Response to HM Treasury and Department for Business, Innovation & Skills Consultation on social investment tax relief

Charities Aid Foundation
September 2013

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Introduction

0.1.1 The Charities Aid Foundation (CAF) is a registered charity that promotes charitable giving and provides financial services and social finance to not-for-profit organisations. We help donors – including individuals, major donors and companies – to give more effectively whilst providing financial and fundraising solutions for charities in the UK and internationally, helping good causes to manage their resources more effectively.

0.1.2 Our pioneering social investment arm, CAF Venturesome has an 11 year track record of providing capital (debt and equity) to charities, social enterprises and community groups. Since 2002, CAF Venturesome has provided over £31m of capital to 390 organisations. CAF Venturesome manages several funds, including a thematic fund which supports the development of Community Land Trusts.

0.1.3 CAF has a strong history of campaigning for changes in policy and legislation in order to improve the giving environment and to secure supportive legal, fiscal and regulatory conditions for donors, charities and social enterprises. Our knowledge and understanding – gained through direct experience and research – makes us a trusted voice on giving and the effective use of charitable funds.

0.1.4 CAF is a member of the Social Investment Forum convened by Social Enterprise UK, and we have separately put our name to a joint submission to this consultation through that group. Our own submission focuses on a number of specific areas in the consultation that are of particular relevance to CAF’s work and where we have distinct views based on our experience.
Charities Aid Foundation response to HM Treasury and Department for Business, Innovation & Skills consultation on social investment tax relief

Responses to Consultation Questions

1) Charities and the new social investment tax relief

Relevant consultation questions:

**Question 4:** Are there any particular advantages or disadvantages to making charities eligible for the relief? In particular, is there a risk that donations to charities will be displaced into investments and what would be the consequences of this?

**Question 5:** If charities are eligible for the relief, it will be necessary for specific anti-avoidance rules to ensure investments do not receive relief as both investments and donations, including the need to account for donations and investments separately. Do you foresee any practical problems with this? Are there any other specific avoidance risks that would arise from allowing charities to be investee organisations?

1.1 It is important that charities are eligible for any new social investment tax relief.

1.1.1 Registered charity status is one of the key legal forms currently available for organisations with a social purpose. Furthermore, an increasing number of charities are undertaking revenue generating activities which could be accurately described as “social enterprise”. Therefore excluding registered charities from a new tax incentive designed to “encourage individual investment in social enterprises” would be misguided. It would also be likely to have a significant negative impact on the take-up of the relief.

1.1.2 Some charities have capital requirements that would be most appropriately addressed by repayable, socially-motivated finance rather than by using grant funding or money from voluntary donations. CAF’s experience of making social investments through our social investment arm, CAF Venturesome, has shown us that there is significant demand from charities for repayable social finance, so they are a vital part of the demand side of the social investment market.

1.1.3 It is important to note, as highlighted in the consultation document, that charities have existing tax benefits not available to social purpose organisations with other legal forms. In particular, individuals are able to get various forms of tax relief on donations to charities (through Gift Aid, Payroll Giving or Share Giving). It is therefore right to consider them as a special case when assessing the introduction of the proposed new social investment tax relief.

1.1.4 There are two key questions to address, one theoretical and one more practical. The first is whether the introduction of a new incentive to make social investments will have an impact on the propensity of individuals to make traditional philanthropic gifts. The second is whether there is a risk that individuals might, accidentally or deliberately, attempt to claim both charitable and social investment tax relief on one and the same transfer of money to a charity.
1.2 The impact of a new SI incentive on philanthropic giving

1.2.1 A number of people have posed the question of whether the availability of social investments will have a negative impact on levels of philanthropic giving. The concern is that in offering people a new way to use their money to achieve social good, we do not encourage more people to get involved or encourage those already involved to do more, but rather simply shift the profile of how they use their money from traditional gifts towards social investments so we end up “cannibalising” existing sources of funding.

1.2.2 There is little solid evidence to suggest what impact social investment will have on philanthropic giving. This is largely because the concept is still relatively new, so there is not sufficient evidence of actual behavioural change. Social investment is also not even understood by many donors, so it is difficult to test their attitudes towards it. A 2011 report looking at the attitudes of wealthy individuals towards various options for social investing suggested that they saw any money they would invest in these options as coming from a “separate pot” to their philanthropic giving or commercial investments. However, this was based on a small sample size so it cannot be used to draw any firm conclusions. It also does not really answer the question we are interested in: someone might view social investment as coming from a “different pot” to charitable donations but still adjust the relative sizes of their various pots so that their amount of philanthropic giving goes down.

1.2.3 There is some evidence that might be indirectly relevant, showing that other new method of using money to achieve social good (in particular cause related marketing) can have a negative effect on levels of charitable giving. This highlights the fact that the impact of offering a new incentive for social investment on traditional philanthropy is a valid concern. The aim of any such new incentive should be to bring in finance for not-for-profits that is truly new, rather than cannibalising existing sources of funding. It also highlights the need for far more robust evidence on the relationship between social investment and philanthropic giving to ensure that in our efforts to developing the one we are not inadvertently harming the other.

1.2.4 If there is an incentive for donors to look for social investment opportunities rather than making donations, charities could suffer. Charities may find themselves pressured into trying to structure investment opportunities in order to meet the needs of donors who want to use the social investment incentive, when their own interests would be in fact be better served by a straightforward voluntary donation or grant. This could lead to problems for individual charities and could also harm the wider development of the demand side of the social investment market if it results in an increase in the number of poor-quality investments being made.

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1.3 The interaction of a new social investment tax incentive with existing charitable tax incentives

1.3.1 The rate at which any new social investment tax incentive is set will determine whether it has an impact on the use of existing charitable tax incentives. If, as proposed, the new incentive is broadly in line with the existing EIS and has a rate of relief of 30 per cent, this makes it significantly more generous than Gift Aid (which is the charitable relief most likely to be at issue, as it applies to direct cash gifts to charity by an individual). Gift Aid is a hybrid relief, in that charities are able to claim back the basic rate of tax paid on a donation by an individual who has filled out a declaration, but individuals (if they are higher-rate taxpayers) can also claim their marginal rate of tax back as personal tax relief through their self-assessment form.

This amounts to a 20 or 25 per cent personal tax relief on the grossed-up value of their donation (i.e. the donation plus basic rate tax), depending on whether the individual pays a 40 or 45 percent upper rate of income tax. If an individual was able to claim 30 per cent personal tax relief through the new social investment tax incentive, this could have a material impact on whether they choose to donate via Gift Aid or make an investment through the new scheme. The actual impact is hard to predict, as the potential incentive will differ dependent on the individual donor’s tax status. For a 40 per cent rate taxpayer, the relief available through the new social investment incentive will be greater, although for a 45 per cent rate taxpayer, Gift Aid will be marginally better.

1.3.2 A concern raised in the consultation document is whether there is a risk of an individual receiving Gift Aid relief and social investment tax relief on a single transfer of money to a charity. It is hard to see how this could be the case in practice: in order to qualify as eligible for the social investment tax relief, any “investment” would have to offer a reasonable risk-adjusted financial return. (Putting aside concerns about the use of the word “commercial”, one presumes that this is broadly what is intended in the “summary of criteria for investment instrument” laid out on page 17 of the consultation document). Given this, no such investment would be eligible for Gift Aid because it would fall foul of the rules on acceptable benefits: for a gift in excess of £1000, the maximum value of the benefits that a donor can receive in exchange is 5 per cent of the gift value, up to a maximum of £2,500. This presumably means that an “investment” would only theoretically be eligible for Gift Aid if it produced a negative return of -95 per cent, and surely such an investment would then not qualify for the proposed tax relief.

1.3.3 There are other potential scenarios one could imagine in which an individual tried to subvert the system to gain double tax relief on a gift of money to a charity. One such scenario is where a donor gives a gift to a charity with which they have a personal link and claims personal relief through Gift Aid. They then also make an investment in the charity which qualifies for the social investment tax relief, and the money they gifted is used to repay this investment. This is clearly an abuse, as the individual has effectively received tax relief without making a gift. However, it seems fairly clear that in this scenario the individual is contravening a number of existing rules, such as
the Gift Aid benefit limits, and would also fall foul of any reasonable stipulations put in place regarding investments by connected persons.

1.3.4 As with other tax incentives that benefit charities, the challenge is to enforce the anti-avoidance rules that are already in place, rather than designing new ones.

2) The rate of return of qualifying social investments

Relevant consultation question:

Question 12: Is it reasonable to require an investment return at a commercial rate, given the nature of the social investment market? If so, what would be the most appropriate way to ensure that any dividends or interest payments that form a return on the investment are paid at a broadly commercial rate? How can the Government best limit opportunities for manipulation on returns?

2.1 Reference to the idea of a “commercial rate” in determining the eligibility of investments is both confusing and potentially worrying. It is clear that in order to ensure that the new relief is well-targeted and to reduce the potential for abuse, the government wants to ensure that there is no possibility of individuals making “investments” that are solely designed for the purpose of gaining a personal tax benefit. However, if the suggestion is that a “commercial rate” is supposed to be assessed relative to mainstream, non-social investments, then it is deeply flawed. Not only would few social investments be able to meet such a criterion, but even more fundamentally, it fails to take account of the fact that many social investors are willing to accept lower financial returns in return for social impact.

2.2 Any suggestion that the “commercial rate” should reflect some sort of agreed standard return within the current social investment market does not work either. The social investment market is too immature and too diverse and for there to be sufficient standardisation of rates for a generalised “social investment commercial rate” to be calculated.

2.3 There is some ambiguity in the interpretation of this question - our primary assumption is that what is proposed is a floor, designed to exclude certain transactions that are not deemed to be sufficiently “investment-like”. However, it is possible that the intention is instead to impose a ceiling on rates in order to protect investees from potential exploitation. On this interpretation, what is being proposed is an upper limit on the rates of any interest or dividend payments that form part of the overall return, in order to ensure that the end recipient of the social investment (i.e. the charity or social enterprise) is not being asked to pay an unreasonable amount so that the investment returns can be inflated.
In this case, setting the cap at a “commercial rate” arguably makes some sense (albeit it still begs the question of how “commercial” is defined). However, it is not clear that there is really a need for such a cap. Organisations are free not to take on investment if it is offered at unfavourable rates, so any investor attempting to do this should struggle in the marketplace. There is also the risk that success could be penalised: if a social investment opportunity emerged that was able to offer above-market returns due to the success of its underlying investees, rather than because of any artificial inflation of rates, it might find itself ineligible for tax relief. This is clearly not a desirable situation.

3) The role of intermediaries

Relevant consultation questions:

**Question 25:** Do you agree that the Government should not introduce a new set of rules specifically to support indirect investment into social enterprises via a separate legal entity such as an LLP? What are the potential effects of using the nominee approach outlined above? Are there likely to be fund managers who are able to offer nominee investments?

**Question 35:** What type of investor is likely to drive an increase in social investment, and are they targeted by the policy as currently outlined? If not, what would be needed to bring them into the policy?

3.1 It is important that the social investment tax incentive is designed so that it lends itself to the creation of funds and products by intermediaries. The vast majority of social investment is currently done through specialist intermediaries, so it is vital that these organisations see the new incentive as something that is of value to them and that they want to promote to investors.

3.2 It is also important because one of the Government’s stated goals is to grow the social investment market. A likely route to achieving this is to encourage retail investors (albeit high-end ones initially) to get involved in social investment. It would be a significant wasted opportunity if a new tax incentive was introduced that was not suitable for the creation - in the future - of funds that enable retail, mass affluent investors to make social investments.

3.3 The concern with limiting the use of the new incentive by intermediaries to a nominee approach is that whilst this might work for some existing intermediaries in the market as it currently stands, it is unlikely to be suitable for the creation of funds that appeal to more retail investors. The use of EIS as a template may not be that helpful here, as VCT would perhaps be a better model, in terms of the way in which it has been used to structure investment funds.
3.4 CAF has led the way in looking to engage individual High Net Worth Individuals (HNWIs) in social investment. Our Social Impact Fund enables individuals who hold a CAF Charitable Trust to invest £10K or more through our social investment fund CAF Venturesome. The fund has offered £3.8 million since July 2011. This money is then lent to charities and social enterprises, with the aim of repaying the individual investors, who can then use that money and any upside generated on investments to make further investments or traditional charitable donations. As all the money in this model has already passed the charitable threshold, an individual cannot receive any private benefit from their investments. These investments would also clearly not qualify for the new tax relief. However, were such an incentive available and suitable as the basis for an investment fund, CAF would certainly be one of the organisations most likely to consider developing such a fund. That is why we believe restricting the use of the new social investment tax relief by intermediaries to nominee arrangements may not be the right approach.