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SOCIAL INVESTMENT TAX RELIEF

ISSUES WITH SUBSIDIARIES

June 2017

For more information and resources on SITR, please visit www.bigsocietycapital.com/sitr.

This note has been prepared to help provide some further clarity around which property transactions can and can’t qualify for SITR, as we understand many have asked questions about this. The note has been prepared for information purposes only and does not constitute legal advice.

INTRODUCTION

Social Investment Tax Relief (“**SITR**”) offers social enterprises the ability to raise funding from investors, but allows the investors to claim tax relief on their investments.

There are a number of conditions that a social enterprise must meet in order to be eligible for SITR funding. Some of those conditions relate to group structure i.e. when and how it is permissible for a social enterprise to have shareholdings in other companies but still qualify for SITR funding.

In this note we are going to look at the specific issues that arise when a social enterprise that is looking to raise SITR-funding is part of a group of companies.

In this note, when we refer to the “**Parent**” we mean a parent social enterprise that:

- is proposing to raise SITR funding, and
- has one or more subsidiaries or holds shares in other companies.

Finally, in this note we do not look at any issues in relation to subsidiaries owned by “accredited social impact contractors”. That is because social impact contractors are only eligible for SITR funding if they have been established only for the purposes of carrying out a “social impact contract” (but for no other purpose). So in practice it is unlikely that a social impact contractor will hold shareholdings in other companies.

LAWYER’S SMALL PRINT – THE USUAL STUFF

This note is for information purposes only to give the reader a better understanding of the issues which a social enterprise may face in qualifying for SITR when it has subsidiaries. This note is not a comprehensive review of the law relating to SITR and it does not explain many of the numerous conditions that a social enterprise must meet in order to qualify to raise SITR funding.

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This note does not constitute an offer or an invitation to buy or sell or a solicitation of an offer or invitation to buy or sell or enter into any agreement with respect to any security, product, service or investment. Any opinions expressed do not constitute investment advice and independent advice should be sought where appropriate.

And finally, please bear in mind that:

- This note is based on our understanding of law and HMRC practice as at the date it is published. All information is current as of the date of publication, subject to change without notice, and may become outdated over time.
- This is still a new area of law, so very little custom and practice has yet been developed by HMRC or HM Treasury. Policy and practice will develop over time.

A FEW GENERAL POINTS

Before we get into the detail its worth mentioning a few general points about social enterprises that hold shares in other companies.

A social enterprise might hold a minority interest in another company – in other words, the social enterprise owns less than 50% of the shares in that other company and that other company is not treated as a subsidiary.

If a social enterprise holds a minority shareholding in another company, bear in mind that owning a minority shareholding is an investment activity. Holding investments is not a qualifying trading activity for SITR purposes. So social enterprises that hold minority stakes in other companies need to take care that they are carrying on a "qualifying trade" for the purposes of SITR. For more detail on what we mean by a "qualifying trade", please see our guidance.

Alternatively a social enterprise might own a majority of the shares in another company, or have control over the affairs of that other company, in which case that other company is likely to be treated as a subsidiary.

If a social enterprise has a subsidiary, that subsidiary must meet certain criteria – which we will explain later in this note.

A social enterprise cannot use SITR funding to purchase shares in other companies.

OVERVIEW OF THE ISSUES COVERED IN THIS NOTE

Here are the key issues we're going to run through in this note:

- SITR investments cannot be made into subsidiaries – it must always be the Parent that raises SITR funding
- All subsidiaries must be "qualifying subsidiaries"
- A Parent that has any subsidiary that is a company limited by guarantee will not be eligible to raise SITR funding
- A Parent cannot "control" another company unless that other company is a "qualifying subsidiary"
- A Parent that is a party to a joint venture needs to check carefully whether the joint venture company breaches the rules on controlling companies that are not qualifying subsidiaries
- Any subsidiary that intends to use the SITR funding raised by the Parent must be a "90% social subsidiary"
- If the Parent has a subsidiary whose only function is to hold or manage land or property, that subsidiary must also be a "90% social subsidiary"
- Under new rules currently before Parliament, acquiring a subsidiary **after** the SITR investment is made could retrospectively breach proposed new limits on state aid funding

SITR INVESTMENT MUST BE MADE INTO THE PARENT

An SITR investment cannot be made into a subsidiary enterprise – it must always be the Parent that raises SITR funding.

This is because the SITR rules provide that the social enterprise raising SITR funding must **not** be:

- A "51% subsidiary" of another company, or
- Under the control of another company, or
- Under the control of another company and persons connected with that other company.

  So if a social enterprise that is a *subsidiary* wishes to benefit from SITR funding:

- The Parent of that subsidiary must raise the SITR funding, by issuing shares or loans, and
- The Parent would typically then on-lend to the relevant subsidiary the SITR monies it has raised (and the subsidiary would then apply the SITR funding for the benefit of its trade)

This does, of course, mean that where SITR funding is raised by way of loans, it is the Parent, and not the subsidiary, that remains legally liable to repay those loans to investors (irrespective of whether or not the subsidiary is able to repay the Parent).

Also, where the Parent raising the SITR funding is a charity, this may create an issue.

Under the Charities legislation, there are restrictions on the ability of a charity to provide financial support for its trading subsidiaries. A charity looking to raise SITR funding must therefore take advice on the extent to which the charity may lawfully raise monies for the purposes of on-lending those monies to a trading subsidiary social enterprise.

EVERY SUBSIDIARY MUST BE A "QUALIFYING SUBSIDIARY"

A Parent cannot raise SITR funding unless every subsidiary of the Parent is a "qualifying subsidiary".

This means that every subsidiary must be:

- a "51% subsidiary" (i.e. the Parent directly or indirectly holds more than 50% of the ordinary share capital of the subsidiary), **and**
- under the ultimate "control" of the Parent, **and**
- not under the "control" of any other person.

AND there must be no arrangements in place under which these criteria could cease to be met.

So before deciding to raise SITR funding, a Parent must check that all of its subsidiaries meet these requirements.

And once the SITR investment has been made into the Parent, this requirement must continue to be met through the period which:

- begins with the date on which the SITR investment is made, and
- ends three years later (the "**three year post-investment period**")

The test as to whether or not a company is under someone's "control" is not straightforward.

In summary, a person ("**P**") is treated as having "control" of a company ("**C**") if P exercises, or is able to exercise, or is entitled to acquire, direct or indirect control over C's affairs.

In particular, P is treated as having control of C if P possesses or is entitled to acquire:

- the greater part of the share capital or issued share capital of C,
- the greater part of the voting power in C,
- so much of the issued share capital of C as would, on the assumption that the whole of the income of C were distributed among the participators, entitle P to receive the greater part of the amount so distributed, or
- such rights as would entitle P, in the event of the winding up of C or in any other circumstances, to receive the greater part of the assets of C which would then be available for distribution among the participators.

The requirement that every subsidiary must be a "qualifying subsidiary" creates a fundamental problem for subsidiaries that are companies limited by guarantee.

Companies Limited by Guarantee

A Parent with a subsidiary that is a company limited by guarantee is not eligible to raise SITR funding.

The requirement that the Parent must own more than 50% of the share capital of each subsidiary creates a problem where one or more of the Parent's subsidiaries are companies limited by guarantee. That is because a company limited by guarantee has no share capital. Meaning that a company limited by guarantee cannot, therefore, be a "qualifying subsidiary". So a Parent with a subsidiary that is a company limited by guarantee can never meet this requirement. The Parent is, therefore, ineligible for investment under SITR.

SHAREHOLDINGS IN COMPANIES THAT ARE NOT SUBSIDIARIES

A Parent cannot "control" another company unless that other company is a "qualifying subsidiary".

AND there must be no arrangements in place under which this condition could cease to be met.

We have explained in the last section what we mean by a "qualifying subsidiary" and what we mean by "control".

So if a Parent owns shares in another company that is not treated as a subsidiary (e.g. a minority shareholding) the Parent needs to ensure that it does not "control" that other company.

If the Parent does control that other company, the Parent will not be eligible to raise SITR funding.

And once the SITR investment has been made into the Parent, this requirement must continue to be met throughout the three year post-investment period.

This condition can give rise to issues with certain types of joint ventures.

Joint Ventures

A Parent that is a party to a joint venture needs to check carefully whether the shareholding in the joint venture company breaches the rules on controlling companies that are not qualifying subsidiaries

Some social enterprises will tackle particular issues or projects by entering into a joint venture with one or more other social enterprises. Often, the joint venture is created by establishing a company (the "**JV Company**") and each party to the joint venture becomes a shareholder in the JV Company.

But if the joint venture is a 50:50 joint venture (i.e. the social enterprise owns exactly 50% of the shares in the JV Company) it is possible that the Joint Venture Company is treated as under the "control" of ***both*** joint venture parties – but it is not a "qualifying subsidiary" of ether. This means that neither shareholder in the JV can meet the requirements described above. Which in turn means that neither of the 50% shareholders of the Joint Venture Company would be eligible to raise SITR funding.

However, whether or not this is an issue would depend on the exact terms of the joint venture arrangements.

ANY SUBSIDIARY RECEIVING ANY OF THE SITR FUNDING MUST BE A “90% SOCIAL SUBSIDIARY

If any of the monies raised from the SITR investment is to be used by a subsidiary (rather than the Parent into which the SITR investment was made), that subsidiary must be (and remain) a “90% social subsidiary.”

There are two tests that a subsidiary must meet if it is to be treated as a “90% social subsidiary”.

First, the subsidiary must be a “social enterprise, as defined in the SITR legislation. In other words, the subsidiary must be a community interest company, a charity, a community benefit society or an accredited social impact contractor.

Secondly, the Parent must:

- own at least 90% of the subsidiary’s issued shares and voting rights, and
- be beneficially entitled to at least 90% of:
  - the assets available for distribution to equity holders of the subsidiary (e.g. capital distributions on a winding up), and
  - of any profits of the subsidiary which would be available for distribution to equity holders (e.g. dividends).

The insertion of another layer of ownership, so that the company is a subsidiary of a subsidiary, does not matter provided that both subsidiaries are social enterprises and if one is a 90 per cent subsidiary the other is a 100 per cent subsidiary. Thus, if there are three companies with A Ltd being the parent company, B Ltd its social subsidiary and C Ltd a social subsidiary of B Ltd, then if B Ltd is a 90 per cent social subsidiary then C Ltd must be a 100 per cent social subsidiary. If B Ltd is a 100 per cent social subsidiary then C Ltd may be a 90 per cent social subsidiary.

PROPERTY MANAGING SUBSIDIARIES

If the Parent has a subsidiary whose only function is to hold or manage land or property, that subsidiary must also be a “90% social subsidiary” of the social enterprise (see above).

That is the case irrespective of whether or not any of the SITR monies are to be used by the property managing subsidiary.

And once the SITR investment has been made into the Parent, this requirement must continue to be met throughout the three year post-investment period.

SUBSIDIARIES ACQUIRED *AFTER* THE SITR INVESTMENT HAS BEEN MADE

Under new rules currently before Parliament, acquiring a subsidiary **after** the SITR investment is made could retrospectively breach proposed new limits on state aid funding.

Some material changes (the "**2017 Rule Changes**") were proposed to SITR in the Chancellor's 2016 Autumn Statement, and the Budget in March 2017. Draft legislation to enact the 2017 Rule Changes was published as part of the Finance Bill. As a result of calling the General Election in June the Government ran out of time, so those amendments are on hold. But it is widely assumed that the 2017 Rule Changes will be made after the election, and will be backdated so that they apply to all investments made after 5 April 2017.

If you want to know about more about the 2017 Rule Changes, please click here.

However one of the changes being proposed means that if a Parent raises SITR funding, and within the following three years acquires a subsidiary, it could retrospectively "taint" the SITR investments, and result in a loss of tax relief for investors.

Here's why:

Under the 2017 Rule Changes a new higher limit for SITR fundraising will be introduced. A social enterprise will be allowed to raise up to £1.5m under SITR over its lifetime (the "**£1.5m limit**").

However there are two key restrictions on this new £1.5m limit:

- First, it is only available for social enterprises that have been trading for less than seven years (the "**seven year rule**"). Social enterprises that have been trading for more than seven years will remain subject to the existing £290K limit
- Secondly, any "risk finance state aid" previously received by the social enterprise will count towards that £1.5m limit.

But if a social enterprise raises SITR under the new £1.5m limit, there may be an issue where:

- The social enterprise qualified for SITR on the basis it has been trading for less than seven years,
- During the three year post-investment period, that social enterprise acquires a subsidiary that has already traded under its previous owners (the "**newly acquired subsidiary**"), and
- Any of the SITR funding originally raised by the social enterprise is applied for the benefit of that newly-acquired subsidiary.

In these circumstances:

- If the newly acquired subsidiary made its first commercial sale more than seven years before the social enterprise raised SITR funding, the social enterprise is deemed, retrospectively, to have breached the seven year rule – meaning tax relief for SITR investors will be withdrawn, and

- Any risk finance state aid previously received by the newly acquired subsidiary is now counted towards the £1.5m limit – so if, for example, the newly acquired subsidiary had already received £1.5m of risk finance state aid before it was acquired, the social enterprise is deemed, retrospectively, to have breached the £1.5m limit – meaning tax relief for SITR investors will be withdrawn

This means that any social enterprise that raises SITR funding and then in the following three years goes on to acquire other companies will need to make sure that it will not inadvertently (and retrospectively) breach the new seven year rule and/or the £1.5m limit.