises – Industrial and Provident Societies, Community Interest Companies and Charities.

Company Limited by Shares (CLS)

There are two types of CLS: private companies, which make up the great majority, and public limited companies (plcs), which are subject to more stringent accounting standards and can offer their shares to the public. Many (but not all) plcs are listed on the stock market. A business with a social mission can be a plc, examples include the Ethical Property Company, but they will rarely be listed.

A CLS issues shares to shareholders, who become the owners of the company with liability limited to the extent of the capital contributed. The ability of a CLS to raise capital by issuing new shares (equity) in the business means that this legal form can attract investment under all the venture capital tax incentive schemes – EIS, CVS, VCT – and can also use EMI schemes.

The other important feature of a CLS from the perspective of social enterprise is the requirement for a Memorandum and Articles of Association. The Memorandum of Association (MOA) contains the company’s “objects” – its aims or purposes – and powers. The Articles of Association set out the internal management structure and procedures. Enterprises with a social mission that have been incorporated as

Achievement of social impact targets

a CLS will define that mission in the MOA, which could also include a non-profit distribution clause or a requirement that on dissolution of the company any surplus be used for a social purpose.

A CLS with a social mission enshrined in its MOA may not fall under the government's definition of a social enterprise. Such enterprises, however, may satisfy the requirements of providers of capital for social investment. Call Britannia, for example, the UK's first call centre business to be based exclusively in deprived areas and to positively discriminate in favour of the unemployed, has attracted financing from the Bridges Social Entrepreneurs Fund and Big Issue Invest. The lenders have, in turn, further strengthened the focus on social purpose by linking the availability of the financing and management incentives to the achievement of social impact targets.

Most clauses contained in the MOA and all the Articles of Association can be changed by special resolution. This is a resolution passed by 75% of the shareholders present and voting at a meeting for which at least 21 clear days' notice has been given. A company can, however, protect its social mission by making additional provisions to prevent changes to the objects. A requirement that a higher proportion of shareholders vote for any changes could be used, or companies might issue a golden share: a nominal share that can outvote all others in certain specified circumstances.

There are not many examples of companies limited by shares that are also registered as a charity. Charity Bank is one, but it was required to be incorporated as a CLS because it was operating as a bank. The Charity Commission must approve any changes to the company's objects.

Company Limited by Guarantee (CLG)

The members become the owners

A CLG is a distinct legal entity, but unlike the CLS there are no shareholders. Instead, the members give a guarantee to cover a company's liability. However, the guarantee is nominal, often being limited to £1. The members of a CLG become its owners and have broadly the same powers as shareholders in a CLS.

The CLG is a commonly observed legal form adopted by charities, trade associations and not-for-profit companies. The company, if a charity, has to register with both Companies House and the Charity Commission. The members of the company may appoint directors, often called trustees, who are responsible for creating and implementing the policies of the company and who enjoy limited liability. A Memorandum and Articles of Association are required. Most CLG constitutions contain a non-profit distribution clause, so members do not have a right to a share in profits or any surplus on the winding up of a company. This is a required feature for all charitable companies.

CLGs can borrow funds, which may include raising finance under quasi-equity arrangements. The legal structure of such borrowings, however, must be carefully

considered since it may conflict with the non-profit distribution requirement adopted by most CLGs. The absence of share capital precludes CLGs from raising equity capital and so they cannot attract investment eligible for tax relief under the EIS, CVS and VCT schemes.

Limited Liability Partnership (LLP)

The LLP is a relatively new form of legal entity, introduced in the UK in 2001. It retains the organisational flexibility of a partnership and is taxed as a partnership, but has a separate legal identity in which members have the benefit of limited liability. Individuals or corporate bodies may be members of an LLP. Unlike a CLS, an LLP has no Memorandum of Association, but the organisation's social mission can be protected in the partnership agreement governing the LLP.

Advantages of an LLP structure for social enterprise:

- single tier structure – members are equivalent to directors of a company and vice versa; and
- tax transparency – members are taxed as individuals, rather than the entity being liable for tax.

**Profits can
be donated to
the charity**

The tax transparency of an LLP can be helpful when one partner is a charity. In the case of a wholly owned trading arm of a charity, the profits arising from the business can be donated back to the charity and are eligible for Gift Aid. When more than one entity owns the trading arm any profits would be treated as dividends and subject to tax. A tax-transparent LLP structure allows the charity's share of profits to be taxed as per the charity's tax status (probably tax free).

Industrial and Provident Society (IPS)

The Industrial and Provident Society is a form chosen by many social enterprises – a large number of CDFIs have adopted it and a number of projects in the alternative energy sector have been set up as IPSs. These are societies, not companies, and are regulated by the FSA. Currently an IPS with charitable objects is an exempt charity and does not have to register with the Charity Commission. This charitable status may change under new regulations currently being phased in (see section below on charities).

There are two types of IPS:

- Community Benefit Society, set up for the benefit of a community rather than the society's individual members. No distribution is permitted to members; and

One member one vote

- Bonafide Co-operative Society, which conducts business through member participation for mutual benefit.

IPS structure/conditions:

- they have share capital, but the value is normally retained at par;
- maximum individual shareholding is set at £20,000, although other IPSs may hold more (in the 2010 Budget the government said it would consider raising the limit to £35,000);
- voting rights are “one member one vote”, irrespective of shareholding;
- capital may be “withdrawable” share capital, which is treated as equity but may be withdrawn under specified conditions;
- subject to corporation tax on profits earned;
- unless the IPS has charity exempt status, no restriction on profit distribution, although IPS for community benefit may have non-distribution rules; and
- income received by members is treated as interest income.

The society’s rules are required to state whether it has the power to borrow or take money on deposit and, if so, on what conditions and up to what maximum level. With the ability to issue shares, an IPS can be eligible for equity-based tax reliefs such as EIS and CVS.

Community Interest Company (CIC)

Not all activities must meet strict charity criteria

Introduced in 2005, the CIC is a “wrapper” added to a limited liability company. It was developed to address the lack of a legal vehicle for non-charitable social enterprises. Charities were not suited to social entrepreneurs who wished both to control the organisation and to receive a salary from it, while existing CLS/CLG forms did not allow for a lock on assets.

A CIC can be either a CLS or a CLG, but cannot be a charity. By the third quarter of 2009 there were 3,316 CICs, of which 2,460 were limited by guarantee, according to data from the CIC regulator. Unlike a charity, a CIC is liable for corporation tax on its profits, with no relief for general non-trading expenditure including that on community purposes. CIC borrowing must be at normal commercial rates.

The test for CIC structure is less strict than for charitable status and the CIC form offers greater operational flexibility compared with a charity. For example, while the primary aim of the business is social, not all a CIC’s activities have to meet strict charitable benefit criteria.

Requirements for CIC status include:

- a CIC must pursue a community interest and file an annual report on how it does this to the CIC Regulator;
- an asset lock, which ensures that the assets are used for the benefit of the community and prevents profits being distributed to members or shareholders other than in certain circumstances (on wind-up the assets must be transferred to another asset-locked organisation);
- for shares issued on or after 6 April 2010, a share dividend cap of 20% of the paid-up value of a share;
- an aggregate cap on the amount of dividends that can be paid out in total, set at 35% of the CIC's distributable profits; and
- for agreements to pay performance-related interest made on or after 6 April 2010, the interest cap will be 10% of the average amount of a CIC's debt, or sum outstanding under a debenture issued by it.

Dividend and interest caps have been increased

Following a consultation process, in 2009 the share dividend and interest caps were increased. Previously the dividend cap was set at 5% over the Bank of England base rate and the performance-related interest cap was set at 4% over base rate. It was felt that the previous caps were too complex, that the maximum dividend rate per share was too low given the level of risk, and the 1 percentage point differential between the debt and equity caps did not give an adequate incentive to investors to make an equity investment. BoE base rate was also seen as less useful because it had become detached from the cost of borrowing in current market conditions, which might discourage social enterprises from using the CIC form.

These increases in allowable returns for debt and equity investors improve the potential attractions. Reaction from within the sector suggests that the dividend cap increase was much needed and that a figure of 20% is an appropriate level for high-risk illiquid investment. The majority of CICs, however, are CLGs with no share capital, while of those CICs incorporated as a CLS, only two have paid dividends in the last four years.

Greater potential exists with the higher interest cap, which would be applicable to quasi-equity revenue participation agreements. Some in the sector, however, argue that quasi-equity carries more than half the risk level of equity and the 10% return cap should be closer to the 20% dividend cap.

Charities/Charitable Incorporated Organisations (CIO)

In 2009 there were 160,515 charities registered in the UK, generating income of about £51bn per annum. Income generation is heavily skewed towards the small proportion

of large charities – 1,710 charities have an income of £5m or more, but they generate over two thirds of the charity sector’s income, while 45% of charities generate less than £10,000 pa. Many social enterprises are also charities, given the considerable tax reliefs on income generated.

Trading activities free of tax liability

Charities’ tax relief:

- charities can carry out trading activities directly related to their charitable aims and objectives free of tax liability;
- chargeable gains made by a charity, eg on disposal of a property, are tax free;
- greatly reduced or waived business rates;
- no tax on bank interest or rental income;
- relief from stamp duty on land when buying a property;
- relief from inheritance tax on legacies; and
- relief from VAT: different forms of charities' income are subject to different VAT considerations – some income is VAT exempt, some not.

Charities also benefit from being able to claim Gift Aid on donations, while donors (individual and corporate) also benefit from reliefs.

One possible disadvantage of the charitable legal form for social enterprises is that an entrepreneur/founder cannot usually be both a trustee and earn income from a charitable enterprise (there is now some scope for “appropriate” payment of trustees).

From two to one principal regulator

Forthcoming changes

Changes under way to the regulation of charities could have implications for the status of some social enterprises.

The Charities Act 2006 allows for a simplification of the charity company structure. Instead of having to deal with two bodies (Companies House, Charity Commission) for registration and reporting and filing of accounts, there will be just one under legislation due to come into force during 2010. Exempt charity is a status often given to IPSs. Currently, these organisations receive all the tax benefits and hold the status of a charity, even though they are not registered with the Charity Commission. Eventually all exempt charities will migrate to a principal regulator. Those not subject to any other principal regulator, with an annual income over £100,000, will

Emphasis on the mission

have to lose their charity exempt status and apply to the Charity Commission for full charitable registration. Charitable IPSs will be able to convert to a new legal form, the Charitable Incorporated Organisation.

The status of charity refers to its public benefit and is tightly defined under the new act. Under the more stringent test, IPSs will need to show a wider benefit beyond the community/members to be registered with the Charity Commission. Some of the structures currently used by IPSs may not be permissible under the new regulations. For example, there are outstanding issues regarding whether an IPS with equity capital paying dividends to its shareholders could be registered under the Charity Commission, effectively creating a distinction between those that are “paying” for costs of finance from their balance sheets (via equity dividends) rather than their P&L (through interest payments on debt).

Investment of charitable funds

Charitable status is also pertinent from the perspective of investment in social enterprises, given trustees’ obligations in investment of charitable funds. Trustees are relieved from personal liability for breach of trust or duty where they have acted honestly and reasonably and ought fairly to be excused. They should avoid “hazardous” or “speculative” investments. Those wishing to make investment decisions on moral grounds (this may include using positive or negative criteria, or a combination of both) must avoid placing the charity at risk of significant financial detriment. Trustees are unlikely to be criticised for adopting a particular policy if they have considered the correct issues, taken appropriate advice and reached a rational result. These considerations may affect a charity’s willingness or ability to engage in Mission Related Investment (MRI) or Programme Related Investment (PRI).

- MRI emphasises the importance of the mission when developing the investment strategy. It is similar to and uses the same approaches as Socially Responsible Investment, but encompasses both market-rate and below market-rate investments.
- PRI refers to investments made primarily to further the aims of the charity with a view to accomplishing one or more of the foundation's exempt purposes. A financial return is sought but this can be concessionary and is not the primary motivation.

Tax incentive schemes

The following sections analysing the individual incentives start with those schemes designed for mainstream enterprise (EIS, VCT and CVS), moving on to schemes aimed at social enterprises (CITR) and charities (Gift Aid). The analysis is completed with a review of other schemes with a possible application for social enterprise.

Enterprise Investment Scheme (EIS)

Qualifying investor	Individuals aged 18 or over and liable to UK income tax. Not connected with the company issuing the EIS shares
Legal form and accreditation of the investee	No specified legal form but, by business, it must be a non-financial trading company and approved under the EIS
Form of investment (equity, loans etc.)	Equity <ol style="list-style-type: none"> 1. Shares must be fully paid 2. Schemes with guarantees or exit arrangements will not attract tax relief 3. Not redeemable 4. No preferential rights on liquidation of the company
Form of further investment by the first recipient of the funds (the investee)	N/A Investee utilises the resources as required in the normal course of the business
Lock-in period on investments to obtain tax relief	3 years minimum holding period
Limit on investment for tax relief purposes	Minimum £500/ maximum £500,000 in a tax year
Other conditions of investment	<ol style="list-style-type: none"> 1. Restrictions on business activities carried out by the investee company, some excluded trades 2. Investor must have no significant controlling stake (<30%) in investee company 3. Unquoted companies, or with no arrangements to list on a recognised exchange at time of share issue, but AIM or PLUS listed companies qualify 4. Small company restriction. Maximum gross assets £7m (£8m after share issue) 5. Investee must not be controlled by another company (>50% stake)
Details of tax relief	Investor can set 20% of cost of shares against individual income tax liability. Capital Gains Tax exemption on disposal, capital gains tax deferral by reinvestment. Capital losses can be offset against income rather than capital gains.
Additional investor return (from the investment itself)	Possible. Varied. Taxable at normal income tax rate to the investor
Restrictions/conditions on deployment of funds	Funds must be invested in qualifying trade, or R&D in qualifying trade, within two years
Taxation of income of the recipient of funds (investee)	Taxed as per the status of the investee

Rules do not allow profits or assets to be distributed

1) Community benefit IPS: Torrs Hydro

Established in 2007, Torrs Hydro New Mills Limited is incorporated as an Industrial and Provident Society for the benefit of the community. Its specific purpose is ownership of the Torrs hydro-electric scheme in New Mills, Derbyshire, the UK's first community-owned hydropower scheme. The company's rules do not allow distribution of profits or assets to the members at any time.

Torrs Hydro has launched two share issues, which closed in January 2008 and March 2009 respectively, each with a minimum investment of £250. Torrs Hydro had already gained an advanced assurance of EIS suitability (prior to full approval) for its second issue when HMRC realised that the shares could be withdrawn at par after three years and, therefore, should not qualify for EIS. Having given the advanced assurance, HMRC allowed the shares to be issued, but subsequent share issues must remove this condition – which had a knock-on effect on the similar Settle Hydro scheme (see below).

Torrs Hydro raised £126,000 through its share issues and believes that EIS helped it raise this capital. However, of 230 members, about half made the minimum investment of £250, which is below the £500 threshold for EIS. Clearly tax benefits were not the primary motivation for many investors, consistent with the IPS's objective of "providing an opportunity for public-spirited people and organisations to contribute financially to the community, with the expectation of a social dividend, rather than personal financial reward." Torrs Hydro also attracted investment from companies, with corporate investment contributing £6,000 to the first share issue and £3,500 to the second. These corporate investors were able to benefit from the Corporate Venturing Scheme.

2) Community benefit IPS with two share classes: Settle Hydro

Half of investors below £500 threshold

A similar project to Torrs Hydro, Settle Hydro was established as an Industrial and Provident Society for the Benefit of the Community, which owns the Settle Weir hydro-electric scheme. Following the clarification by HMRC of the eligibility of the Torrs Hydro second share issue for EIS, the prospectus for Settle Hydro's March 2009 community share issue was rewritten to include two classes of shares: 1) Ordinary shares withdrawable after a three-year holding period and 2) Enterprise Investment Scheme shares, which are not withdrawable.

As with Torrs Hydro's share offer, the EIS tax incentive appealed to some potential investors. When the prospectus was issued EIS status had been applied for but had not been granted. The company reports that two larger investors would have invested sums considerably in excess of the minimum if EIS status had been fully approved at that time. Once again, however, out of 158 investors, 77 made an investment smaller than the £500 minimum threshold for EIS and only 35 subscribed to the EIS share class. Furthermore,

while the investment is in an equity instrument, the IPS for community benefit structure and the objectives of the company mean that investors cannot invest with any expectation that they will be able to exit at a profit. For Settle's EIS non-withdrawable share class, there is not even a mechanism for investors to recoup their capital.

A further issue is that, under current arrangements, IPS are at an advantage over Community Interest Companies (CICs) limited by shares, in that they are exempt from many of the FSA rules regarding share issuance. This is a considerable saving and allows them to raise share capital in a more cost-effective manner.

IPSs for community benefit can currently receive "charity exempt" status, which gives many of the tax advantages of charities with few of the reporting demands. CICs, while they do not have charity exempt status, have lighter regulations to abide by. Changes under the Charities Act 2006 now being enacted may, however, make it more difficult for IPSs to hold charitable status (see legal forms section).

3) Bonafide co-operative IPS: Westmill Wind Farm

**Share offer,
with EIS
relief, was
oversubscribed**

With a different legal structure – an Industrial and Provident Society, with a bonafide co-operative structure established for the mutual benefit of its members – it is possible to offer the prospect of greater financial returns to potential investors in a community project.

Westmill Co-op was established in 2004 to construct and operate a community-owned wind farm at Westmill Farm in Oxfordshire. Westmill's £3.75m share offer, which closed in 2006 and attracted EIS relief, was oversubscribed, eventually raising £4.4m. Variable annual interest is paid on members' shares from trading surpluses from the sale of electricity. When the share issue closed, returns were expected to be approximately 5% annually in the first five years rising to an average of 12% over the 25-year life of the project.

Investors do have an exit route. The original investment will be returned in full when the wind farm is decommissioned at the end of the 25-year duration of the scheme and cash reserves from trading surpluses will be accumulated in a depreciation fund to allow this repayment. Shares are only transferable for the first five years (although this would affect EIS relief, subject to the three-year minimum holding period), after which shares can be transferred, or withdrawn up to a maximum of 5% pa on a first-come, first-served basis at the discretion of the board.

Some aspects of the Westmill example would not be possible under the latest iteration of the EIS scheme. In July 2007 a £2m ceiling on how much can be invested in a single enterprise in any 12-month period under one, or all, of the EIS, CVS and VCT schemes was introduced, which is a significant setback for larger projects in the environmental energy sector.

Also, following clarification on the issue of withdrawable shares, it is unlikely that shares with a guaranteed exit at the end of the project financed by a depreciation fund would be eligible for EIS tax relief. The bonafide co-operative IPS structure permits a higher-yielding investment over the life of the project, which may prove attractive to some investors, but the EIS scheme is currently incompatible with a guaranteed exit route, which removes risk from the investment.

Higher-yielding investment over life of project

4) EIS fund: Triodos EIS Green fund

In addition to investing directly in companies, investors can also invest in an EIS fund. Such funds seek HMRC approval under EIS and invest in qualifying companies. For example, Triodos has a £1.5m Triodos EIS Green fund and is currently fundraising for the Triodos EIS Green fund 2, with a target of £5m. The minimum investment in the fund is £5,000 and the maximum £500,000. The Triodos EIS Green fund invests in a portfolio of high-growth-potential, sustainable UK companies in the following sectors: renewable energy generation and technology; energy efficiency; sustainable living; low carbon products and technology; waste recycling and reduction.

The focus on companies with high growth potential, with additional EIS tax benefits, appeals to financially motivated investors, who may be looking at alternative energy for financial plus environmental returns. While, in theory a similar fund structure could be used to target investments in social enterprises, there are fewer businesses that can issue equity in the sector and, given the focus on social impact, financial returns tend to be lower. It could prove difficult to deliver comparably attractive returns to investors. Triodos has discovered that, for its EIS product, investors tend to be more commercially minded than socially driven. Similarly, Investing for Good, a socially responsible investor, argues that the size of possible investments in social enterprises is often too low to attract commercially minded social investors.

5) CLS in environmental sectors

DIY Kyoto is a CLS established in 2006 with seed funding from NESTA. It has designed and markets two home energy monitoring products, Wattson and Holmes. The company has raised £750,000 in four separate share issues. Its investors are almost all high-net-worth individuals, whom DIY Kyoto has attracted without the help of brokers and without a public share offering, with the attendant costly process of complying with FSA regulations for share prospectuses. A disclaimer on any agreement made between investors and DIY Kyoto covers the potential risk issue. High-net-worth investors like the EIS arrangement and the incentive has helped the company's fundraising efforts considerably. The company did not find the pre-approval process overly burdensome. It might in future prove attractive for VCT funds targeting the alternative energy space.

£750,000 raised in four share issues

Summary and recommendations

- The potential universe of investable social enterprises for EIS investment is restricted, given that the majority have a legal structure that does not permit share issuance.
- Given the independence requirement of the investee company, the trading arms of charities might have problems raising capital under the above schemes unless the holding charity dilutes its control. Consideration would have to be given to ways of protecting the social mission of the trading arm.
- Since the relief was designed for mainstream businesses, EIS is best suited to those social enterprises that most closely resemble fully commercial enterprises – CLS structures either in environmental sectors or CLS with a social mission, where expected financial returns are attractive.
- Gaining EIS tax relief is not the biggest motivation for many social investors, but has contributed to attracting investment, particularly into community-owned environmental energy projects with an IPS structure.
- Because of the lack of a clear exit, the recent HMRC clarification that shares must be non-withdrawable to be eligible for EIS potentially reduces the attraction of IPS share offers for more fiscally motivated investors. This reduction may be greater for a community benefit IPS, which cannot offer high yields as an alternative to a defined exit.
- IPSs, particularly those for community benefit, are at a disadvantage relative to a private company in attracting patient equity capital. The usual incentive offered to compensate for the high risk taken by investors in an IPS is the eventual return of their capital through a withdrawable share, albeit without capital gain. Investors in mainstream private companies have no guaranteed par exit, but have the prospect of capital growth.
- Allowing a negotiated withdrawal of shares from an IPS, but without a guaranteed par value, would reintroduce the possibility of at least a partial return of capital for investors. Given that the investor is taking the risk on the capital's value, such an arrangement should be eligible under EIS.
- To further improve the applicability of EIS (and VCT) to social enterprises, certain excluded activities could be made eligible for the tax reliefs. Nursing and residential care homes would be an obvious example, while the restrictions on leasing or letting assets can also affect a number of social enterprises. The definitional problem of what constituted a social enterprise could be addressed by making such reliefs available for CICs limited by shares, given that they fall under the oversight of the CIC regulator.

HMRC clarification may reduce attraction

Venture Capital Trust Scheme (VCT)

Qualifying investor	Tax reliefs are only available to individuals aged 18 years or over and not to trustees, companies or others who invest in VCTs.
Legal form and accreditation of the investee	VCTs are a form of investment trust, listed on the London Stock Exchange. Must be pre-approved as VCT by HMRC
Form of investment	Ordinary shares
Form of further investment by the first recipient of the funds (the investee)	Equity, loans and securities in small companies not listed on a recognised stock exchange, but AIM or OFEX listed companies qualify
Lock-in period for tax relief	5 years minimum holding period
Limit on investment	£200,000 in a tax year
Details of tax relief	<ol style="list-style-type: none"> 1. For purchase of shares in an IPO: 30% of the subscribed amount deducted from tax payable for the year, or the tax payable, whichever is less 2. No capital tax gains on disposal of the shares 3. No income tax on dividend income received
Additional investor return (from the investment itself)	Possible. The VCT may distribute income in the form of dividends, on which investors are not liable for tax
Restrictions/conditions on deployment of funds	<ol style="list-style-type: none"> 1. Restrictions on business activities carried out by the investee company 2. At least 70% of the VCT investments must be in new 'qualifying investments' e.g. shares in private UK companies which carry on qualifying trades and this level must be reached within three years 3. Of this 70%, currently 30% must be in qualifying equities rather than loans * 4. Maximum size of company VCT can invest in is £7m gross assets, with <50 employees 5. Limit of £1m investment in one company in any tax year and the holding cannot be > 15% of total holdings at cost 6. VCTs cannot retain >15% of income derived from equities/securities 7. Minimum 10% equity component of each holding 8. Investee company cannot be controlled by another company
Taxation of income of the recipient of the funds (investee)	Exempt from corporation tax and capital gains tax

* The 2009 Pre-Budget Report proposed changing this requirement such that a VCT must hold 70% (of the overall 70%) in eligible shares, but there would also be a widening of the definition of eligible shares based on EU guidelines.

Since 2006, when the government cut income tax relief on VCT investments to 30% from 40%, investor interest in the VCT scheme has declined:

Funds raised by VCTs per tax year (source PricewaterhouseCoopers)	
2004-05	£505m
2005-06	£779m
2006-07	£267m
2007-08	£219m
2008-09	£152m

More recently, partly because of the reduction in pension tax relief for high earners introduced in the 2009 budget, investor interest in the VCT scheme has picked up again. For example, in February 2010 the *Financial Times* reported:

“Between now and the end of the tax year on April 5, total investment in VCTs in 2009/2010 is on course to reach £250m, according to Tax-Efficient Review – 70 per cent more than in the previous tax year. But VCT manager Downing calculates that £56m had already been committed by the end of January – suggesting an annual increase of 93 per cent.”

Ebbs and flows in appeal of VCT

These ebbs and flows in the appeal of VCT illustrate the sensitivity of investors focused on financial returns to changes in the tax reliefs available under different schemes, and so suggest potential for encouraging investment in a desired direction.

The VCT scheme, however, is not well suited to social enterprise and in the course of this research no VCTs specifically investing in social enterprise were identified. Venture Capital Trust provider Triple Point Investment, which is raising up to £50m for its TP10 VCT, lists social enterprise among its targeted sectors, alongside health, leisure, communication, environmental and technology. The leisure sector, however, accounts for over 50% of its pipeline of potential investments.

There are examples of VCTs with a remit to invest in the renewable energy sector. For example, Climate Change Capital’s Ventus Funds have raised more than £50m since their launch in 2005 and are specialist venture capital trusts making investments in the small to medium-sized UK onshore renewable energy sector.

Ethical AIM VCT

The VCT structure has been used in the past for ethical investment. For example, the Pennine Downing Ethical Venture Capital Trust, the UK’s first ethical VCT, was launched in 1999. Pennine Downing’s VCT, which later became the Ethical AIM VCT, sought to invest in “companies which make a positive contribution to society through the provision of useful products and services, the creation of jobs and

Divide between ethical investment and social enterprise

through good management, without compromising expected returns on investment”. In this case a negative screening process was applied to exclude sectors such as armaments, with investment directed towards socially and environmentally beneficial sectors such as renewable energy and healthcare. It should be noted that there can be a substantial difference between ethical investment, which merely screens negatively, and social enterprise, where the primary purpose of the business is to create a positive social impact.

Achieving sufficient fund scale to make the structure cost effective proved difficult: with a small fund the burden of administrative costs and a fund management fee is proportionally greater. On the investment side, meanwhile, the small universe of VCT suitable investable opportunities limited the scope for growth. After disappointing performance, in early 2008 the Ethical AIM VCT was merged into the Pennine Downing AIM VCT2 fund, which has no ethical investment remit. The reported reason for the merger was that the Ethical AIM VCT was of an “unfeasible” size.

Social Venture Capital funds

Social Venture Capital is an emerging part of the VC market with at least three new funds launching in the last 18 months – The Triodos Social Enterprise Fund, The Bridges Social Entrepreneurs Fund and Big Issue Invest – but none of these funds is structured as a VCT.

There are two main reasons given for not utilising the VCT structure. The Triodos Social Enterprise Fund, for example, which is structured as a “discretionary portfolio management agreement”, believes the restrictions of VCT (and EIS) on having to deploy the funds within a given timeframe and hold investments for a minimum period create too great a constraint. The Social Enterprise Fund is already targeting a defined sector and the additional restrictions of VCT might exclude suitable investment opportunities.

Main reasons for not utilising VCT structure

This reflects, once again, the recurring theme that finding “investment ready” social enterprises is one of the major constraints in this sector. Triodos closed its fund in summer 2008, raising £3.8m. Thus far the only investment, in May 2009, has been £320,000 in Charity Business, which provides back office services to charities to improve their efficiency and effectiveness.

Triodos’s website sets out the type of businesses it is seeking as follows:

Is the Triodos Social Enterprise Fund suitable for your social enterprise?

Possibly, if

- You have been trading for at least two or three years and have at least £400,000 of annual sales;
- You have a scalable business model and ambitious growth plans with regional or national reach;
- You have an outstanding and entrepreneurial management team; and/or
- You are willing to share ownership, governance and future profits with social investors.

Probably not if

- You are a start up social enterprise or have annual turnover of less than £400,000;
- Grants make up more than 25% of your turnover;
- You aren't looking to share ownership of the organisation and future profits with social investors;
- You would really rather get a grant; and/or
- There isn't a group of stakeholders that benefit from the existence of the organisation.

The challenge is to find scalable businesses

These criteria clearly illustrate one of the sector dilemmas. It is possible (albeit not easy in the current market environment) to raise capital for social investment. But equally challenging is finding or devising a market mechanism that seeks out sufficient scalable businesses, if they exist, where the company's structure, track record and/or the desires of its management do not preclude third parties sharing ownership, or where management is not entrenched in a "grant mentality".

The second reason for not choosing a VCT structure is that the investors being targeted to seed the fund may not be eligible for tax relief, or may prefer a different tax structure. VCT relief is aimed at retail investors, while the emerging social VC funds are often targeting institutional investors, foundations and charities. Investors in Big Issue Invest, which is structured as a Limited Partnership open to qualifying investors according to FSA definitions, include the Esmée Fairbairn Foundation and NESTA.

Bridges Social Entrepreneurs Fund, which is also a Limited Partnership, focuses on institutional investors and high-net-worth individuals. The Bridges Charitable Trust is among its investors. Bridges has chosen an LP structure because it is more tax transparent from the investor's perspective. Tax transparency allows the investors to be taxed as individuals, rather than taxing the structure itself, which would allow investors, if they were also charities, to benefit from their tax exemption on profits.

VC funds may also have a minimum investment beyond the reach of many individual investors. The minimum investment to become a Limited Partner in Big Issue Invest, for example, is £250,000. The fund is, however, in discussions with one wealth management adviser regarding the establishment of an investment club. This would pool smaller sums from a large number of investors to achieve the minimum

level required for limited partnership. At present, however, the necessary market infrastructure to find and channel such retail flows into social VC funds has not been developed.

Returns linked to growth in turnover

Flexible and innovative investment

Social VC funds have adopted investment criteria capable of including enterprises with a social mission where the distribution of profits may fall outside the current government definition of a social enterprise, as well as businesses that more closely fit that definition. For example, the two investments made to date from the Bridges Social Entrepreneurs Fund have been in Call Britannia and HCT Group (formerly Hackney Community Transport). Call Britannia, the call centre business based in deprived areas and discriminating in favour of the unemployed, is structured as a commercial CLS, but with a social mission enshrined in its articles of association. The holding company (“TopCo”) of HCT Group, by comparison, is a charity and is limited by guarantee.

New social VC funds are emerging as an important element in the social enterprise market, particularly through their use of quasi-equity products and financing linked to social impact performance. Investors in Call Britannia’s recent financing have the right to call in their loans if the business does not meet social impact targets. HCT Group in February 2010 announced it had raised £3m through a fixed rate loan and “social loan” financing package for which Bridges Social Entrepreneurs Fund is the lead investor. HCT Group believes this is the first use by a registered UK charity of a revenue participation agreement, quasi-equity product, which both links investors’ returns to growth in turnover and puts conditions on the financing based on social impact performance. (See HCT case study.)

Exclusion of activities restricts universe

Summary and recommendations

- Outside the renewable energy sector, the use of VCT for investment in social enterprise has been limited. The requirement for a minimum equity component in each VCT investment precludes social enterprises with a legal structure that does not permit share issuance. It also precludes those investors who provide loans and quasi-equity with no, or only a small proportion of, equity.
- The exclusion of a range of activities from “qualifying trades”, for example, nursing or residential care homes, restricts the universe of allowable investments in social enterprises.
- Given the independence requirement of the investee company, the trading arms of charities might have problems raising capital under the above schemes unless the holding charity dilutes its control. Consideration would have to be given to ways of protecting the social mission of the trading arm.

Social VC funds provide a new conduit

- Proposed changes to VCT rules outlined in the 2009 Pre-Budget Report might further restrict the scheme's applicability to social enterprises. The changes would require VCTs to invest a greater proportion of their capital as equity compared with loans. Even for social enterprises with a legal structure that permits equity issuance, potentially restricting the amount of investment they can receive in the form of loans or quasi-equity may be incompatible with their desired capital structure.
- The relatively high costs and fund management fees associated with a listed VCT structure mean that scale is necessary for a fund to be viable. Social enterprises may, therefore, be at a disadvantage under this scheme because of the sector's small investable universe. The lower financial return that some of these enterprises offer may mean that a portfolio of such investments may not generate an adequate fund return for investors net of costs and fees. The restrictions on deployment of capital under VCT may be a further hindrance to growing the fund to a viable size.
- Emerging Social Venture Capital funds provide a new conduit for institutional, foundation and charity, as well as individual, investment into social enterprise, with the fund managers' expertise helping promote flexible and innovative financing more closely tailored to a social enterprise's needs.
- One possibility for improving the applicability of VCT (and EIS) would be to consider allowing social enterprises in certain excluded activities to become eligible for the tax reliefs. Nursing and residential care homes would be an obvious example, while the restrictions on leasing or letting assets could be relaxed. The definitional problem of what constituted a social enterprise could be addressed by making such reliefs available to CICs limited by shares, given that they fall under the oversight of the CIC regulator.

Corporate Venturing Scheme

Qualifying investor	Companies
Legal form and accreditation of the investee	No specified legal form, but by business it must be a non-financial trading company approved under the CVS
Form of investment (equity, loans etc.)	Shares
Form of further investment by the first recipient of the funds (the investee)	N/A Investee utilises the resources in the normal course of its business
Lock-in period on investments to obtain tax relief	3 years minimum holding period

Limit on investment for tax relief purposes	No limit on the investment that can be made. Tax relief, however, is the lower of 20% of the qualifying investment or the actual tax liability for the year
Other conditions of investment	Investing company: <ol style="list-style-type: none"> 1. Trading group, not an investment group. No financial trades 2. Maximum shareholding 30% (non-controlling) 3. Cash investment in ordinary shares only.
	Investee company: <ol style="list-style-type: none"> 1. Trading, with some excluded trades 2. Maximum gross assets £7m (£8m after share issue) 3. Unquoted companies (but may be listed on AIM/OFEX) 4. 'Independent individuals' must own at least 20% of the issuing company's ordinary share capital 5. Must not be controlled by another company
Details of tax relief	<ol style="list-style-type: none"> 1. Corporation tax relief up to 20% of the investment made 2. No CGT exemption. Deferral of taxable gains arising out of (part) disposal of investment by reinvesting the gains 3. Offsetting capital losses on disposal of the asset allowed, net of tax relief obtained
Additional investor return (from the investment itself)	Possible. Varied. Taxed at normal rate to the investor
Restrictions/conditions on deployment of funds	Funds must be invested in qualifying trade, or R&D in qualifying trade, within two years (for shares issued after April 22 2009)
Taxation of income of the recipient of the funds (investee)	Taxed as per the status of the investee

Limited use by social enterprises

The corporate venturing scheme was due to expire at the end of March 2010. There were no provisions in the Pre-Budget Report to extend the scheme. Usage by social enterprises of this scheme appears to have been very limited. The only example discovered during the course of research for this report was the Torrs Hydro hydro-electric project. Torrs Hydro attracted investment from companies, with corporate investment contributing £6,000 to its first share issue and £3,500 to its second. These corporate investors were able to benefit from the Corporate Venturing Scheme. (See EIS section for Torrs Hydro case study.)

Community Investment Tax Relief (CITR)

Qualifying investor	Individuals and companies that invest in accredited intermediary organisations, called Community Development Finance Institutions (CDFIs), which in turn onward invest in enterprises that operate within or for disadvantaged communities
Legal form and accreditation of the investee	<ol style="list-style-type: none"> 1. No specified legal form 2. Investee must be an accredited CDFI under the CITR scheme 3. Either retail CDFIs, which finance enterprises directly, or wholesale CDFIs which invest in other accredited CDFIs
Form of investment (equity, loans etc.)	Loans, securities or shares; Deposits (for CDFIs that are banks)
Form of further investment by the first recipient of the funds (the investee)	Loans, securities and shares in 'qualifying enterprises' – broadly SMEs unable to obtain finance from mainstream lenders, based in or serving a geographic and/or thematic disadvantaged community
Lock-in period on investments to obtain tax relief	5-year minimum holding period to obtain maximum tax relief
Limit on investment for tax relief purposes	No limit for investors claiming relief, but limits on the amount of investment an individual CDFI can raise
Details of tax relief for original investors	Income tax or corporation tax relief equivalent to 5% of the amount invested per year, with a maximum relief of 25% over 5 years
Restrictions/conditions on deployment of funds	<ol style="list-style-type: none"> 1. A CDFI cannot raise more than £20m for a retail CDFI or £30m for a wholesale CDFI over a 3-year period 2. CDFI must onward invest at least 25%, 50% and 75% of funds by first, second and third years respectively after accreditation. After 3 years must onward invest an average of at least 75% of its fund. 3. With loan investments, no repayment allowed for first 2 years. For subsequent years these cannot exceed 25%, 50% and 75% respectively 4. Loans to profit-distributing enterprises must bear interest at or above 'market' rate ie the European Commission's Hurdle Rate 5. No interest rate requirement on lending to non-profit distributing enterprises 6. Provide finance for SMEs with <250 employees; <€50m annual turnover or <€43m balance sheet total; no more than 25% of capital or voting rights controlled by another organisation

	<p>7. SME should be located in specified geographic areas or areas meeting specified criteria reflecting deprivation</p> <p>8. Investments that do not qualify include: those protected by publicly funded guarantees, loans to profit-distributing enterprises exceeding £100,000; investments in non profit-distributing businesses exceeding £250,000, investments in residential property; investments that exceed 20% of the CDFI's funds</p>
Additional return (from the investment itself)	Possible. Varied. Taxable at normal income tax rate of the investor

Applications for loans doubled to £360m

CITR was created in 2002 to stimulate the flow of private finance into the UK's poorest communities, through accredited intermediary organisations called Community Development Finance Institutions. CDFIs lend to enterprises that traditional lenders may consider too costly to serve or too risky (reasons might include the absence of a track record or lack of security to offer to the lender). The businesses supported by CDFIs nevertheless have viable business plans and will also have a positive impact on the community in which they operate.

According to *Inside Out 2009*, an industry-wide survey conducted by the Community Development Finance Association (CDFA), the trade body for CDFIs:

- CDFIs lent a record £113m in 2009, up 50% from the previous year;
- the value of CDFI loan applications more than doubled to £360m in 2009; and
- the CDFI loan portfolio stands at £394m.

Funds raised through CITR channels, however, do not contribute the majority of CDFI financing. Only some £58m has been raised using CITR. The CDFI states that 27% of its members eligible to use CITR have been accredited and that 70% of those accredited – 20% of all eligible members – have raised funds using CITR. Furthermore, the top three users of CITR have raised roughly 80% of the total amount, notably 64% of the total by a CDFI that takes bank deposits.

1) Co-operative and Community Finance (previously Industrial Common Ownership Finance)

Co-operative and Community Finance is a CDFI structured as a private company limited by guarantee. Alongside – but independent of – the Co-operative and Community Finance holding company is ICOF Community Capital Ltd, an IPS that raises finance through withdrawable shares. The company extends loans of between

Share issues an important source of capital

£5,000 and £300,000 to co-operatives, employee-owned businesses and social enterprises. It often co-invests alongside other CDFIs (principally Triodos, Big Issue Invest and The Social Enterprise Loan Fund). The key sources of capital funding in recent years have been:

- Capital grants, including regional investment funds from East of England Development Agency and Avon and Bristol Co-operative Finance.
- Share issues have historically been an important source of capital income through ICOF Community Capital Ltd.
- Co-operative and Community Finance has been relatively successful in generating investment through the CITR scheme. It decided to obtain CITR resources from a single investor to avoid spending time generating small amounts from a large number of investors. A £1m loan was obtained from the Co-operative Bank in 2003, topped up in 2008 by an additional £600,000 from the same source. Representatives reported no difficulties in identifying eligible businesses for lending using CITR resources.

2) Aston Reinvestment Trust (ART)

ART is a Birmingham-based CDFI with an IPS structure. It fills a niche between bank lending, grant funding and charitable donations, with a remit to help create jobs for local people. ART lends between £10,000 and £50,000 to businesses and social enterprises in Birmingham and Solihull in a range of sectors.

Private individuals and companies can invest between £250 and £20,000 in ART and investments may qualify for CITR. ART also has a £1.7m line of credit with Unity Trust Bank: the agreement is written on a commercial basis, but if CITR is available Unity Trust pays a rebate to ART, passing on part of the tax benefit. This helps ART to lend at 12% over base rate, which is low for micro-finance lending. Higher rate taxpayers with a background in social investment have expressed an interest in investing in ART via CITR as the low level of prevailing market interest rates has made the relief more attractive. Indeed ART is more concerned about the challenge of deploying the £2m it has available to lend.

Reality of £58m far short of £1bn claims

Criticisms of CITR

The consensus view is that the uptake of the CITR scheme has been disappointing. Several of the CDFIs interviewed for this report compared the claims made when the CITR scheme was introduced – anecdotally that it could direct up to £1bn investment into deprived areas – with the reality that thus far £58m has been raised. Some felt that it would be difficult to argue the case for the scheme's continuation to European Union authorities, which must approve any extension when the current regime expires in 2012.

Attractiveness to investors

The value of the tax relief to investors depends partly on prevailing market interest rates. Some non-bank CDFIs argue that if the last two years of exceptionally low interest rates are excluded, experience suggests that CITR relief was insufficient to compensate for the risks of investment in CDFIs. They point to the recent regulatory changes that allow CICs to pay higher interest rates on loans and higher dividend rates as a recognition that risk capital requires higher levels of return than had been on offer in the social enterprise sector.

Larger CDFIs that are also banks have proved able to attract CITR deposits, even when interest rates have not been at exceptionally low levels. In part this is thanks to a deposit guarantee, which is permitted under CITR because it arises from the bank's normal commercial business. Charity Bank, for example, has £24m of CITR funds lent out, but has a waiting list of (predominantly private) investors wanting to deposit a further £10m. The constraint it faces is in the ability of the bank to invest the capital, given the restrictions on onward lending.

Calls for a loosening of 75% requirement

Onward lending restrictions

In submissions to the Treasury, the CDFA argues that the criteria for onward CITR investment by CDFIs are too restrictive, both in terms of the timescale in which the money must be lent and the narrowness of the qualifying enterprises definition. It is calling for a loosening of the 75% on-lending requirement, a widening of the categories of enterprise eligible for CDFI investment, a raising of the £250,000 lending cap and a broadening of the scheme's scope to include housing and personal lending. The Social Enterprise Coalition in its February 2010 manifesto calls for "strengthening, simplifying and extending Community Interest Tax Relief (CITR) to encourage longer-term investment in social enterprises and other businesses in deprived communities."

Enterprise Finance Guarantee Scheme (EFG)

In 2009, the UK government's Enterprise Finance Guarantee Scheme was extended (subject to certain conditions) to banks lending to CDFIs. To avoid a double tax subsidy, the CDFI is not entitled to then on-lend those funds and treat them as a relevant investment for CITR purposes. A CDFI can benefit from EFG on onward loans to businesses, but only where those loans are from sources of funding other than CITR (e.g. from that portion of the CDFI's capital provided by grant or other financing).

Support to convert overdraft into loan

Eligibility conditions for EFG:

- open to businesses with an annual turnover of up to £25m, seeking loans of £1,000 to £1 million, repayable over 3 months to 10 years. State aid rules restrict or exclude businesses in certain industries such as agriculture, coal and transport;
- open to viable businesses with no security or insufficient security;
- the guarantee is to support new or existing borrowing or to convert an overdraft into a loan. The lenders must make the decisions on loans, not the Department for Business, Innovation and Skills (BIS);
- the UK government, through BIS, will guarantee 75% of any loans made, with the bank covering the remaining 25%; and
- lenders participating in the scheme cannot claim back more than 13% of the total amount lent under EFG, so only 9.75% (three-quarters of that) of the total loan portfolio is recoverable.

In addition to its complexity, many CDFIs argue that EFG is not well suited to their risk profile. The guarantee's effective 9.75% limit at the portfolio level may be less than the actual rate of default experienced by lenders. The limit has been set to comply with European Commission regulations on the extent of state aid permissible before notification of the aid is required. The CDFA argues, however, that at current exchange rates, the £750,000 maximum guaranteed under EFG (75% of £1m) is well below the €1.5m limit for guarantees in the EU state aid regulation, provided the 'gross grant equivalent' of the guarantee remains under the regulation's €200,000 limit.

Lack of awareness

Introduction of fees based on success

In addition to the restrictions on onward lending, social enterprises are often unaware that they could be a suitable investment for a CDFI lender with CITR capital. Investees would be wise to establish which fiscal incentives their company could offer potential investors. This is part of a broader issue of awareness regarding eligibility for tax incentives, which could be addressed through initiatives such as the Social Enterprise Access to Investment programme being run by NESTA and jointly funded by the Office of the Third Sector. This programme has introduced the concept of success-based corporate finance fees to the social enterprise market. It gives financial incentives to Investment Readiness Providers (IRPs) of advice and brokerage services to help social enterprises improve their investment proposals.

Summary and recommendations

CITR suffers from aiming to replicate for social enterprise the incentives to invest found in other schemes, such as EIS and VCT, without making sufficient allowance for the realities of the sector. The risk of investing in a social enterprise may be as high, or higher than, in a mainstream company, but the financial returns may be limited or capped. The result is an overly complex incentive scheme, which has failed to attract the investment originally envisaged for it.

Desire to direct investment towards disadvantaged

- The existence of a bank deposit guarantee for bank CDFIs puts smaller non-bank CDFIs at a disadvantage.
- The scheme is so restrictive on onward lending that even those CDFIs that can attract CITR funds struggle to deploy the capital.
- The principle of investments subject to guarantees not being eligible for tax relief is incompatible with investors' perception of the risk of much CDFI lending.
- Such guarantees as are allowed are not well suited to CDFI risk profiles.
- The excluded sectors are ones in which social enterprises might be most needed in deprived communities, including personal lending and social housing.

The difficulty of reconciling guarantees on investment with giving relief for the risk taken by investors is a conceptual issue that runs through all the current enterprise schemes and can be summed up as “no risk=no relief”.

Scope to include personal lending

For its part, government clearly wants to direct investment towards disadvantaged areas and communities and has designed the CITR/CDFI model to target this objective. Recognition is needed, however, that the “no risk=no relief” concept may be inappropriate to achieve the goal of increasing investment in these areas. The extension of EFG to CDFI lending recognises that investors require greater certainty to compensate for the perceived higher financial risk. Having in effect agreed the principle that some form of guarantee is needed, the current system should be improved by increasing cover under EFG, as proposed by the CDFA, and making the presence of a guarantee a permanent feature of CDFI lending.

Regardless of the above, there is also a good case for reviewing the restrictions on onward lending. Extending the scope of CITR to include social residential housing and personal lending should be considered. Bringing personal lending within the scheme would potentially allow CDFIs aiming to counteract predatory lending to attract more capital. Careful consideration, however, would be needed to assess whether it would be better to address predatory lending through other means, such as the introduction of a UK Community Reinvestment Act.

It is important to ensure that any changes to the scheme reflect best sector practice, rather than individual CDFI experience. There is, for example, a tendency to equate high loan portfolio losses with the high-risk nature of the underlying loans, yet losses could also reflect the quality of CDFI lending decisions.

Gift Aid/Charitable Status

Qualifying investor	Individual taxpayers, sole traders, partnerships
Legal form and accreditation of the investee	No specified legal form, but has to be a registered charity
Form of investment (equity, loans etc.)	Donation
Form of further investment by the first recipient of the funds (the investee)	Grants/investments in charities, non-profits, social enterprises etc which meet charitable object criteria
Lock-in period on investments to obtain tax relief	None
Limit on investment for tax relief purposes	Gift Aid claimed by the charity cannot exceed the tax paid by the donor in the year
Other conditions of investment	Maximum donation benefit to donor cannot exceed £500 in a year
Details of tax relief	<ol style="list-style-type: none"> 1. Charity can reclaim the basic rate tax from HMRC on the 'gross' equivalent of a donation – the amount before basic rate tax was deducted 2. No investor relief to basic rate taxpayer 3. Higher rate taxpayers can claim relief on the difference between the higher rate of tax and the basic rate of tax on the total (gross) value of the donation
Additional investor return (from the investment itself)	None
Restrictions/conditions on deployment of funds	Can be specified by the investor
Taxation of income of the recipient of the funds (investee)	Charities are normally exempt from corporation tax, CGT, IHT, subject to certain conditions

The combination of the advantages of Gift Aid in augmenting income from donations with the numerous tax advantages on trading that charities enjoy (see legal forms section) makes charitable status an attractive option for many social enterprises.

Once formed as a charity, there is little incentive for an enterprise to change to a different status even as newer legal forms appear, such as CICs, which have a less onerous reporting regime but no tax benefits.

Trading arms of charities at an advantage

A common structure used by charities is to set up a subsidiary trading arm, either wholly or partly owned. In the case of partly owned subsidiaries the social mission of the trading arm can be protected either through the use of a golden share in a CLS structure or via an LLP partnership agreement. The profits from the trading arm's operation can then be donated back to the charity to benefit from Gift Aid.

It is worth noting that the trading arms of charities, rather than being disadvantaged compared with mainstream businesses, may be at an advantage in some respects. These include the reduction, or waiving, of business rates and the concessions/exemptions on VAT enjoyed by charities.

When considering charitable status, a social enterprise must weigh the tax reliefs that charities receive against the restrictions on raising investment that the non-equity based legal form entails. If a charity does not need to raise capital, for example because it has strong endowment backing, the financial benefits of charitable status on its revenue/income generation are considerable. If, however, a charity is likely to need to raise capital, then donations and grants and loans, while tax efficient, may not give the scale that could be achieved through equity financing. Almost half of charities generate less than £10,000 per annum.

The recent financing by HCT Group illustrates one possible route for charities to access growth capital while continuing to benefit from the tax advantages/Gift Aid that charitable status provides.

HCT Group (previously Hackney Community Transport)

Originally founded in 1982, HCT Group is an award winning and rapidly growing provider of public transport and related training services based at depots in London and Yorkshire. The company operates mainstream bus routes, education transport for children with disabilities, social services transport for older and disabled people, yellow school bus services and a wide range of community transport services.

Gift Aid structure for tax advantages

The holding company ("TopCo") structure of the group is a charity limited by guarantee, but within the group there are also two other charities, one IPS and two CICs. The group has a complex Gift Aid structure to benefit from the tax advantages offered by a charity TopCo.

HCT's turnover has grown by about 25% a year over the last eight years and was expected to exceed £20m in the year to 31 March 2010. In February 2010 HCT raised its targeted figure of £3m out of an eventual £5m fundraising, partly as a fixed-rate loan and partly as a "social loan". The total fundraising is expected to comprise £2m in social loan and £3m in a traditional fixed-rate loan. Bridges Social Entrepreneurs Fund was the lead investor in the fundraising, which also had support from the Futurebuilders Fund, which the Social Investment Business manages on behalf of the OTS.

Social loan overcomes disadvantage

The social loan is a quasi-equity product, which offers debt investors variable coupon payments linked to turnover. Bridges has invested £1m in the social loan and will receive 1% of any increase in turnover above an agreed base level of £24.4m, the turnover forecast for HCT's next financial year (if for example turnover reached £30m, Bridges would receive 1% of £5.6m). Investors putting in less than £1m would receive a lower percentage of the turnover increase on a pro rata basis. The maximum interest payment per year is capped at 20% of the loan amount. Importantly, investors also have certain protections over the social loan if HCT does not meet specified social impact targets. There is an increasing emphasis on social impact both in the supply of capital (attracting investment) and in demand for services (as contract tenderers need to provide social impact in the delivery of goods and services).

HCT's financing is an important market development, which also illustrates some of the drawbacks with alternative structures/schemes:

- HCT believes its social loan is the first quasi-equity revenue participation agreement product, with provisions for social impact performance, to be used by a registered UK charity.
- The social loan overcomes the disadvantage faced by a social enterprise, such as a charity, that cannot issue equity. Traditionally it has not been possible to offer potential investors the opportunity to share business risk and obtain potentially greater financial returns. Dai Powell, chief executive of HCT Group, says: "This gives 'proof of concept' that social enterprises can now compete on a more level playing field in the capital markets."
- The financing is the culmination of a two-year review of HCT's capitalisation, a drawn-out process that occupied 50% of the CEO's time in the second year.
- HCT considered raising quasi-equity finance under one of its CIC structures. The interest rate cap of 4% over base rate (before recent changes by the CIC regulator – see legal forms section) was, however, considered too low to be attractive to investors. Also the CIC structure does not share the same tax advantages as a charity, and distribution back-up to the charity TopCo from the CIC would have added complexity.
- An ethical share offer through the CIC structure was considered. (Such an issue might have been eligible for EIS relief.) The trustees, however, had concerns about directors' liabilities/responsibilities with regard to ordinary rather than "sophisticated" investors, as defined by the FSA. The social loan structure has been aimed only at sophisticated investors.
- A suitable VCT partner could not be found, given that typical VCTs require both high growth and an exit route. There are currently no social VCTs targeting both social and financial returns.
- CITR/CDFI was considered, but deemed inappropriate. Under this approach HCT would have borrowed the capital and routed it through a CDFI institution

to be reinvested in HCT's business. HCT considered that this structure could have been unethical (possible tax avoidance issue). Also borrowing back the money it had already raised at CDFI lending rates would have conferred no advantage on HCT. Equally, borrowing £5m directly from a CDFI would have had no particular advantages for HCT.

Summary and recommendations

Charity benefits while offering equity-style returns

- The positive lesson from HCT's experience is that it has been possible to find a legally permissible structure that allows a charity to continue to enjoy the tax benefits of charitable status, while offering investors equity-style returns on growth capital. Revenue participation agreements have been used before in social enterprise, but HCT believes this is the first use by a charity of quasi-equity with financing linked to social impact.
- The deal provides a template with applicability to other social enterprises that cannot issue equity. The lengthy gestation period required to finalise the deal reflects the fact that financing structures of this type are not yet widely used by social enterprises. It is important to ensure that other social enterprises are aware of the opportunity to use this sort of transaction. The Social Enterprise Access to Investment programme could facilitate this process.
- The negative lesson from HCT's review of its capital structure is that a well established, investment ready and scalable social enterprise, which has the ability to use a number of legal forms and whose management was prepared to consider all the available options, was unable to design a suitable financing package to take advantage of the current enterprise tax incentives available.
- The tax advantages offered by charitable status provide powerful incentives and there is scope to use similar reliefs to pursue wider social objectives in businesses that may not be charities. The Social Enterprise Coalition, for example, suggests extending VAT exemptions to businesses engaged in recycling activities: "Environmental sustainability requires making better use of all resources and yet there are currently limited financial incentives to promote the reuse, recycle and repair of goods and buildings. Introducing financial incentives for repair and re-use could encourage the growth of a sector where social enterprises are excelling. This should include removing VAT on the resale of reusable items; reducing VAT payable on building repair and maintenance; and introducing an enhanced company tax incentive for product donations." In the 2010 Budget the government said it would consider options for introducing the EU cost-sharing VAT exemption.

Reliefs to pursue wider objectives

Other Schemes

Individual Savings Accounts (ISAs)

Qualifying investors	Individuals
Legal form and accreditation of the investee	Authorised and approved by HMRC Cash ISA schemes are normally offered by banks and building societies. Share ISAs are normally offered as 'collective investments' through Unit Trusts, OEICs and investment trusts
Form of investment (equity, loans etc.)	Cash, stocks and listed shares
Form of further investment by the first recipient of the funds (the investee)	N/A May be varied if investment is in products offered by financial intermediaries
Lock-in period on investments to obtain tax relief	None specified
Limit on investment for tax relief purposes	£7,200 pa (£10,200 for individuals over 50. This higher limit to apply to all from 2010-11 tax year.) 50% can be held in cash, balance in stocks/shares
Other conditions of investment	ISA manager can invest the funds in: <ol style="list-style-type: none"> 1. Shares in listed companies on a recognised stock exchange or securities (loans, loan stocks, debentures, bonds) with minimum residual term of 5 years 2. Gilts 3. Authorised unit trusts, OEICS and investment trusts 4. Shares from SAYE schemes and share incentive plans 5. Cash ISAs with a deposit taker, building society or credit union 6. Premium bonds and similar securities 7. Specific life insurance policies
Details of tax relief	<ol style="list-style-type: none"> 1. No income tax on interest earned or dividends received, no CGT on ISA investments 2. Losses on ISAs cannot be offset to reduce CGT liability on non-ISA investments 3. No tax relief on entry
Additional investor return (from the investment itself)	Yes, varied. See above for tax relief
Restrictions/conditions on deployment of funds	N/A
Taxation of income of the recipient of the funds (investee)	Assets invested under the scheme are not subject to tax

Protected by deposit guarantee

ISAs are a tax-efficient wrapper for investment in cash, stocks and shares, which are well understood and utilised by the investing public. Ethical ISAs, which screen positively according to the fund manager’s priorities, already exist as do socially responsible ISAs, which screen negatively to exclude certain sectors such as arms and tobacco.

Social investment banks such as Triodos and Charity Bank offer cash ISAs, the proceeds of which are lent according to ethical/social criteria. Cash ISAs are protected by the bank deposit guarantee scheme. Also given that 50% of share ISAs can be held in cash deposits, there is theoretically a subcategory within share ISAs of un-invested cash, which potentially could be used for social investment.

ISAs have considerable potential for channelling retail investor flows into social enterprises – providing the necessary market infrastructure is developed. For example, if plans to launch a Social Stock Exchange come to fruition, investors could invest in listed social enterprises on that exchange. If a VCT based on investing in companies on that social stock exchange were created, ISA investors could invest in the VCT. In a similar fashion, as equity capacity increases in the social enterprise market, investing in social Self Invested Pension Plans (SIPPs) would become increasingly viable.

Self Invested Pension Plan (SIPP)

Qualifying investor	Individuals
Legal form and accreditation of the investee	<ol style="list-style-type: none"> 1. Scheme requires a scheme provider and an administrator. Under trust-based schemes, also a scheme trustee 2. Scheme provider must be an insurance company, bank, building society, unit trust, open-ended investment management company or friendly society 3. Authorised by the FSA
Form of investment (equity, loans etc.)	Stocks and shares, futures and options, unitised insurance funds, deposits and deposit interests, commercial property, derivatives, gold bullion and traded endowment policies
Form of further investment by the first recipient of the funds (the investee)	N/A May be varied if investment is in products offered by financial intermediaries
Lock-in period on investments to obtain tax relief	Benefit available on retirement (age 55 from 6 April 2010)
Limit on investment for tax relief purposes	<ol style="list-style-type: none"> 1. Up to 100% of earned income up to the annual allowance of £245,000 for the 2009-10 tax year 2. Standard lifetime allowance £1.75m in 2009-10
Other conditions of investment	<ol style="list-style-type: none"> 1. Contributor makes the investment decision 2. Stocks, shares, futures and options must be listed/traded on a recognised exchange 3. Unit Trusts, OEICs and other UCITS funds must be authorised

	<p>4. Investment trusts must be subject to FSA regulation</p> <p>5. Unitised insurance funds from EU insurers and IPAs</p> <p>Investments not permitted include: exotic assets such as wine, vintage cars, stamps and art; residential property; any tangible moveable property (with value >£6,000)</p>
Details of tax relief	<p>1. Individual contribution automatically receives basic rate tax relief</p> <p>2. Employer contributions allowable against corporation or income tax</p> <p>3. Income from assets within the scheme is untaxed</p> <p>4. Free from CGT</p> <p>5. Transfer to nominee free of IHT in case of death before funds drawn from the SIPP account</p>
Additional investor return (from the investment itself)	Yes, varied. Refer to above for tax relief
Taxation of income of the recipient of the funds (investee)	Assets invested under the scheme are not subject to taxes

VC Loss relief

In the case of a loss on an “arm’s length” sale of ordinary shares held by an individual in a “qualifying” unquoted company, those losses can be offset against income rather than capital gains.

Entrepreneur’s Relief

The director or employee of a company who held at least 5% of the ordinary share capital, carrying at least 5% voting rights, wanting to sell all of his/her shares or dispose of the business in whole or part, would pay capital gains tax on a reduced gain. In the 2010 Budget the Entrepreneur's Relief lifetime limit was doubled to £2m and the annual investment allowance was also doubled to £100,000.

Substantial Shareholder Exemption (SSE)

A trading company or member of a trading group selling shares (or interest in shares, or assets attached to those shares) in another trading company/group, holding company or subgroup will not be liable for a chargeable gain if:

- the shareholder has been in possession of those shares for at least 12 months of the last two years before disposal;

Schemes could apply to trading arm of charity

- the holding is considered substantial – the shares being disposed of must represent at least a 10% interest in the trading company.

Relevance to social enterprise

The three schemes detailed above are only relevant to those enterprises that offer equity investment. These schemes could apply to the trading arm of a registered charity, if that trading company structure is one that allows for equity holdings (eg Traidcraft, a subsidiary of the Traidcraft Foundation, which is a charity).

In practice, very few companies that have sold equity have realised a gain such that exemption would be beneficial. For example, Café Direct shares are currently valued at £1 per share, which may be lower than most purchase prices. There are very few, if any, trading groups holding shares in any other “social” trading group so SSE is not generally applicable. Ethical Property Company, Café Direct and Traidcraft are all public limited companies offering a matched trading (between buyers and sellers) market in shares, with almost all holdings in individual hands. VC Loss and Entrepreneur’s Relief could be relevant, although lack of liquidity in matched bargains reduces share turnover substantially.

No income tax or NI contributions due

When considering a broader definition of social enterprise to include environmental technology companies, there may be greater scope for investors to benefit from these reliefs, which could encourage investment.

Enterprise Management Incentives (EMI)

EMI is an employee stock option scheme, which encourages employee participation in small and medium-sized businesses with gross assets of less than £30m and fewer than 250 employees. Similar restrictions to other enterprise incentive schemes on qualifying trades and company independence apply.

There is no income tax or National Insurance contributions charged on the grant of a qualifying EMI option. If an EMI option is exercised within 10 years and there has been no disqualifying event, there will be no income tax or NI contributions due, provided that the employee buys the shares at a price at least equal to the market value they had on the day the option was granted. Any capital gains on exercise are liable to CGT.

Relevance to social enterprise

Once again, the relevance of the EMI scheme to social enterprises is restricted to those legal entities that can issue stock and stock options.

Losses can be set against other gains

While not an EMI scheme, the recent fund-raising by Call Britannia, the call centre business based in deprived areas and targeting the unemployed, links management's share in the equity of the business to the achievement of social impact targets. Call Britannia, a CLS with a social mission enshrined in its MoA, has raised £500,000 from Bridges Ventures, £350,000 from the Big Issue homeless charity, about £300,000 from the government and £150,000 from its management team. The external investors can call in their loans if managers fail to hit social return targets, but management will receive additional equity should they sell the business, providing they have exceeded those targets. This example illustrates that the concept of employee participation in a business through the granting of equity ownership can be adapted to fit the objectives of a social enterprise.

Sideways Loss Relief

This relief scheme allows trading losses arising to an individual to be set against other income and capital gains. These reliefs may be claimed by individuals who carry on a trade in partnership – generally referred to as “sideways loss reliefs”. To be eligible an individual must prove that he/she is active in the “side business”, putting in a minimum 10 hours per week in the initial six months.

These schemes have been used in the film industry, where investors join a partnership whose trade involves the production of films. The partnerships combine a real equity investment in the underlying film with potential tax relief, depending on the performance of the film.¹ The schemes have proved popular with those who face large tax bills and have some spare time, such as professional footballers. In October 2009, however, the government acted against what it described as “evidence of avoidance activity that relies on the creation of contrived losses for use as sideways loss relief”.

Relevance to Social Enterprise

Use for avoidance deters social investors

In theory, the ability of an investor who takes an active role in a business to obtain tax relief could be applicable to a social enterprise. In practice, however, the widespread use of sideways relief for tax avoidance is likely to deter many investors with a social rather than purely financial motivation. The use of such schemes illustrates the considerable tax expertise that is applied to adapting relief schemes for commercial projects. Tapping into this expertise, perhaps through pro bono arrangements, should form part of the process by which social enterprises seek to become “investment ready”.

1. “Daisy chaining” has also been used in the film industry – a practice in which several different EIS approved companies, each capped at £2m, contribute to the same film via a partnership or LLP. Changes to EIS, announced in the 2009 pre-budget report, mean that this practice is now forbidden.

PART TWO: Recommendations for improving the flow of investment into social enterprises

Introduction

Sensitivity to availability of incentive

The second part of this report builds on the findings of part one, starting with the specific changes to existing incentive schemes that could help improve their applicability to social enterprise. The report then recommends more far-reaching changes that could be made to exploit existing social enterprise legal forms, notably the Community Interest Company (CIC), to enhance the flow of investment. For the sector really to flourish, however, incentives must be seen as one element in a wider social enterprise “ecosystem”. The final part of this report, therefore, considers some of the potential new products and market infrastructure that, alongside incentives, could help promote investment in social enterprise.

Tax incentives clearly influence the flow of investment into mainstream businesses. The recent resurgence in interest in VCT following changes to pension tax relief and the HMRC crackdown on “sideways loss relief” illustrates the sensitivity of investment to the availability and magnitude of incentives. Experience from the social enterprise sector suggests that for social investors, tax incentives are not the main motivation, particularly when the investment is made with little or no expectation of future financial gain. However, just as “hybrid” commercial businesses with social missions are emerging, some investors wish to gain a financial return plus a social return. Tax incentives, therefore, have a role to play in attracting investors pursuing “blended” returns in the social enterprise sector.

Specific changes to existing schemes

This report’s review of existing tax incentive schemes revealed a number of shortcomings regarding their applicability to social enterprises:

- Most tax incentives are targeted at equity investment, but many social enterprises are unable to issue shares either because of their legal status or because the shares they do issue are not eligible (IPS withdrawable share issues). They may also be unwilling to raise equity because of a desire to retain control.

Inadequate protection against risk

- Many social enterprises opt for charitable status limited by guarantee, which confers considerable tax advantages, or CIC status limited by guarantee. But by being unable to issue equity, these forms limit access to growth capital. Once chosen, there is little incentive to create a different structure to attract growth capital, often restricting the enterprise to a grant or loan-financed route.
- The CITR incentive aimed specifically at community investment is complicated and heavily restricts onward investment by CDFIs. Furthermore, the perception is that the guarantees available for CDFI lending under the Enterprise Finance Guarantee scheme do not adequately protect investors against the risk of investment. The result has been very poor uptake, which calls into question the scheme's renewal in 2011, requiring EU approval.

These problems can be addressed in two ways – by changing the tax incentive schemes and/or by changing the legal structures. With respect to changing the incentives, the first part of this report identified specific alterations to some of the schemes that could improve their applicability to social enterprises:

- allowing withdrawable shares issued by an IPS to be eligible for EIS, providing there is no guarantee that those shares can be withdrawn at par value and that the minimum holding periods are observed before withdrawal;
- allowing some of the excluded businesses under EIS and VCT – such as nursing and residential care homes and potentially those with restrictions on leasing assets – to be eligible to offer tax relief to investors when the activities are carried out by a social enterprise as defined by the CIC regulator (CIC status);
- increasing EFG cover for CDFI loans to reflect higher rates of default up to the maximum limit permissible under EU state aid rules and making a guarantee a permanent feature of CDFI lending; and/or
- extending CITR relief for CDFI lending into the social housing and personal lending sectors.

Question over probability of renewal

Such changes, however, represent marginal alterations to schemes that are either ill-suited to social enterprise (EIS, VCT) or whose longer-term existence is in question (CITR). The risk is that considerable effort is expended for relatively little gain in terms of increased investment flows.

Before any overhaul of the CITR system it would be prudent, first, to establish whether the system is likely to gain EU approval for renewal in 2012. While it will probably not be possible to gain a definitive answer from the EU ahead of the current scheme's expiry, an assessment of the probability of renewal is needed.

For the remaining incentive schemes, a wider perspective is necessary. The goal is to promote investment into social enterprises and a specific legal form, the CIC, now exists for such businesses. At present, however, there is no specific link between CIC status and the encouragement of investment into such businesses through the use of the tax system.

Using the CIC structure to promote investment

To date CIC status has been under-utilised. The main advantage this status has provided has been as a branding exercise for non-charitable social enterprises. In addition, compared with a charity, the CIC structure has fewer restrictions on salary payments to those controlling the organisation and less onerous reporting requirements than those demanded by the Charity Commission.

High price for social enterprise label

As a means of promoting investment in social enterprise, however, the CIC offers no advantages and, indeed, is at a disadvantage to other legal forms. CICs do not enjoy the Gift Aid and other tax advantages of charities, nor the reduced obligations on share issues enjoyed by IPSs. Choosing to become a CIC can also hinder access to growth capital compared with a mainstream company, given the restrictions on the payment of interest and dividends (and in the CLG version by the ability to issue share capital at all). The upward revision of caps on dividend and interest payment rates may help to improve CICs' potential attractiveness to investors but, overall, these disadvantages appear a high price to pay for the social enterprise label.

CICs could, however, become the focus for promoting investment into social enterprises if the following changes were made:

- the introduction of tax relief on investments in CICs that meet specified social impact targets;² and
- widening the criteria for CIC status to include “hybrid” private companies without an asset lock, but which have a social mission enshrined in their Memorandum of Association.

These changes raise a number of issues that must be taken into consideration in implementation:

- The CIC's social mission should be protected with the requirement that it can only be changed with the agreement of the CIC regulator. Charity Bank, for example, is an exempt charity structured as a CLS with a social mission, which can only be altered with the agreement of the Charity Commission.
- Eligibility for tax relief should be subject to the achievement of social impact targets. Social VC funds have begun to link the availability and terms of the financing they extend to the achievement of social impact targets and this methodology should be extended to tax relief.
- Tax relief should apply not only to equity investments but also quasi-equity agreements, providing an incentive for investment in CIC CLG as well as CIC CLS entities. Tax relief would extend some of the benefits of charitable status to CICs and is analogous to Gift Aid, but with the focus on investment it would help social enterprises to think beyond a grant-only mentality.

2. Lawyers at Bates, Wells and Braithwaite, the law firm which helped set up the CIC structure in 2005, advocate tax relief for investment in CICs.

Help to think beyond grant-only mentality

Regulator's powers should be strengthened

- Existing enterprise tax incentives for equity investment, such as EIS and VCT, do not encounter problems with EU state aid, so an analogous scheme for social enterprises should also be permissible.
- Should state aid concerns be raised, many social enterprises would in practice benefit from either 1) *de minimis* exemption of €200,000 aid allowable per enterprise in any fiscal three-year period, or 2) SME exemptions up to various limits. These exemptions include, for example, aid for young innovative enterprises, for enterprises created by female entrepreneurs, for small enterprises set up in assisted regions and for risk capital subject to certain conditions. At a higher level, government should advance the argument that achieving social objectives warrants exemption.
- Incentives for social enterprise should offer a similar level of investor benefit as do mainstream reliefs such as EIS and VCT. But rather than trying to shoe-horn social enterprises into incentive schemes designed for mainstream businesses, a separate incentive would shift the focus of relief away from “no risk=no relief” towards “no social impact=no relief”.
- With a focus on the social objectives of the business, it would be easier to provide comfort to HMRC that widening reliefs to include sectors currently excluded from incentive schemes, such as nursing and residential care homes, would not promote abuse of the system (see specific scheme recommendations above). Health and social care service provision, for example, are areas in which CICs are particularly engaged. Exclusion of certain sectors may be the result of historical attempts by investors to enjoy tax advantages on safe asset-backed investments. Linking relief to achievement of social impact targets would help ensure the correct motivation.
- Given that the current light touch CIC regulatory regime does not envisage proactive supervision of CICs, the regulator’s powers would have to be strengthened.

One objective of these changes would be to achieve a simpler system. Many social enterprises are lacking in financial literacy and even if they become aware that they might benefit from a tax incentive, the question of which scheme might best suit the business must be addressed. Establishing “CIC relief”, subject to social impact performance, applicable to both forms of CIC and to equity and quasi-equity investments, would provide much needed clarity.

The investment opportunities provided in a broader-based social enterprise sector would be considerable, and the specific link between incentives and social impact should appeal to investors pursuing blended financial and social returns. The risks and challenges in introducing such changes, however, should not be underestimated. This report, for example, does not deliver a full technical exposition of the legal and tax ramifications of the proposals. As well as technical issues there are potential conceptual issues to address. Accepting a wider definition of what constitutes a social enterprise is necessary to encourage capital into the sector, but will require a considerable shift in mindset compared with the current government definition.

The issue of social impact measurement could also prove contentious. How broad would the concept be? Would it, for example, include environmental as well as social

Difficulty of measuring social impact

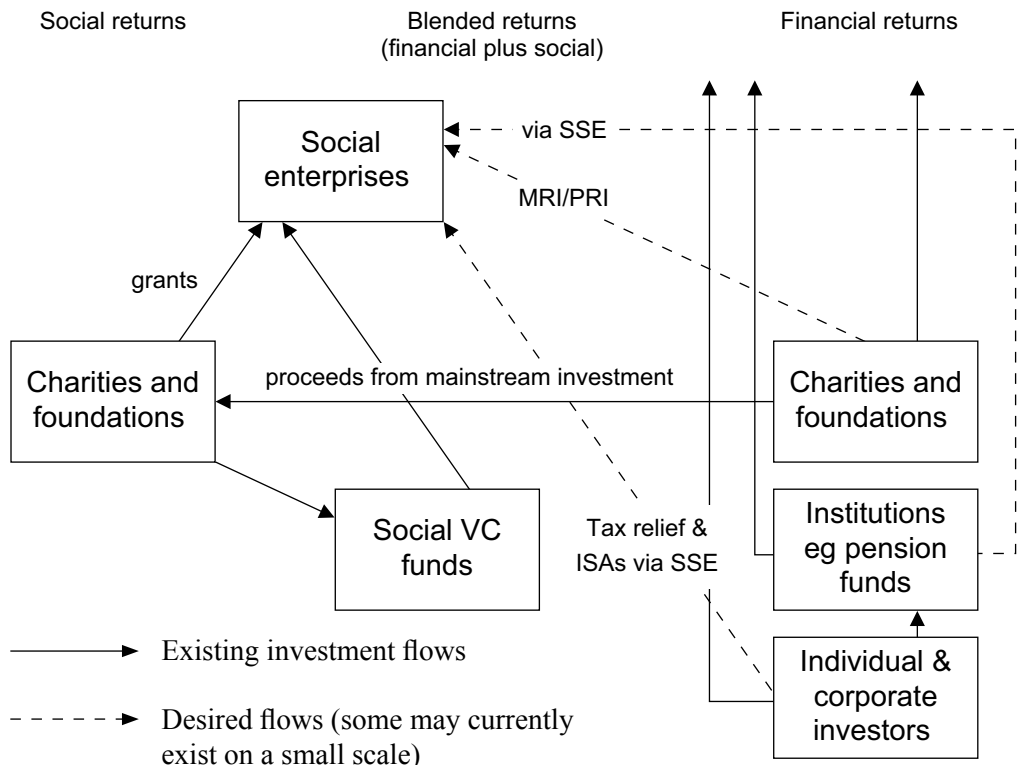
impact? How do you measure the sustainability and causality of the impact? Would it be desirable, or possible, to claw back tax reliefs for later under-performance against social impact targets?

One particular measurement issue is that the social impact created by some CICs may be in the form of public sector cost savings – money that the government would have had to spend in the absence of the social enterprise. Specific structures are being developed, known as “social impact bonds”, whose use could be adapted to address this issue. (A social impact bond is a financial vehicle that brings in non-government investment to pay for services, with the aim of delivering both social value and public sector cost savings. Investors receive a financial return from a proportion of the public sector cost savings delivered.)

The social enterprise ‘ecosystem’

The use of tax incentives to encourage the allocation of private venture capital to social enterprise is an important way to develop long-term sustainable finance for the sector. There are, however, additional pools of capital that could be directed into the sector, or routed in a different manner to provide more direct investment in social enterprise.

Stylised investment flows into the social enterprise sector



Charities appear in two positions to reflect their investment in mainstream markets, with the proceeds deployed for social returns.

As the flow chart shows, streams of capital are currently predominantly allocated to mainstream financial markets:

- Institutional flows: The United Nations encourages socially responsible investment by institutional investors such as pension funds. The problem for large institutional investors, however, is that the scale of investment opportunities available in the UK in listed businesses which meet the criteria for socially responsible investment (SRI) is too small for them to consider, given the size of the capital pools they need to allocate.
- Charity/foundation flows: The typical pattern for these flows is for capital to be invested in mainstream financial markets with the returns earned subsequently used to pursue the charity's objectives through grants and other onward investments. Mission-related investments, where capital is invested in businesses consistent with the charity's objectives, form a small minority of investment.
- Retail investor flows: The ISA system is well understood and utilised by individual investors for mainstream equity investing, but currently there is a lack of listed social enterprises in which to make equity investments.

SRI investment opportunities too small for institutions

Tapping into institutional flows could be achieved through a combination of tax incentives, new market infrastructure and new products based on that infrastructure.

The Dutch precedent

International comparisons offer some guidance on the potential use of tax incentives to direct investment into institutional funds targeting social and environmental objectives. Individuals in the Netherlands, for example, can offset up to €55,000 per year against their annual wealth tax liability for investment in specified funds including green business and social, cultural and seed capital funds. Given existing tax reliefs on UK pension fund investment, it may not be appropriate to offer additional incentives on these flows, but reliefs could be considered on non-pension investment products offered by other institutional investors such as banks and insurance companies.

Market infrastructure and new products

Even if investors can be incentivised to choose institutional funds with social objectives, the problem of deploying those funds remains. The development of a UK Social Stock Exchange (SSE) would be a step towards facilitating such investment.

Social Stock Exchange a step towards greater use of equity

The Rockefeller Foundation funded a two-year feasibility study into a UK SSE, which has now been completed and Social Stock Exchange Limited is currently fundraising to launch the project.

The idea of an SSE generates much criticism along various lines. Some consider it is too early in the development of the social enterprise sector for an SSE to be viable and that companies listing would be in a “wilderness” away from the usual sources of financing. Others are concerned that an SSE is a step towards a system based only on CLS structures, which ultimately would be indistinguishable from the mainstream market.

The premise of this report, however, is that commercial businesses with a social mission should be considered as social enterprises and that greater use of equity is needed for long-term sustainability. On that basis the idea of an SSE has merit.

If a broader definition of social enterprise is accepted, it would be possible initially to populate an SSE by switching across or dual-listing companies currently listed on other markets, including AIM, that satisfy the criteria for inclusion. The risk is that because the social enterprise sector is at an early stage of development, market liquidity would remain too low to provide a viable source of equity capital. The AIM market, however, started with a very small number of stocks and now has about 1,300 listed. Furthermore, index providers such as FTSE could create a social stock index once there were about 20 companies listed. Index tracker funds and Exchange Traded Funds (ETFs), derivatives that track the performance of stock indices, could then also be developed.

For many in the social enterprise sector, particularly following the credit crunch, the idea of derivatives based on listed social enterprises will be anathema. But bundling together a number of social enterprises into an index and allowing economic exposure to the market through ETFs could bring the scale of investment up to a level that would start to attract institutional flows. It would also provide a conduit for wider retail investor involvement through the development of social ISAs and the inclusion of listed social enterprises and index products in social SIPPs.

Index products would widen conduit for investors

Given the potential for an SSE eventually to draw both retail and institutional investment into the social enterprise sector, it is an important piece of market infrastructure that is currently missing.

Borrowing further from the mainstream

The concept of adapting product structures used in mainstream financial markets for use in the social enterprise sector need not be limited to equity instruments. Securitisation is a much-maligned word in the wake of the credit crisis but the basic concept remains valid: pooling securities together to create an investable product

with a lower risk profile than any one of the individual constituents. For example, by packaging together individual CDFI loans, securities could be created for onward sale to institutional investors, fulfilling the twin goals of attracting new investors to the sector and helping CDFIs mitigate the risks of their lending by shifting some of the exposure off their own balance sheets. Indeed, in the government's consultation on the establishment of a Social Investment Wholesale Bank (SIWB), respondents to the survey "highlighted that the SIWB could aggregate fragmented pools of capital into something investable by larger, more commercially-oriented investors". (See below under the development of intermediaries.)

For many businesses the value of property they own represents a source of locked-in capital. Sale and leaseback arrangements are often used in mainstream businesses to realise the value of a company's real estate by splitting the business into an operating company and a property company (opco-propco split). If social investment real estate funds were developed, growth capital could be released from within social enterprise by similarly splitting the business into two parts.

Property a source of locked-in capital

Mission and programme-related investment

Alongside encouraging direct venture capital investment into social enterprise through tax incentives and stimulating institutional and retail flows through a Social Stock Exchange, the third element in the 'ecosystem' is to encourage more mission related and programme related investment by charities and foundations.

Charitable trusts in the UK currently hold investment portfolios valued at about £77bn. There is scope within the Charities Act (2006) to allow trustees to consider prudent investment in both mission and programme investment opportunities. The concept is achieving growing recognition in the UK, particularly among larger charitable trusts. Esmée Fairbairn, for example, which has available funds of about £800m, has put £20m into The Finance Fund, which invests on MRI/PRI principles without explicitly using those labels. (See Gift Aid section for further detail on tax advantages applicable to charities.)

Trustees of UK charities must ensure that their decisions will not place the charity at risk of significant financial detriment, which can deter investment in PRI with lower financial returns. It is often easier for charities to invest in the conventional financial markets and distribute the returns through grants rather than make PRI investments. As ways to measure social impact develop, the responsibilities of trustees should be redrawn to include an assessment of both the social and financial impact of their investments. This should acknowledge the fact that grants are, in effect, the highest risk category of venture capital given that they carry a guaranteed zero return.

Efforts to push charitable foundations towards MRI and PRI are more developed in the US. The campaigning organisation, More for Mission, encourages foundations

US foundations encouraged to invest portion of endowments

to invest a percentage of their endowments in MRI and PRI. Social Venture Capital Trusts (often backed by venture philanthropy) include Acumen Fund, Good Capital Fund and F B Heron. The US is also considering the adoption of an organisational status called L3C, a low-profit limited liability company piloted in Vermont. As a mechanism for offering PRI investment, the L3C helps to identify purpose and social mission for Internal Revenue Service approval and would complement Corporation B status (a for-profit corporation that also has a social mission). The recent emergence of social VC funds in the UK, which count charitable foundations among their investors, is therefore an important step forward.

The proposals for CIC-relief outlined above should also be designed to allow tax relief to apply to social VC fund investment in CICs. This would encourage the growth of a social VC model with a mix of charitable and non-charitable investors. Through the use of tax transparent structures, such as LLPs, non-charitable investors could receive CIC-related tax relief, while charities receive their share of investment returns in accordance with their tax status.

The development of intermediaries

Alongside identification of the capital flows, market infrastructure and new products necessary to promote investment in social enterprise, financial intermediaries also have a part to play. They could develop products and educate investors and investees regarding the availability and possible applications of different sources of capital.

The availability of corporate finance and individual investment advice for social enterprises is limited. While there are consultants with deep sector knowledge and some institutions have offered limited “Investment Readiness Programmes”, the amount of available advice falls well below the necessary minimum to support a range of products and infrastructure.

Available advice falls well below necessary minimum

Recent initiatives to address this include the Social Enterprise Access to Investment programme, run by NESTA and jointly funded by the Office of the Third Sector. This is introducing the concept of success-based corporate finance fees to the social enterprise market. By offering financial incentives to Investment Readiness Providers of advice and brokerage services, the aim is to improve the quality of investment proposals put forward by social enterprises to increase their chances of success. Payable on equity and quasi-equity investments, fees have been set at 3%-5% of deal value, comparable to the levels for mainstream corporate finance advice.

The need for advisory services was one of the many issues addressed in the government’s consultation on the establishment of the SIWB. While many respondents acknowledged the need for more advisory services for third sector organisations, many were concerned about the conflicts of interest raised if the SIWB were a provider of both capital and advisory services. Respondents suggested that

it might be more appropriate for the SIWB to support and fund the development of advisory services through existing and new retail intermediaries, rather than directly provide advice.

If the SIWB, however, maintains a mandate as a strictly wholesale provider of capital, which is necessary to avoid the potential for crowding out other providers, then extending corporate advisory services to retail social enterprises should not present unmanageable conflicts. Given the importance of legal structure in determining the ability of a social enterprise to access growth capital, an early-stage corporate advisory service is crucial to raise social entrepreneurs' awareness of the implications of their choice of legal form, notably for growth potential.

Conclusion

Current incentives ill-suited to social enterprises

Tax incentives have a role to play in the promotion of investment flows, but the current range of UK enterprise incentive schemes is ill-suited to the legal forms most commonly adopted by social enterprises. In short, tax reliefs are available for equity investment, but the tax advantages of charitable status and the not-for-profit motivation of many social entrepreneurs lead them to choose legal forms limited by guarantee, which do not allow equity issuance. The end result is that many social enterprises are shut off from potential sources of growth capital and are restricted to a grant-dependent/loan financing mentality. Meanwhile, the CITR incentive scheme specifically aimed at social investment is complex and overly restrictive and, judging by its poor uptake, has been a failure.

Certain specific changes to existing schemes could improve their applicability, but the essential problem would remain of trying to shoe-horn social enterprises into schemes designed for purely commercial businesses. Instead, a fresh approach should be taken, bringing the under-utilised CIC legal form to the forefront of efforts to promote investment in social enterprise.

A new tax incentive scheme should be introduced offering relief for investment in CICs, with eligibility subject to the achievement of social impact targets. At the same time the criteria for CIC status should be widened to include hybrid commercial businesses, which have an embedded, protected social mission. This CIC relief would apply both to equity and quasi-equity investments, thereby allowing social enterprises with CLG status to offer equity-style returns to potential investors.

Widening CIC status would require a considerable shift in mindset away from the current UK government definition of what constitutes social enterprise. But if the social enterprise sector is to attract private capital and achieve long-term sustainability, wider acceptance is required of the need for income generation and the ability to offer equity ownership to investors. A change of mindset is also essential among social entrepreneurs, as well as policymakers, as part of an obvious need for greater financial literacy in the sector. This is essential to achieve investment readiness.

Shifts in capital flows will start to happen

Tax incentives for venture capital investment in social enterprise must, however, be placed in the context of a sector at an early stage of development. By developing new market infrastructure, such as a Social Stock Exchange, and new financial products that borrow from mainstream investment markets, the social enterprise sector can begin to attract institutional and retail investment flows. Coupled with greater efforts to direct charitable funds into programme related investment, the supply of private capital into the sector could be transformed.

Broad shifts in capital flows take time to develop, but with the necessary tax incentives, products and infrastructure in place they will start to happen. In the last year, new social VC funds have emerged, innovative new product structures have been launched and the building of new infrastructure is under way. Government must ensure that it keeps pace with these trends. It should balance social investment funding with appropriate fiscal incentives, which engage other investors in helping to underpin the emerging social enterprise sector.

Appendix

Comparison of social enterprise legal forms, access to growth capital and eligibility for incentive schemes

Legal form and status (all incorporated)	Types of investments available	Relevant fiscal schemes for investor / investee	Capacity for growth capital	Examples
CLG No charitable status	Grants (limited without charitable status), loans, bond issues, quasi-equity	CITR in certain areas and sectors	Limited to bank loans, quasi-equity; could issue social bonds (fixed rate or variable)	Hub world ltd
CLG with charitable status	As above with more access to charitable foundation grants/venture philanthropy, soft loans	CITR for investors; Gift Aid for investee; exempt from corporation tax on profits	Limited to bank loans, and quasi-equity; unless establish trading arm/joint venture with equity capacity; golden share held by charity can protect the trading arm's social mission ¹	Oxfam; Save the Children; Golden Lane Housing with trading arm gift aiding its proceeds to the Unltd charitable foundation
CLS without charitable status	Grants (limited) without charitable status), loans, quasi-equity and equity	Potentially investors can benefit from any/all of the following: EIS, VCT, CITR, SSE and could be included in SIPPS and social ISAs if listed; Not Gift Aid	Plentiful options: all of above as per CLG plus equity; but may find themselves less attractive to social investors without any charitable or SE 'badge' – potential to overcome this by social impact reporting	Ethical Property Company; Café Direct; Divine Chocolate; Green Stationery Company
CIC CLS	Equity, loans or quasi-equity	Investors in CICs with CLS could receive EIS, VCT relief	Considerable –tracks its social impact and can raise equity, bond or loan finance for growth; caps on dividend/loan repayments;	HCT has one and donates its income to HCT charitable foundation
CIC CLG	As other CLGs with no charitable status above	As other CLGs without charitable status above	Subject to corporation tax, unlike CLG with charitable status; could gift aid its profits to charity if in joint venture, but then limited capacity for growth (capital stripped out each year)	Bikeworks Women Like Us

Legal form and status (all incorporated)	Types of investments available	Relevant fiscal schemes for investor / investee	Capacity for growth capital	Examples
<p>IPS-two types: Co-operatives and Community Benefit societies. Can receive charity exempt status; co-ops more focused on members' interests rather than community interests; both types can issue shares</p>	<p>Can raise equity capital through community share issues; limit of £20,000 per person on one-member-one-vote basis; can offer withdrawable or transferable share capital; BenCom IPS may have rules prohibiting profit distribution</p>	<p>Individuals holding minimum of £500 of non-withdrawable EIS eligible shares can obtain EIS tax relief. Advantage over CICs as IPSs are exempt from some FSA share raising obligations; IPSs, which are CDFIs can use CITR for community investment</p>	<p>Equity raising capacity limited by community investor appetite. Co-operative structures offering profit distribution to members have raised several million</p>	<p>The Phone Co-op Co-op Bank Citylife IPS (BenCom) Aston Reinvestment Trust Westmill Hill Farm – wind power co-op Torrs Hydro IPS (BenCom)</p>

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Katie Hill has recently returned to the UK after spending a decade on the Continent. Having worked in Brussels, she then assisted the governments of Lithuania and Poland on EU pre-accession issues around employment. Moving to Bulgaria, she spent four years as executive chair of one of the first social enterprises in the country. She became convinced that this business model had “legs”. She has just completed an MBA at Oxford University, focusing on social enterprise. She is currently undertaking various contract work, including at Oxfam HQ.

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