

## **TAXREP 11/01**

### **ENTERPRISING COMMUNITIES: A TAX INCENTIVE FOR COMMUNITY INVESTMENT**

*Response submitted in June 2001 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to the Revenue in relation to a Consultation Document issued in March 2001.*

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### **Enterprising Communities: – A tax incentive for community investment**

1. We are pleased to be able to comment on the 'Enterprising Communities: A tax incentive for community investment' Consultation Document, which was issued in March 2001.
2. The Institute of Chartered Accountants in England and Wales (ICAEW) is very supportive of the concept of helping community regeneration and for initiatives to support enterprise and community enterprise. However, we do have some reservations relating to this particular tax incentive which we outline below.

#### **Summary of our key comments**

3. This particular Consultation Document raises a number of issues which cause us some concern. It is intended to use the tax system for social engineering and, as is often the case, this appears to be leading towards highly complex legislation that will have as many pitfalls as advantages.
4. We believe there are two basic flaws to the Consultation Document. Firstly, where an enterprise cannot obtain the finance it needs from commercial sources this is normally either because the project is not commercially viable - even presumably with the benefit of the existing loan guarantee scheme - or secondly the enterprise does not know how to access appropriate sources of finance.
5. The proposals do not address either of these problems. If a financier is not prepared to risk £1,000, a promise of £250 of tax relief spread over 5 years is unlikely to make the investment attractive. The investor is likely to be as reluctant to lose £750 on what he perceives to be an unviable proposition, as he is reluctant to lose £1,000.
6. There also appears to be a problem with expecting the promoters of a project to first raise sufficient finance to have a proper business plan prepared, in the knowledge that if the project is not selected for tax relief it will collapse (as there are, by definition, no other available sources of finance). We believe it would be more sensible to adopt a two stage process under which projects would be put forward to the Community Development Finance Institutions (CDFIs) in a fairly brief outline (containing an indication of its financial viability), with the CDFI then making funds available to these projects that it is inclined to back to pay for a full business plan to be produced.
7. If a person is to back socially needed investments he often wants to be identified with the investment itself, not have an intermediate vehicle that distances him from it. An investor ought to be encouraged to provide management advice and similar skills (if he wishes to) in addition to money so that the business can achieve financial viability as early as possible.

## Detailed comments

8. We set out below our detailed comments on some of the issues raised in the Consultation Document. These are shown using the same headings as found in the Consultation Document.

### *Paragraph 21*

9. If a project is not capable of **fully** servicing debt or equity on all of the finance it needs, giving tax relief to the investor (presumably to try to reduce the yield he requires) is an inefficient way of dealing with the problem. Tax relief in itself is unlikely to induce people to look for a lower return. It would be more effective to give a Government grant to the project. Knowing that the project has non-interest bearing finance removes the first layer of risk (as it is only an eventual loss in excess of the grant that will result in a loss to the investor). That would both make it easier to attract investment on commercial terms and ensure that the entrepreneur is fully aware that to sustain the business requires the generation of sufficient profit to give a commercial return to investors.

### *Paragraph 23*

10. We would like to see some evidence that the proposals will expand the supply of debt and equity for regeneration. There is a real concern that instead it may make it more likely that it will switch the available funds away from investments that are viable into those that are marginally viable. That would not be helpful to anyone.

### *Paragraph 34 – Question 3*

11. We do not agree that a tax-based system would be more effective. We are unconvinced that people familiar with the concept of tax-advantaged commercial investments would be attracted towards investment that are either non-viable or only marginally viable merely because they are familiar with tax reliefs. The most likely potential investor in such businesses is unlikely to be the ‘tax-driven’ person. It is more likely to be the person with a social conscience or one who sees a benefit to his own business in being seen to aid community projects. It is hard to see why tax relief should influence either category.
12. We suspect that most people would find a Government grant a greater incentive than a tax relief, as cash in hand has a greater impact than the reduction in a future tax liability. In any event, as indicated earlier, we believe that a Government grant should go to the project not to the investor.

*Paragraph 42 – Question 4*

13. We are not convinced by the suggested delivery mechanism. It appears to be a very bureaucratic process and involves a large amount of work on projects that may never come to fruition. An alternative would be to make provisional allocations on the basis of presentations by the CDFI's. The CDFI's should then finance a detailed business plan and give the go ahead if this suggests a project is viable. It would return the allocation to the allocation authority if it decided that the business plan was not viable.
14. There also seems a 'chicken and egg' scenario, with the allocation authority presumably assessing a bid on the assumption that the allocation of tax relief to it will generate the necessary investment. What if there is a shortfall in the funds raised? That would make the project non-viable but in many cases a little extra Government money might have made it viable. One of the greatest causes of insolvencies is, of course, projects starting with inadequate finance.
15. We do not think that many investors will be persuaded to sign up to a potentially precarious investment on the strength of a tax relief, if that relief could be subsequently withdrawn because of some event outside of the investor's control (as outlined in paragraph 41 of the document). Admittedly the same might be said of most tax-favoured investments. However, the existing ones tend to involve either a substantial investment, such that the investor can reasonably be expected to have some influence over events, or a fund which is managed by a commercial organisation whose reputation depends on getting it right (and who can probably be sued if they do not). It is not clear that the same would be true of the CDFIs.

*Paragraph 44*

16. It is unclear how the CDFI itself is to be financed. Will this be by the Government, is it intended that part of the funds raised by a project should be diverted to the CDFI, or is local business expected to finance the CDFI? If it has to raise its own funding locally this might divert potential funding from the projects it wants to support.
17. The Consultation Document does not make clear why it is thought that a potential investor should want to put his funds into a CDFI rather than in the individual projects. We believe it is likely that an investor in a community project would want to be identified with an individual project.

*Paragraph 46*

18. This seems inconsistent with paragraph 39. Paragraph 39 suggests that the funding will go to specific projects. Paragraph 46 suggests that once having put forward specific projects and obtained an allocation of tax relief the CDFI can use the money as it wishes, not necessarily on these specific projects. Why should a CDFI, which

gets an allocation, be able to lend to other CDFI's? What is the point of the bidding process being project-based if the CDFI can 'on-lend' the funds to support completely different projects – particularly ones which the allocation authority has specifically decided not to support? We would welcome some clarification on this point.

19. Furthermore, the comment in paragraph 42 that the process would create nugatory bidding costs greatly underplays the costs if only a small number of CDFI's are likely to succeed in obtaining an allocation of tax relief.
20. It also seems odd that success should be an all or nothing concept. The Consultation Document appears to suggest that if a CDFI puts forward, say, four projects tax relief will be allowed for all of them even if it is only one or two that the allocation authority particularly likes. We would welcome clarification as to whether this is really what is intended.

*Paragraph 49 – Question 5*

21. The proposed evaluation criteria seem sensible. However, we do have concerns about the request for a strong investment track record. This makes it difficult for new CDFI's to get off the ground. In the circumstance we believe the CDFI should be judged on its ability to nurture investments which are not normally commercially viable and not on its ability to produce a commercial return – which could most easily be done by financing only businesses with a high apparent level of viability.

*Paragraph 50 – Question 6*

22. We favour a two-stage process. This will significantly reduce abortive costs.

*Paragraph 55 – Question 7*

23. We agree the approach to defining 'disadvantaged communities'. However, we wonder whether many projects in such communities will meet the desired investment criteria. It is important that any incentive goes to help projects that would otherwise not get off the ground rather than a CDFI becoming a clone of a Venture Capital Trust; i.e. its role should be to finance only businesses that would not otherwise come into existence.

*Paragraph 56*

24. The role of a CDFI seems contradictory. The aim that a CDFI should only support enterprises that cannot obtain the finance that they need from commercial sources suggests that the CDFI is expected to take much greater risks than commercial lenders or investors would contemplate. If that is not the case why cannot an enterprise obtain the finance they need from a commercial source? It is surely either because the entrepreneur does not have the ability to present an effective business plan or does not have the means to identify an appropriate commercial source. It is

not that the requisite finance is unobtainable. In such a case the CDFI should logically help the entrepreneur to raise finance – but it is not being given the necessary resources to do this.

25. However, there is an obligation only to support enterprises that have a good prospect of becoming viable in the longer term. We are not sure what this means. If a business does not have a good prospect of becoming viable it should not be encouraged to proceed. But if it does, surely commercial finance will be available if the entrepreneur looks hard enough. The large number of dot.com businesses and Enterprise Investment Scheme (EIS) companies that have been able to raise finance with little evidence of viability bears this out.
26. It is also unclear how much investment can (or should) a CDFI make. For example a business that needs £500,000 of finance could probably borrow half of it if it had £250,000 of equity. Can a CDFI nevertheless provide the whole £500,000 as equity? A potential investor in the CDFI needs to know what its policy will be. If it provides the full financial needs for say ten companies it would probably be a low risk investment. If it provides the full finance for two companies only it would be higher risk. If it provides pump-priming finance for 50 it would be very high risk.
27. If the tax incentive is to meet the social objectives being sought a CDFI should concentrate on businesses that are genuinely so risky that finance is not available commercially even with a reasonable equity base, but such a business is unlikely to be seen initially to have a good prospect of becoming viable in the longer term. Of course a CDFI should not back businesses that clearly have no prospect of success but it ought to back socially desirable businesses that can produce (ideally with help) a business plan which suggests that the business will achieve profits within three or four years and where the CDFI feels that there is at least, say, a 50% chance that the plan will be met.
28. It is also unclear whether a CDFI can use the tax incentive to raise further funds for businesses it has already backed. One of the biggest causes of business failure is running out of cash. A CDFI should clearly not throw good money after bad but if one of its investee companies experiences unexpected problems it ought to provide further support.
29. In other words once a CDFI has decided to back a business and has been allocated tax credits based on that business, it should have an obligation to help the business until such time as it achieves viability. But we believe the proposals will not let this happen in reality. The CDFI is unlikely to be able to raise the additional cash injection that a business needs unless it is allocated the appropriate tax credits in a later year – and in many cases the business will have folded before such an allocation is considered.
30. The discussion document is also silent about whether and to what extent the CDFI is to have a continuing involvement in investee companies. Can it appoint non-executive directors? Can it make its investment conditional on, say, the business

taking on a full time finance director?

*Paragraph 59 – Question 8*

31. This question should not need to be asked. If the CDFI identifies that an enterprise cannot obtain finance from a commercial source but believes that the business is likely to be viable and will benefit the community it should not matter whether it is property backed. It begs the question of what sort of enterprises does the Government believe desirable in disadvantaged communities? Obvious ones might be retail businesses, social clubs, entertainment venues, credit unions, crèches and local transport undertakings. These have a common attribute; they all require premises. Why should they be forced to rent rather than buy such premises? Indeed with the current penchant for upward only rent reviews, buying premises may well be the safest way to achieve viability for the business.
32. It should also be remembered that the EIS rules initially had a 50% limitation on property investment but this restriction was quickly removed for investment of up to £50,000 and the restriction was removed completely in 1994 (although certain specific property based activities are still excluded).
33. If a 50% restriction was felt to create an unacceptable disincentive for business in general, a 75% restriction in disadvantaged areas will be a positive discouragement to such investment – particularly if the potential investor has the option of putting his funds into an EIS investment.

*Paragraph 66*

34. We are not sure why a pension fund should be attracted to co-invest in a business that is too risky to raise the finance it needs from commercial sources. Surely a pension fund should adopt very prudent investment criteria?

*Paragraph 68 – Question 9*

35. We believe it is curious that the discussion document does not mention limited liability partnerships (LLPs) which are probably the most appropriate form of investment as it allows the investor to become involved in the business while having limited liability.
36. The form of the Community Investment Vehicle (CIV) is perplexing. The CIV appears to be the same as a CDFI so it is unclear why two terms should be used. A CIV appears on the face of it to be a CDFI which succeeds in a bid for an allocation of tax credit. The return to the CIV will either be interest, dividends or capital gains. If the investee is a company it does not matter whether the CIV is transparent as far as income is concerned. If the investee is transparent the CIV ought to be transparent also, as otherwise the benefit of that transparency will be lost. Ideally the CIV ought to be either specifically exempted from tax on capital gains or should be a transparent

vehicle. Accordingly the most appropriate form would appear to be an LLP.

*Paragraph 69 – Question 10*

37. We would have assumed the purpose of the tax credit is to encourage the financing of a business that would not otherwise have happened. It should not matter if one investor owns 100% of the CIV. After all the CDFI will get an allocation of tax credits only if it satisfies the allocation authority that it will use the investment wisely.

*Paragraph 76 – Question 11*

38. Again there seems to be a conflict. If the tax relief is to be given over five years the investor should have to invest for at least such a period. A CIV is unlikely to invest in a business that cannot achieve viability within five years. As indicated earlier investors are likely to be attracted to the social desirability of the underlying investment rather than to the CIV itself. On the other hand the investee businesses are unlikely to be able to pay loan interest in their early years. The only benefit of a loan to an investor is, therefore, the ability to withdraw his/its funds. This points to a CIV needing to be financed wholly by shares but for it to be able to issue shares that are redeemable once they have been held for at least five years.

*Paragraph 78 – Question 12*

39. We are unsure why individuals are excluded. A CIV does not need to raise funds in small amounts if it does not want to do so. If it wants to try to raise funds from within the local community it ought to be able to do so. The best way to help a community business to grow is to involve the community in its success. Special rules for individuals need not be complicated. Section 574, ICTA 1988, (relief for losses on unlisted shares in trading companies) and section 72, FA 1991 (deduction of trading losses from capital gains) are both very succinct.
40. Whether individuals are prepared to invest in a CIV is likely to depend on what the CIV does. If all it does are genuinely community-based investments it is likely to attract both socially responsible investors and individuals who want to improve their community. Indeed individuals are probably more likely investors than companies.
41. This begs the question of what is the incentive for a corporate investor? The tax relief alone is unlikely to be persuasive as why risk 100% to get tax relief of 25%? Will the corporate investor be swayed by a sense of community? Possibly this is the case but the tax incentive should not be necessary if that is the motive. It may be persuaded by a possible commercial benefit? This is unlikely as it appears to us that an investment in a CIV is not well targeted.

*Paragraph 85 – Question 14*



42. It is hard to envisage a CIV being able to give a commercially viable return when most companies look for an investment rate of return of around 20% from investments and the stock market is producing annual returns of well over 20%. The real question is how much of an incentive is needed to induce someone to make an investment that he/it would not otherwise have made. A 25% tax credit spread over 5 years, or 5% per annum on top of the return produced by the investment over that period seems very low. Paragraph 14.3 of the Inland Revenue's Share Valuation Handbook suggests that an uplift to quoted yields of 20 – 30 % is normally appropriate in valuing a minority interest in a quoted company. A higher uplift would undoubtedly be needed for a high-risk investment. And a 5% uplift that lasts for only 5 years is probably only about a 1% real uplift in valuation terms.

*Paragraph 88 – Question 15*

43. We are not convinced that deferral relief would generate large new investment flows. An individual can already get such relief under EIS Reinvestment relief and a company will be able to do so under the new deferral relief. A capital gains tax exemption would be a concrete incentive if the investment is not too risky but is not very attractive for a high risk investment such as the scheme is (or ought to be) aimed at. Business asset taper relief for an individual gives an effective tax rate of only 10%, and the effective tax rate for a company is only 30% of the gain, so the potential incentive is not that great in the context of a 100% (or 75% if a tax credit is given as well) risk.

*Paragraph 91 – Question 16*

44. A one off relief of 25% at the time of the initial investment would give a greater incentive than 5% per annum for 5 years. It is also administratively far simpler.

*Paragraph 94 – Question 19*

45. We believe five years seems a little long. Four would be more attractive. Four years should be long enough to assess whether a business is going to be commercially viable. If it is it can raise funds elsewhere at that stage so the risk money ought to be diverted to fresh investments.

**The way forward**

46. We are happy to discuss further any of the issues outlined above. We also look forward to receiving the feedback which results from this consultation.