

Lower cost debenture capital for SMEs, social housing and energy infrastructure

– raising capital outside the ‘speculative illiquid securities’ FCA restrictions

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Companies or charities can borrow money from retail investors by issuing debentures which pay tax free interest, to finance:

- (asset backed) industrial and commercial purposes; or
- ungeared social housing property investments

outside of the FCA restrictions on the promotion of speculative illiquid investments.

Both are important.

In this article I want to talk about how investments by private investors in debentures issued by a company or a charity can be held within an innovative finance ISA Account (an “**IFISA**”) if the investor’s subscription is arranged online through an electronic system (i.e. a website) and is facilitated by a person authorised by the FCA to arrange deals in investments.

Lower cost capital for the growth and development of all worthy SMEs

The sustainable growth and development of SMEs and local energy infrastructure can only be enhanced if the engagement of private investors is made worthwhile.

Not all companies qualify for investment under the Enterprise Investment Scheme or by Venture Capital Trusts yet remain worthy of state support despite the current EU imposed limitations on the UK’s venture capital schemes; why should UK manufacturing companies which have been trading for more than seven years be denied access to venture capital?

Lower cost debenture capital held within an IFISA should be considered by SMEs.

Lower cost capital for local social housing and energy infrastructure

The provision of local housing for young families and local energy infrastructure is essential if our communities are to retain the social glue and facilities which ensure that local populations regenerate.

In an [earlier article](#), I have described how the availability of business property relief can induce private investors to invest capital for a lower investment return on their money which might then be available to be lend to young families at a lower cost so those families can afford to buy their own home.

Good ideas can be combined.

So, a refinement of my earlier model would be for a Community Benefit Trust to invite investors to subscribe convertible IFISA debentures so that, whilst the investment is in its debenture form, interest paid by a Community Benefit Society would be received tax free by the investor. When the investor’s priorities change

to focus on the mitigation of their inheritance tax bill, they might then convert their debenture into community shares in the hope that, if they survive the conversion by two years, their estate will be able to claim business property relief, if still available at the relevant time.

“Community ownership will be a major growth area for the co-operative sector, not least because of the Government’s Local Power Plan and Community Right to Buy legislation.

We believe the sector and government should work together to emulate the following practices and approaches found in the largest and most impactful co-operative economies around the world:

- **Common capital** – more effective accumulation, pooling and reinvestment of common capital within and between co-operatives.
- **Institutional finance**- a greater role for institutional finance in the co-operative economy including pension funds, impact investment funds, philanthropic funders and more specialist institutions in the co-operative ecosystem.
- **External investment** – raising equity, quasi-equity and debt in larger amounts from external investors, especially institutions, in addition to raising capital from members.”

[‘Unlocking options for co-operatives to raise more capital’](#)

[Co-operatives UK](#)
[July 2024](#)

IFISA Taxation

Investments in debentures issued by a company or a charity can be held within an innovative finance ISA account (an “**IFISA**”) if the investor’s subscription is arranged online through an electronic system (i.e. a website) and is facilitated by a person authorised by the FCA to arrange deals in investments.

Debentures must be an instrument creating or acknowledging indebtedness.

This means that interest can be paid tax free to investors by the issuing company or charity to the extent that investors qualify for ISA tax benefits and their subscriptions to all ISA accounts do not exceed £20,000 per annum.

Investors can also transfer existing monies held within their cash ISA, which can be substantial for those who have habitually utilised their annual allowance, to an IFISA in order to subscribe debentures.

As at 30th June 2023 [HMRC statistics](#) record £563 million as being the total market value of cash and debentures held in IFISAs and over £280 billion as being the total cash held in cash ISAs. The average subscription to an IFISA was £8,690.

Any investment in debentures can be facilitated by our FCA authorised company, [Paxiot Limited](#), which is also authorised by HMRC to act as an IFISA manager.

The terms and conditions set out in the relevant company or charity website would constitute a contract which is binding on investors and Paxiot in relation to any purchase of debentures which an investor makes through the website and holds in the investor's ISA. An investor's ISA will be managed entirely by Paxiot as the ISA manager.

Paxiot would treat an investor as their client and undertake on each investor's behalf to— (i) receive payments in respect of their debentures; (ii) receive and make payments, when due, in respect of the debentures to each investor; and (iii) exercise, or facilitate the exercise of, rights in respect of each debenture.

Paxiot is a private limited company incorporated in England registered with the Registrar of Companies for England and Wales under number 07455644 with its registered office at 6 Kinghorn Street, London EC1A 7HT; which is registered in The Financial Services Register under number: 610217 and with HMRC with ISA manager reference: Z2072.

These arrangements comply with the requirements of the ISA Regulations in relation to ISA accounts which specify that the following additional conditions must also be satisfied for a holding of debentures within an ISA account:

- “(d) The investment in debentures must not be part of a scheme or arrangement the main purpose, or one of the main purposes, of which is the avoidance of tax;
- (e) Debentures not made available to investors by reason of their or of another's status, whether past, present or prospective, as an employee, director, partner, trustee or the holder of any office;
- (f) Investors must not be connected with the issuing company or charity, and for this purpose “connected” means an investor must not hold or be entitled to acquire directly or indirectly more than 30% of the issuer's ordinary share capital; issued share capital; voting power; or of the issuer's assets on a winding up;

[but restriction (f) does not apply to the single company in which a debenture issuing single company holding vehicle will invest – see further below on this]

- (g) Debentures must not be connected with any other investment held outside an ISA account by the investor or any other person, and for this purpose an investment is to be treated as connected with another if— (i) either was made with reference to the other or with a view to enabling the other to be made on particular terms; (ii) the terms on which either investment was made would have been significantly less favourable if the other investment had not been made; and
- (h) The investment in debentures must be made on genuine commercial terms.

An investor may only subscribe to a single ISA account in a particular year. The beneficial ownership of Investments within an ISA account must be held in the name of the investor.

There is no withholding tax on investments held in an ISA, such as debentures, or investments held through SIPPs. HMRC does require the Company to withhold basic rate tax on all payments of Interest it makes to an investor in connection with an investment in debentures which are not held in an ISA account or SIPP.

No liability to UK Capital Gains Tax should arise on the issue of debentures or on their subsequent redemption on the redemption date. No stamp duty or stamp duty reserve tax will be payable on the issue of debentures. A holding of debentures would normally form part of an investor's estate for inheritance tax purposes.

The above statements in relation to certain United Kingdom taxation considerations are intended as a general guide only and do not purport to be a complete analysis of all the potential United Kingdom tax consequences of acquiring, holding or redeeming debentures. They are based on current United Kingdom legislation as at the date of this note and they apply only to investors who are resident, ordinarily resident and domiciled for tax purposes in (and only in) the United Kingdom who hold their debentures as an investment. The precise tax treatment of any particular investor will depend on their individual circumstances and the law and practice in force at the relevant time and this may be subject to change in the future and investors should therefore make sure they understand any changes that are made. Prospective investors are advised to consult their own professional advisers concerning the tax consequences of the acquisition, ownership or redemption of debentures and any interest and other benefits derived therefrom.

Regulatory

There are three permitted use cases under the FCA COBS rules¹. As these use cases are permitted, they fall outside the speculative illiquid securities restrictions.

Outside these permitted use cases, an FCA authorised firm is **not allowed** to communicate or approve a financial promotion to a retail client which relates to debentures that are issued with a denomination or minimum investment of less than £100,000 where some or all of the proceeds raised will be employed in the provision of loans, buying shares, debentures and other securities etc; or (save as described in use case (2) below) buying investments, real estate or funding construction ("**speculative illiquid securities**") unless the debentures are listed or expected to be listed and are or are expected to be regularly traded.

The three permitted use cases, where debentures are not regarded as speculative illiquid securities, are as follows:

- (1) Debentures issued by a company or a charity where the proceeds of the issue will be used by the issuer or a member of the issuer's group for a general commercial or industrial purpose which it carries on.

A general commercial or industrial purpose includes the following: (a) a commercial activity, involving the purchase and/or sale and/or exchange of goods or commodities and/or the supply of services; or (b) an industrial activity involving the production of goods; or (c) a combination of (a) and (b).

In summary, an own funds 'working capital facility'.

- (2) Debentures issued by a company or a charity where the proceeds of the issue will be used: (a) to buy or acquire investments (other than shares, other debentures and securities etc) or (b) to buy real property or an interest in real property or (c) to pay for or fund the construction of real property **where**, in each case, the relevant property or investment will be used by the issuer or a member of the issuer's group for a general commercial or industrial purpose which it carries on **and, additionally, where** the ability of the issuer to pay any coupon or other income and/or capital at maturity is not wholly or predominantly linked to, contingent on, highly sensitive to or dependent, on a return generated as a result of buying real property or an interest in real property or paying for or funding the construction

¹ COBS 4.12B.50R to COBS4.12B.56

of real property.

In summary, an own funds 'asset-backed working capital facility'

- (3) Debentures issued by a company or a charity where the issuer is: (a) a property holding vehicle, or (b) a single company holding vehicle where, in each case, the rules applicable to the promotion of restricted mass market investments ("RMMIs") are followed.

Use case (3) deals with two quite different uses, whose only common feature is that both are treated as RMMIs.

The first limb of this use case is, in summary, an ungeared social housing property investment facility.

The second limb of this use case permits a single company holding vehicle – that is to say, a third party finance company - to provide an asset-backed working capital facility to another single company that would otherwise fall within use case (2) were it to be the issuer of its 'own funds' debentures.

Interestingly, the IFISA restriction (f) referred to above, sic:

- “(f) Investors must not be connected with the issuing company or charity, and for this purpose “connected” means an investor must not hold or be entitled to acquire directly or indirectly more than 30% of the issuer’s ordinary share capital; issued share capital; voting power; or of the issuer’s assets on a winding up”

is not wide enough to prevent an investor subscribing for debentures issued by a single company holding vehicle which then lends the money raised to a single company with which the investor is connected.

On this basis, an investor could subscribe for debentures issued by a third-party finance company (to which they are not connected) in order to provide an asset backed working capital facility to another company in which the investor holds more than 30% of that other company’s ordinary share capital; issued share capital; voting power; or of that other company’s assets on a winding up.

Care would need to be taken to ensure that the following IFISA restrictions were not breached, sic:

- “(d) The investment in debentures must not be part of a scheme or arrangement the main purpose, or one of the main purposes, of which is the avoidance of tax;
- (g) Debentures must not be connected with any other investment held outside an ISA account by the investor or any other person, and for this purpose an investment is to be treated as connected with another if— (i) either was made with reference to the other or with a view to enabling the other to be made on particular terms; (ii) the terms on which either investment was made would have been significantly less favourable if the other investment had not been made; and
- (h) The investment in debentures must be made on genuine commercial terms.”

An investment in debentures issued by a third party finance company with the express purpose of the issue proceeds being lent to the single company in which the investor is connected would not seem to be prohibited by the restriction at (g), provided it is made with reference to the single company with which the investor is connected and is not made in reference to their investment in that single company

or on terms significantly more favourable because of the existing investment in that other single company.

If the investment is made on genuine commercial terms the restriction at (h) would not apply. If the investment is not made as part of a scheme or arrangement to avoid tax the restriction at (d) would not be breached.

That said, the ubiquitous "main purpose/one of the main purposes" test has, over recent years, been subject of a number of Tribunal cases, in various areas of tax law, and HMRC has generally had the greater success rate. So caution is required as regards the restriction at (d).

A complex series of definitions support use case number (3), but their meaning is relatively clear.

- Property holding vehicle** a single body corporate which:
- (1) is the sole legal or beneficial owner of a single income generating property;
 - (2) issues debentures which have a fixed maturity date or preference shares;
 - (3) issues debentures or preference shares in a sum which does not exceed the value of the income generating property owned;
 - (4) issues only one tranche of debentures or preference shares;
 - (5) does not and will not carry on any activities other than the holding of the income generating property referred to in (1) and associated activities, which may include the collection of rent or other income from the income generating property and appointing a manager to maintain the income generating property, but must not include the development of the income generating property that goes beyond maintaining it in a suitable condition; and
 - (6) does not enter into any loan agreement whether as the borrower or lender.

- Income generating property** a single property or multiple properties within a single development which:
- (1) is actually used, or is available for use, for residential or commercial purposes;
 - (2) is located in the United Kingdom;
 - (3) is available for occupancy or occupied by one or more persons who have no relationship with the directors of the relevant property holding vehicle and who pay rent at a commercial rate or a rate reflecting regulated market practice **for social and affordable housing**; and

- (4) has been valued by an independent valuer: (a) who is a member of the Royal Institute for Chartered Surveyors; and/or (b) in accordance with the RICS Valuation Standards (The Red Book).

Single company holding vehicle

a single body corporate which:

- (1) is only able to carry on the following activities:
- (a) issuing debentures or preference shares for the purpose of investing the proceeds in shares or debentures issued by a single company (without prejudice to the single-company holding vehicle's ability to constitute itself);
 - (b) investing the total proceeds of the debentures or preference shares it issues in shares or debentures issued by a single company and no other company and having no discretion in relation to the proceeds of the issue;
 - (c) paying returns to holders of the debentures or preference shares in sums equal to any income it receives from the shares or debentures it owns (issued by the single company), including income from any sale of the shares or debentures, on a pro rata basis, less any reasonable fees (without prejudice to relevant legislation governing companies and taxation); and
- (2) has adequate arrangements in place to ensure that:
- (a) the proceeds of the issue are protected and not used for any purpose outside of (1)(b) above; and
 - (b) either:
 - (i) income from the single company is held by the single-company holding vehicle on trust for holders of the debentures or preference shares on terms that ensure that those investors receive the full amount they are entitled to according to (1)(c) above; or
 - (ii) the holders of the debentures or preference shares have security over the income from the single company on terms that ensure that those investors receive the full amount they are entitled to according to (1)(c) above; and
- (3) ensures that neither the single company, nor members of its group, will use any of the monies received from the single-company holding vehicle directly or indirectly for one or more of the purposes in COBS 4.12B.50R(2) as modified by limb (b) of the single company Glossary definition.

Single Company

a single company that is not part of the same group as the single-company holding vehicle investing in it and which:

- (a) uses the funds received from the single-company holding vehicle solely for the purpose of its own commercial operations or those of its subsidiaries carrying out the same commercial operations as the single company; and
- (b) does not undertake [*any of the activities that would render its shares as speculative illiquid securities*].

The FCA gives the following examples to illustrate the application of its rules.

Example 1

A company issues a debenture or preference share and uses the proceeds to purchase IT equipment for use in its business, to the extent that the IT equipment might be considered an investment, the debenture or preference share will not be a speculative illiquid security because the IT equipment is used by the company for its own commercial activities (in this case, for use by its staff to provide services to customers).

Example 2

A supermarket chain issues a debenture or preference share and uses the proceeds to purchase stock (for example wine) for sale as part of its retail business. To the extent that the wine might be considered an investment, the debenture or preference share will not be a speculative illiquid security because the wine is used by the supermarket for its own commercial activities (in this case, to sell it on to its retail customers for a profit).

Example 3

A company issues a debenture or preference share and uses the proceeds to buy or acquire art or fine wine as an investment, and so they will be a speculative illiquid security because the art or fine wine will not be used by the company itself for its own commercial activities.

Example 4

A company issues a debenture or preference share and uses the proceeds to purchase IT equipment for the purpose of hiring or leasing those out to another company, and so they will be a speculative illiquid security because it is not using the IT equipment for its own commercial activities and hiring and leasing services are excluded from the definition of general commercial or industrial purpose.

Example 5

A retailer issues a debenture or preference share and uses the proceeds to build a shop, the debenture or preference share will not be a speculative illiquid security because the property is used by the retailer for its own commercial activities (in this case, the sale of goods).

Example 6

A property developer issues a debenture or preference share and uses the proceeds to fund the costs of a property development or construction of property, which is intended to be sold or rented out for commercial purposes or as residential dwellings, and so they will be a speculative illiquid security because the development will not be used by the developer itself, and property development and construction services are excluded from the definition of general commercial or industrial purpose.

Example 7

A company issues a debenture or preference share to fund the costs of constructing a power station which the company intends to operate itself with a view to selling the electricity it produces, the debenture or preference share will not be a speculative illiquid security because it will use the property for its own commercial or industrial activities (generating electricity) provided, that is, that the ability of the issuer to pay any coupon or other income and/or capital at maturity is not wholly or predominantly linked to, contingent on, highly sensitive to or dependent, on a return generated as a result of constructing of the power station.

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