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NEW UPDATES

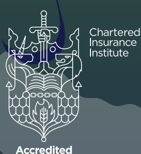
An Adviser's Guide to
Venture Capital Trusts

The latest developments in Venture Capital Trust rules and practicalities

Second Edition

Find inside:

- VCT landscape
- Risks and rewards
- Rules for VCTs
- Claiming the tax reliefs
- Interaction with pensions and other tax wrappers
- Charges and practicalities
- Suitability
- Research and due diligence
- Case studies



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Specialists in VCT investing

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Tax treatment depends on an investor's individual circumstances and may be subject to change. Certain investments carry a higher degree of risk than others and are, therefore, unsuitable for some investors.

An Adviser's Guide to

Venture Capital Trusts

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Introduction

This guide is designed to help financial advisers to unpick the technical requirements that support the Venture Capital Trust (VCT) model, grasp where and when the hazards could strike, calculate the potential benefits and determine what this mix could mean for their clients.

It looks at the current legal, regulatory and tax aspects, considering the practicalities that should be part of the basis of any VCT investment recommendation.

We also produce a free quarterly VCT Industry Update offering a snapshot of market conditions through opinions, analysis and research.

Simply visit intelligent-partnership.com/research-format/publications

Learning Objectives

After reading this guide, advisers will be able to:

- Describe the main rules that govern the VCT reliefs available.
- Explain the main risks associated with VCT investments.
- Define the key aspects that need to be taken into account when considering client suitability for a VCT investment.
- Evaluate the main due diligence considerations for a VCT investment and investment provider.
- Identify some of the real-life situations for which VCTs can fulfill client planning needs
- Ascertain the circumstances in which VCT reliefs can be withdrawn.

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We would like to thank our sponsor, Triple Point Investment Management. It would not be possible to produce educational material like this without their generous support and contribution towards the production and distribution of the guide.

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JACK ROSE
HEAD OF SALES
TRIPLE POINT

Opening Statement

After a challenging few years for the UK economy, how can it regain momentum and boost its growth outlook? In 2023, the International Monetary Fund had this to say about the UK economy: "Reviving private investment, labour supply, and productivity is pivotal to lifting potential growth". The good news is that the growth recovery is already underway, and can be found at the early-stage level where VCT funding begins.

Moreover, more private investment capital is being invested into early-stage companies than ever before, as VCT fundraising figures demonstrate. Earlier this year, the Association of Investment Companies (AIC) reported that VCT fundraising in the 2022/23 tax year passed the £1 billion milestone for the second successive year, with £1.08 billion raised from investors just falling short of the £1.13 billion raised in the 2021/22 tax year. As the AIC's Richard Stone rightly points out: "This much-needed support to the UK's fast-growing companies helps deliver vital economic, social and environmental advantages to the country. It's crucial VCTs can continue to fund young businesses which create jobs, develop skills and knowledge, increase exports and raise the tax take across many sectors including healthcare and technology."

When it comes to entrepreneurship and innovation, we remain the envy of our global peers. In 2022, the UK was ranked 4th out of 132 economies featured in the 2022 Global Innovation Index.

And despite our slower economic growth, the UK is still the biggest venture capital market in Europe, and more billion-pound companies are created here than anywhere else. According to the Department for Business and Trade, the UK has created 114 innovative companies with a market value of more than $1 billion. This means investors seeking growth, innovation and entrepreneurship can find it right here in the UK, and VCTs offer several valuable incentives to encourage investment, as this guide points out.

But the continued popularity of VCTs shouldn't be attributed to the tax incentives alone. In our experience, investors are drawn in by the tax reliefs, but they also want to know they are investing in ground-breaking ideas, exceptional companies and future-focused industries. It's no coincidence that the UK is a hotbed of innovation in some of the key industries shaping all of our futures, such as life sciences, healthcare, fintech, and deeptech.

Of course, while unicorns grab headlines and are a strong selling point for VCTs, by their very nature those exceptional companies will always be one-offs. The greater selling point for VCTs, in my view, is the collective good they contribute to society, using capital to lay the foundations for longer-term prosperity. VCT investing is about balancing high risk with high reward, but it's also about investing in potential, and turning failure into success. In difficult times, there's nothing more important.

The VCT landscape

Purpose

Venture Capital Trusts (VCTs) are specialised investment companies. VCTs must be listed on a UK recognised Stock and all current VCTs are listed on the LSE. The government grants various tax reliefs to VCT investors to encourage investment into portfolios of small and medium-sized enterprises (SMEs) in the UK. SMEs are recognised as vital contributors to economic growth and job creation. They are generally deemed to be risky investments and therefore the government offers incentives to investors in VCTs in the form of tax advantages.

The VCT scheme is not a tax avoidance scheme that operates by taking advantage of legal loopholes. It is a statutory scheme that uses tax reliefs to incentivise investors to invest in a vital part of the UK economy.

£10.8bn
invested into VCTs

1995 2022

Types of VCT

VCTs commonly fall into THREE broad categories:

GENERALIST - investing in unquoted companies across a range of sectors;

SPECIALIST SECTORS - for example, technology or healthcare;

AIM - shares listed on the Alternative Investment Market.

The investment strategies employed by VCT managers differ and we will discuss the different types in more detail in further sections.

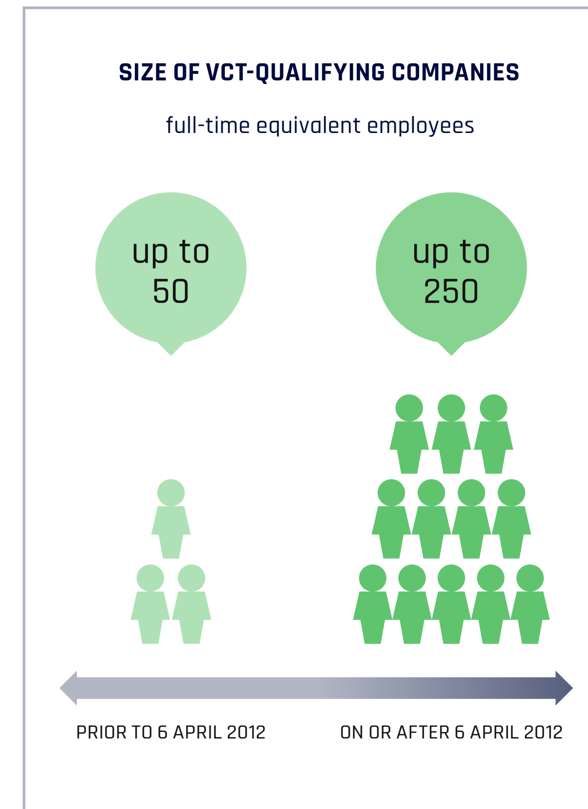
History and main developments

VCTs were first announced in the November 1993 Budget and, following a short consultation, introduced in the Finance Act 1995 to stimulate investment in small businesses.

Since then, close to £11 billion has been raised by VCTs and today there are typically more than 30 VCTs raising funds in any given year. This is widely seen as a great success and the scheme has enjoyed the support of successive governments.

The majority of changes that have been introduced to the rules governing VCTs, have been made with the intention of ensuring the schemes continue to support high growth companies.

The scheme was expanded in 2011 and 2012 to allow greater levels of investment into larger companies.



Further changes to the VCT scheme were made in 2015 to ensure that the VCT reliefs continued to comply with EU State Aid rules. Overlapping with changes made to EIS qualification, these changes had the effect of restricting the types of companies that qualify for VCT investment.

In the Finance Act 2016, changes were made with regard to the permitted non-qualifying investments a VCT can make, limiting such investments to a narrower list of permitted investments required only for liquidity management purposes (including short-term deposits and shares or securities acquired on a European regulated stock market).

In addition, and in line with similar rules introduced for EIS and SEIS, it was announced in the Autumn Budget 2017 that the 2017/18 Finance Bill would include a new ‘principles based approach’ to identify lower risk activities that should not benefit from the tax reliefs. The ‘risk-to-capital condition’ applies to investments made on or after 15 March 2018.

The Autumn Budget 2017 also included a welcome boost for VCT investments into knowledge-intensive companies. Knowledge-intensive companies (explained in greater detail in later sections) are those which are carrying out significant levels of research and development (R&D); these can qualify for higher amounts of VCT (and EIS) funding than other companies.

The government remains supportive of the Enterprise Investment Scheme and Venture Capital Trusts and sees the value of extending them in the future."

AUTUMN STATEMENT, NOVEMBER 2022

None of these recent changes should be interpreted as the government changing their support of VCTs and the associated tax reliefs. However, it should be noted that some of these targeted changes result in a greater proportion of VCTs’ funds being invested in smaller, higher risk trading companies. In meeting these requirements, VCTs also hold lower amounts of cash and liquid resources.

Risks and rewards

Investments into unquoted small and medium-sized enterprises are deemed high risk. The value of smaller companies can rise and fall more sharply than that of more established businesses and investment returns will typically be more variable.

It is important to understand the key risks associated with VCT-qualifying investments in a general sense, and we will examine some of those risks here. However, each individual VCT will have its own unique risks and, therefore, each VCT must be individually assessed.

Investment risks

Statistically speaking, smaller companies fail more often than larger, more established ones. The reasons for this include:

- They may be more reliant upon a small number of customers.
- They have less capital available to withstand a downturn in fortunes.
- They can take a long time to bring new initiatives to fruition and become profitable.
- Where they are listed on AIM, they can experience significant share price volatility.

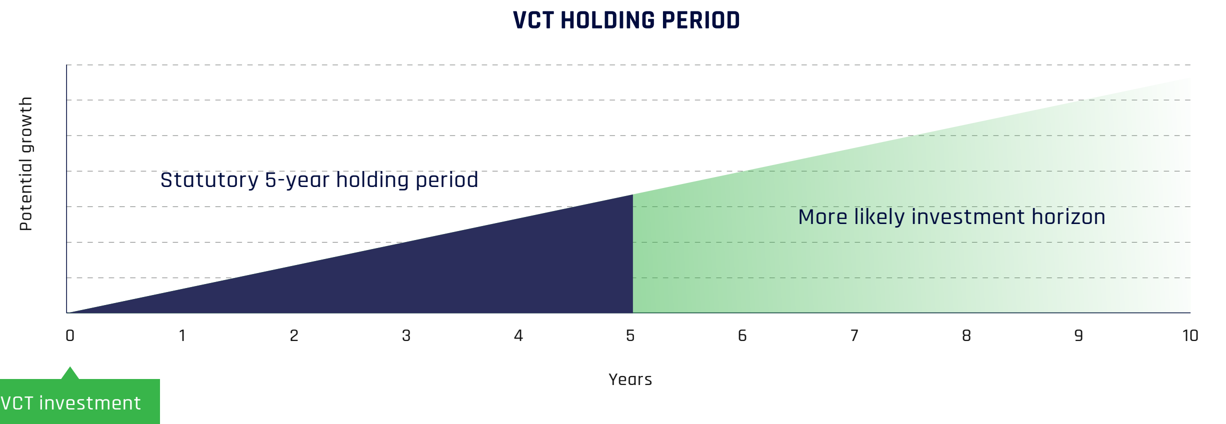
These risks can be offset to some extent by measures, including: skilful stock selection and sufficient diversification; and, where possible, investing in more mature companies with existing customers and assets (to the extent that this is permissible under the 'risk-to-capital' condition), or by a combination of both of these strategies. VCTs can use gearing (borrowing money to invest), which can magnify risks (as well as returns). However, the use of gearing within VCTs is extremely rare.

Liquidity

VCTs are investment companies and investors can sell their shares on whichever market the VCT is listed on. In addition, up to 20% of the VCT's assets (up to 30% for accounting periods ending before 6 April 2019) may be held in cash, or certain other liquid assets. However, liquidity can still be problematic. VCTs' shares are not widely traded and they usually trade at a discount to their Net Asset Value (NAV).

VCT managers do often offer share buyback schemes to enable divestment, but these are usually at a discount to the underlying asset value and are not guaranteed.

Although the minimum holding period to qualify for and retain income tax relief is at least five years (note, there is no minimum holding period for Capital Gains Tax (CGT) disposal relief and tax-free dividends – although these are subject to the permitted maximum), in reality investors are likely to have to commit their funds for much longer;



most VCT investments should be viewed on a five to ten-year investment horizon.

Some VCTs were previously positioned as 'limited life' or 'planned exit' and had an objective of winding up as soon after the five-year minimum holding period as possible. However this was still subject to being able to successfully dispose of the qualifying investments (without there being any arrangements in place to sell the assets from the outset, which would impede qualification for the tax reliefs).

Tax risks

In order to qualify for the tax reliefs, VCTs must follow a number of rules. The rules govern:

- The types of investments that they make;
- How much cash they can retain within the fund;
- How quickly they have to deploy any funds they raise.

If the VCT breaches any of these rules, it may lose its approved status and investors would risk having their tax relief withdrawn and clawed back by HMRC.

The specific rules will be explained further in the 'Rules for VCTs' section which starts on page 17.

Regulatory risk

VCTs that meet all the qualifying conditions are approved by the Venture Capital Relief Team on behalf of HMRC.

VCTs are either fully approved (once established) or provisionally approved (for new VCTs) by HMRC.

Loss of VCT approval is extremely rare, but for completeness, if a VCT loses its approval:

1. HMRC may claw back any income tax relief if the VCT loses its approval within five years of the share issue, or at any time if the VCT was only provisionally approved;
2. All dividends paid by a VCT with provisional approval will be treated as if they were never exempt from income tax, and HMRC may claw back the tax due;
3. Any VCT shares whose disposal would ordinarily have been exempt from CGT will lose that exemption.

There is more on the various conditions that VCTs have to meet in the 'Rules for VCTs' section on page 17.

The permitted maximum

Investors can purchase as many shares in VCTs as they like, in either new share issues or in the secondary market. However, there is a limit on how many of those shares will qualify for the tax reliefs. That limit is known as the permitted maximum and is currently set at £200,000 worth of VCT share purchases a year, including purchases of newly-issued shares and purchases in the secondary market.

The permitted maximum was £100,000 up to the tax year 2003-04. Therefore, this limit needs to be used when calculating the value of tax reliefs relating to VCT shares purchased prior to April 2004.

This means that it is perfectly possible to build up a portfolio of tax-advantaged VCT shares in excess of £200,000, provided that no more than £200,000 of shares were purchased in any single year.

Note: There is no income tax relief for VCT shares purchased on the secondary market.

Rules when the permitted maximum is exceeded

If the permitted maximum has been exceeded, when calculating which shares to claim reliefs on, it is NOT possible to choose which shares will be treated as acquired in excess of the permitted maximum (and therefore do not attract any reliefs).

Instead, shares acquired earlier in the tax year count towards the permitted maximum first. The basic rules are:

- The annual limit applies to all the taxpayer's acquisitions in VCTs in the tax year concerned;
- Shares acquired earlier in the tax year count towards the permitted maximum first;
- Shares in different VCTs or different classes of ordinary share in the same VCT, acquired on the same day, are identified on a pro-rata basis.

VCT Tax Reliefs Summary

VCT TAX RELIEFS	INCOME TAX RELIEF	TAX-FREE GROWTH (DISPOSAL RELIEF)	TAX-FREE DIVIDENDS
RATE OF RELIEF	Up to 30% of the value of VCT shares subscribed for subject to permitted maximum	100% CGT exemption on disposals of VCT shares subject to permitted maximum	Dividends are not subject to income tax subject to permitted maximum
MINIMUM HOLDING PERIOD	5 years from the acquisition date of the shares in the VCT	None	None
WINDOW OF OPPORTUNITY	Relief can be claimed in the same year as the VCT shares are issued (unlike EIS, there is no carryback of a VCT subscription to a previous year)	Subject to the VCT maintaining its qualifying status, no CGT to pay upon disposal if VCT shares are sold at a gain at any time	Subject to the VCT maintaining its qualifying status, no income tax to pay on dividends paid from VCTs at any time
RELIEF ON SECONDARY MARKET PURCHASES	No	Yes	Yes
MAXIMUM LIMIT	£60,000 based on the annual permitted maximum of £200,000 worth of VCT share purchases in any tax year	Gains on the disposal of ordinary shares in a VCT are not chargeable to CGT providing individuals aged 18 or over acquire ordinary VCT shares (whether by subscription for new shares or otherwise) within the annual permitted maximum	Individuals aged 18 or over who acquire ordinary VCT shares (whether by subscription for new shares or otherwise) are exempt from income tax on dividends in respect of shares acquired within the permitted maximum
FURTHER CONSIDERATIONS	Maximum limit includes purchases of newly-issued shares and purchases in the secondary market	Losses made on disposals of shares in VCTs cannot be used to offset gains made elsewhere when calculating an investor's CGT liability	Investors who receive exempt dividends do not have to show them on their tax returns

Income tax relief

VCT investors are potentially able to claim a reduction in their income tax bill of 30% of the cost of the VCT shares they have purchased, up to the permitted maximum of £200,000 worth of shares in any tax year. The reduction is applied to the investor's income tax bill in the same tax year as the shares are issued. However, unlike EIS, there is no carry back of a VCT subscription to a previous year.

POINTS TO NOTE:

An investor's overall income tax liability cannot be negative (i.e. it is not possible to claim relief on tax that hasn't been paid or isn't due to be paid).

Example

A client who purchased the maximum £200,000 of VCT shares would be entitled to claim up to £60,000 of income tax relief (£200,000 x 30%).

If the client only paid £30,000 of income tax , £30,000 of that potential relief would be lost (£60,000 - £30,000). Leftover income tax relief cannot be carried back or forward.

In this case the client could have invested £100,000 in VCT shares and still have reduced their income tax bill to zero.

The minimum holding period to retain the income tax relief is five years, starting from the date of the share issue. It ends on the fifth anniversary of the date of the share issue. If an investor disposes of their shares prior to the end of the five-year period, HMRC claws back the income tax relief.

Example

A client subscribes for £100,000 of VCT shares and receives £30,000 income tax relief. If the client was to then sell those shares for £150,000 within five years, HMRC would claw back the full £30,000.

The only cases when it might make sense to sell shares within the five-year period, are when the sale proceeds exceed any clawback of income tax relief.

If all shares are disposed of at a loss within five years, the clawback will be equivalent to the sale proceeds multiplied by 30%.

Example

Assume a client buys £100,000 of VCT shares and receives £30,000 income tax relief. If the client was to then sell those shares for £34,000 within five years, HMRC would claw back £10,200 (£34,000 x 30%).

If some of the shares are disposed of at a loss within five years there is a slightly more complex formula.

Example

Assume a client buys 100,000 VCT shares for £100,000 and receives £30,000 income tax relief. If the client then sold 10,000 of those shares for £2,000 within five years, the clawback would be the smaller of:

- *the relief given on shares disposed of (£30,000 x 10,000 / 100,000 = £3,000 in this example).*
- *the consideration received x 30% (£2,000 x 30% = £600 in this example).*

In this example the relief to be withdrawn is therefore £600.

If shares are disposed of other than at arm's length (a normal commercial transaction between two or more persons that does not favour one or other of the parties i.e. there is no collusion between the buyer and the seller) all the relief given in respect of the shares disposed of is withdrawn.

Clawbacks

The clawback can never be more than the amount of the initial income tax relief (subject to any interest that may be due). If the shares are disposed of at a gain within five years, HMRC will claw back the full amount of the tax relief received. HMRC will claw back income tax relief by raising a special assessment for the tax year in which the relief was obtained.

Transferring the shares to a spouse or civil partner within the five-year period does NOT trigger a clawback of income tax relief, but transferring the shares to any other third party does. There is no clawback if the disposal or transfer is a result of the investor's death.

Brand new shares

To qualify for income tax relief the client must subscribe, pay for and be issued brand new shares in a VCT. Secondary purchases, either purchased on an exchange or arranged privately, do not qualify for income tax relief.

Tax-free dividends

Dividends issued by VCTs are exempt from income tax and investors who receive exempt dividends do not have to show them on their tax returns. There is no minimum holding period for this relief, and it applies to both subscriptions for newly-issued shares and purchases of shares in the secondary market. However, the exemption from income tax on dividends is subject to the permitted maximum.

Example

A client with a £250,000 portfolio of VCTs that yielded 5% would be entitled to £12,500 tax-free income annually (provided that no more than £200,000 of VCT shares had been purchased in any single tax year).

Tax-free growth (disposal relief)

Disposals of VCT shares are not subject to CGT as long as the company was a VCT both when the investor acquired the shares and when he or she disposed of them, and they are aged 18 or over at the date of disposal. There is no minimum holding period for this relief, and it applies to both subscriptions for newly-issued shares and purchases of shares on the secondary market. However, disposal relief is subject to the permitted maximum.

Example

A client purchases £50,000 of VCT shares and then sells them for £75,000 six years later. Conventional shares would have attracted £5,000 CGT (ignoring any annual allowances and applying the higher CGT rate of 20%), but shares in VCTs are CGT exempt.

Losses made on disposals of VCTs cannot be used to offset gains made elsewhere when calculating an investor's total annual CGT.

Comparison: EIS and VCT tax reliefs

There are some notable differences in how the tax reliefs available with VCTs compare to those available through EIS (the other major tax-advantaged venture capital scheme in the UK).

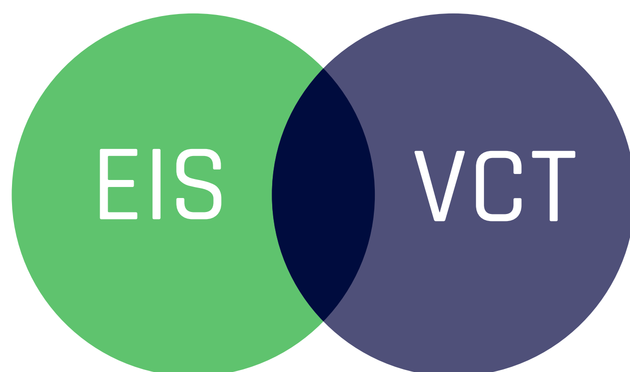
- Income tax relief is subject to a five-year minimum holding period with VCTs, compared to three years with EIS (although the investment horizon is likely to be five years or more).
- Unlike EIS, VCT investment cannot be carried back to previous tax years.
- There is no loss relief, CGT deferral relief or IHT relief with VCTs.
- VCTs can pay dividends tax-free, EIS cannot.
- Both VCTs and EIS investments are not subject to CGT on capital gains made, (subject to certain conditions).

With a VCT, income tax relief is claimed at the point at which the shares are issued by the VCT. This is also treated as the starting point for the minimum holding period. In an EIS company investment, the minimum holding period starts when the shares are subscribed for and income tax relief can be claimed as soon as the company has issued an EIS3 certificate to the investor.

From a risk perspective, the biggest difference between EIS and VCT is that VCTs generally operate a much bigger pool of investee companies, giving increased diversification and limiting investment risk.

Secondly, as they are listed on a recognised exchange and hold more liquid assets than EIS funds (at least 20% of a VCT's funds are not required to be invested in qualifying holdings), VCTs have increased liquidity.

For these reasons, a VCT would usually be viewed as a less risky investment than an EIS company or fund.



VCT and EIS comparison

	VCT[1]	EIS portfolio/fund[1]
INCOME TAX RELIEF	30%	30%
MINIMUM TERM	5 years	3 years
LIKELY INVESTMENT HORIZON	5 - 10 years	5 - 10 years
MAXIMUM ANNUAL INVESTMENT ELIGIBLE	£200,000	£1m plus £1m carry back*
DIVIDENDS	Tax exempt	Taxed
CAPITAL GAINS	Tax exempt	Tax exempt
CGT DEFERRAL	No	Yes
LOSS RELIEF	No	Yes
IHT RELIEF	No	100% after 2 year holding period
DIVERSIFICATION	30 - 60 companies	4 - 15 companies
LIQUIDITY	Up to 20% (for accounting periods ending on or after 6 April 2019), of the VCT's assets may be held in cash**	There is no large-scale active secondary market*** in unquoted shares
TARGET DEPLOYMENT TIMELINE FOR FULL INVESTOR SUBSCRIPTION	1 - 6 months unless there are fixed allotment dates for each tax year	12 - 24 months

[1] Subject to conditions being met.

* From 6 April 2018, maximum £2m where at least £1m is invested in knowledge-intensive companies.

** VCT managers do often offer share buyback schemes to enable divestment, but these are usually at a discount to the underlying asset value and are not guaranteed. VCTs' shares are not widely traded and they usually trade at a discount to their Net Asset Value (NAV).

*** EIS managers do not offer buy-backs. Investors should regard themselves as locked in to the shares until the underlying company lists on a recognised stock exchange, achieves a trade sale, or the company is wound up. AIM listed EIS-qualifying shares have the potential for faster disposal.

The government is committed to ensuring cutting-edge innovative firms have access to finance to invest and grow."

AUTUMN BUDGET, 2022

VCTs after Brexit; the UK Subsidy Control Regime

Since the UK's exit from the European Union, the EU State-aid rules that previously applied to VCTs with the intention of ensuring a level playing field in trade relations within the EU, no longer apply. Those rules defined what constitutes reasonable levels of state aid, or government subsidies for business. The restrictions to qualifying criteria for investee companies and on the level of reliefs available under VCTs, have been at least partially attributed to the EU's intervention in this regard.

In the EU-UK Brexit trade deal the parties take a principles based approach to controlling subsidies, with the UK free to design a system that meets these principles.

Principle C of the UK-EU Trade deal subsidy principles is that, "Subsidies are designed to bring about a change of economic behaviour of the beneficiary that is conducive to achieving the objective and that would not be achieved in the absence of subsidies being provided." Since 4 January 2023, UK subsidies have generally been subject to the new UK subsidy control regime, the framework of which is set out in the Subsidy Control Act 2022 which received Royal Assent on 28 April 2022.

The more permissive nature of the new regime, suggests that changes to encourage more VCT investments are possible, although no attempt has been made to push these boundaries to date.

The new regime replaced the interim rules and involves public bodies making assessments of the compliance of subsidies they award against seven main UK-wide principles. The intention is to ensure that, "support for businesses reflects the United Kingdom's strategic interests and drives economic growth."

The Coalition for a Digital Economy (Coadec, now the Startup Coalition)..., told us that the tax relief schemes [including VCT] had contributed to making UK venture capital competitive internationally."

HOUSE OF COMMONS TREASURY COMMITTEE, VENTURE CAPITAL NINETEENTH REPORT OF SESSION 2022-23

Rules for VCTs

Structure of VCTs

VCTs are specialist investment companies that list their shares on a regulated market. All existing VCTs are currently listed on the LSE.

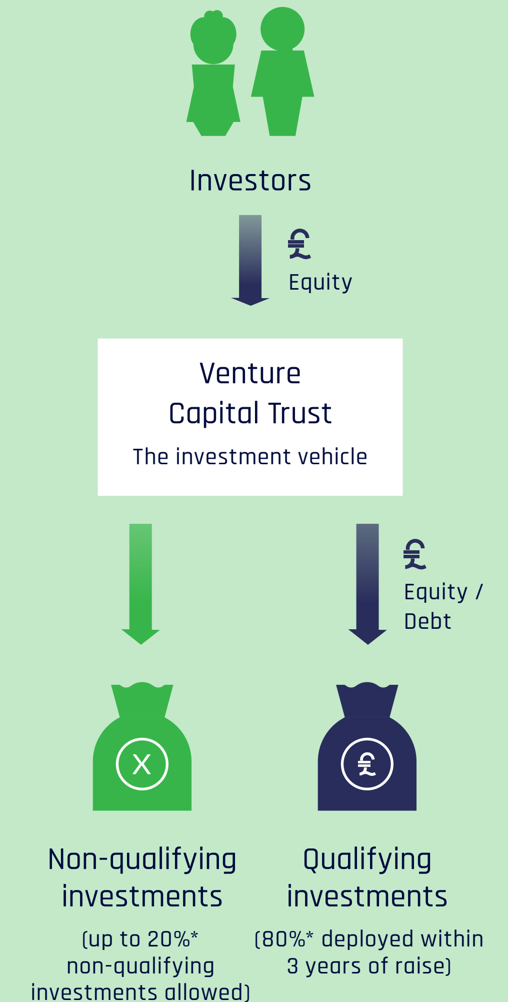
Because VCTs are investment companies, they have a closed-ended structure. This enables the VCT fund manager to take a long-term view and invest in less liquid assets than open-ended structures would normally do, as they do not have to worry about selling assets to meet redemptions.

The flip side to this is that if demand for their shares is low (because the upfront income tax relief is not available when buying VCT shares on the secondary market), then it is likely that they will trade at a discount to their Net Asset Value (NAV).

Many VCTs offer to buy back shares from the investors who originally subscribed for them, at a predetermined discount to the NAV (usually between 5% and 10%).

This helps address the issue of the lack of liquidity in VCT shares and gives investors a potential exit; however the VCT is not obliged to buy back shares and it is not guaranteed. VCTs will typically allocate a budget for buy backs, and may suspend the service if the budget is exceeded.

As investment companies, VCTs also have an independent board of directors who are responsible for looking after the VCT's interests.



*For accounting periods beginning before 6 April 2019 this was 30% and 70% respectively.

In addition, at least 30% of all new funds raised in accounting periods beginning after 5 April 2018 need to be invested in qualifying holdings within 12 months of the end of the accounting period in which the VCT issues its shares.

Investors are shareholders of the VCT itself (not customers of the fund management company as is the case with open-ended funds) and therefore, in theory, they have a say on how the company is run in accordance with their voting rights and company law.

Unlike open-ended funds, VCTs can use gearing (borrowing money to invest), which can magnify both gains and losses. However, the use of gearing is rare. VCTs can also retain some of their profits and pay them out later, which can allow VCTs to "smooth" dividend income.

Fundraising

Bearing in mind the closed-ended structure of VCTs, there are several different types of fundraising that VCTs might engage in.

1. A brand new VCT issuing shares for the very first time. There is no existing portfolio for investors to buy into.

2. A new share class in an existing VCT that will invest in a new portfolio of investments that will be kept separate from the existing portfolio. The investor will only enjoy returns from the assets allocated to that share class. The benefit over a new VCT is that the VCT's performance thus far can be assessed (although the new share class investors won't share in the performance of other VCT share classes, unless they already have an existing holding in the other class or classes) and the VCT's costs can be spread across a larger asset base.

3. Top-up to an existing share class - Investors purchase shares that give them exposure to an existing pool of assets and can immediately start earning dividend income if income is available. The top-up will also spread the VCT's costs across a larger asset base. VCTs do not necessarily raise new money every year, and some VCT fundraises can be relatively small and completed quickly.

OPEN VCTS INVESTMENT METRICS

There is a diverse range of sizes among VCT investments.

It is difficult to plot a correlation between a VCT's target fundraise and other characteristics as, the varying fundraising capabilities of the managers must be taken into account.

Typically, the majority of open VCTs do not have a sector bias and invest in General Enterprise, although there are VCTs that focus on specific trades, such as Technology.

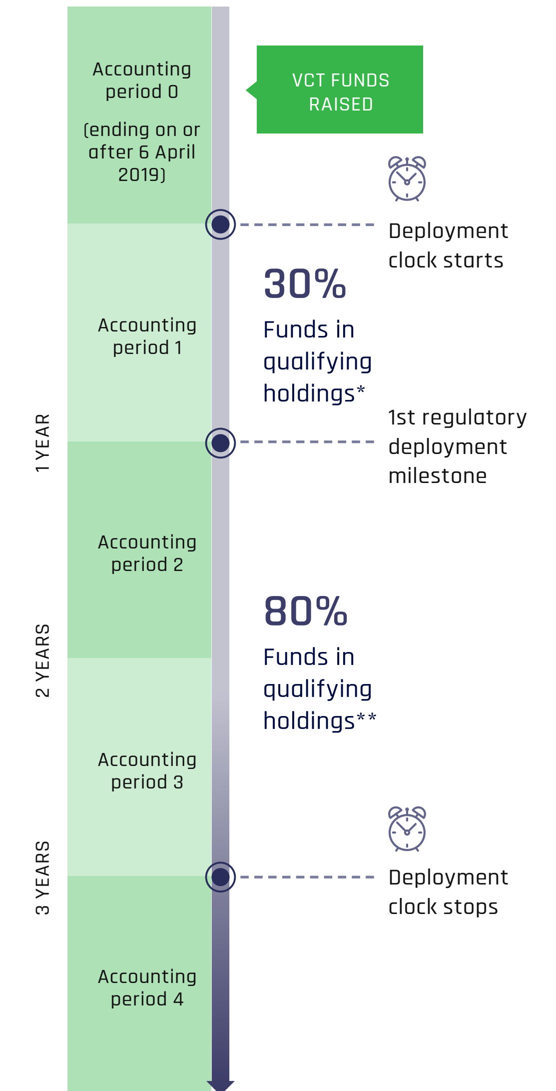
VCT investors have a range of different attitudes to risk. Almost half (48%) of respondents to the survey consider themselves as medium-high risk investors and a further 14% say they are high-risk investors. However, 28% of VCT investors classify themselves as medium-risk and 10% cautious."

ASSOCIATION OF INVESTMENT COMPANIES, MARCH 2023

Deployment in qualifying holdings summary

- 30% of funds raised by VCTs need to be invested in qualifying holdings within 12 months of the end of the accounting period in which the funds were raised, for accounting periods beginning after 5 April 2018.
- For funds raised in accounting periods beginning on or after 6 April 2019, 80% of funds must be held in qualifying companies by three years from the end of the accounting period in which the funds were raised.
- Previously VCTs were allowed to invest less of the funds raised into qualifying companies and to hold more cash and liquid resources.
- During the period that the new money raised is not invested in qualifying holdings, it is usually invested in cash, certain short-term deposits, listed shares and securities (including investment trusts) until funds can be deployed in suitable qualifying companies.

Timing of deployment



*For all new funds raised in accounting periods beginning after 5 April 2018.

**For funds raised in accounting periods beginning on or after 6 April 2019.

Rules governing portfolio construction

There are a number of rules governing portfolio construction for VCTs. VCTs must:

1. Derive their income wholly or mainly from shares and securities.

2. NOT retain more than 15% of the income from shares and securities.

3. NOT hold an investment in a company that exceeds 15% by value of the VCT's total investments.

4. Have at least 80% of their investments in qualifying trading companies (for VCT accounting periods ending before April 2019 this percentage was 70%).

5. NOT make an investment in a company that causes that company to receive:

   more than £5m of State-aided investment (which includes EIS and VCT investment) in the 12 months ending on the date of the investment (this increases to £10m for qualifying knowledge-intensive companies (more details are available on knowledge-intensive companies on page 27) from 6 April 2018); or

   more than a lifetime total of £12m (£20m for a knowledge-intensive company).

6. In general, NOT invest in a company whose trade is more than seven years old (ten years for a knowledge-intensive company).

7. Only make minority investments (less than 50%) in investee companies.

8. NOT invest in a company that goes on to use the VCT funds to acquire another company or business.

9. VCTs must only invest in:
   - Qualifying holdings (i.e. unquoted where "unquoted" means not quoted on a recognised investment exchange, for example the Main Market of the LSE, meaning that companies quoted on AIM can be VCT qualifying investments) in or qualifying trading companies that meet certain conditions;
   - certain permitted non-qualifying holdings (cash and short-term deposits, allowed for liquidity management purposes, together with listed shares and securities).

At least 10% of a VCT's investment in a company must be in "eligible shares" (broadly, ordinary shares that don't carry any present or future preferential rights).

The remainder of a VCT's investment in a company can comprise any class of shares (even preference shares) or loans. However, loans must not be secured or guaranteed, be repayable within five years (other than in default situations) and must be at a commercial rate of interest.

The qualifying trading companies in which VCTs invest must also meet a number of detailed rules, as described on page 25.

A trade is NOT a qualifying trade if it consists of certain 'excluded activities'. Excluded activities are explained further on page 25.

Returning capital to shareholders

A VCT must NOT return capital to shareholders within three years of the end of the accounting period during which the shares were issued. If it does, this is a prohibited payment and could result in the VCT losing its qualifying status.

In addition, certain arrangements that previously allowed investors to sell and then buy back shares in the same VCT, thus qualifying for another round of tax relief, are now excluded.

If an investor buys shares within six months of a disposal of shares in the same VCT, the shares will not qualify for a new round of tax relief. This applies whether the disposal takes place before or after the purchase of shares in the same VCT.

"Over the last two tax years, VCT fundraising has topped £1 billion both times. That money is being invested into ambitious early-stage UK companies, creating new job opportunities, fostering world-class innovation, and contributing significantly to the UK's economic growth overall." **JACK ROSE, HEAD OF SALES, TRIPLE POINT**

Timeline of share acquisition and disposal in a single VCT by a single investor

Qualifying companies

Introducing the rules

To ensure that VCTs are meeting their objective of financing small to medium-sized businesses struggling to obtain investment from other sources, there are stringent criteria that govern whether a company and its proposed share issue is a qualifying investment for a VCT. These criteria change from time to time.

A VCT may well have a portfolio of existing investments that would not currently qualify if being made as new investments (such as renewable energy investments, hotels and care homes) and such investments are effectively 'grandfathered' from the current rules (although no new investments in such trades can be made by the VCT).

This section sets out the rules as they stand today and also details some of the most recent changes.

Risk-to-capital condition

Announced at the Autumn Budget 2017, the risk-to-capital condition applies to all investments made on or after Royal Assent of the Finance Act 2018 on 15 March 2018. However, HMRC has applied the test for all advance assurance applications submitted from December 2017.

From this point, HMRC has declined to provide advance assurances for investments that appear likely to fail the risk-to-capital condition.

The government is keen to stress that the Venture Capital Schemes are intended to support early-stage, entrepreneurial companies that have the potential to grow in the long term. The company must be set up to carry out trade on an ongoing basis, not to carry out a single project before being wound up.

The conditions were implemented following the government's 2017 consultation, 'Financing growth in innovative firms'. The conditions are intended to exclude tax-motivated investments, where the tax relief provides most of the return for an investor or with a limited risk to the original investment (that is, preserving an investor's capital).

The condition depends on HMRC taking a 'reasonable view' on all relevant factors in the round, as to whether an investment has been structured to provide a low risk return for investors.

THE RISK-TO-CAPITAL CONDITION HAS TWO PARTS:

1. Whether the company has objectives to grow and develop over the long term (which broadly mirrors an existing test with the schemes); and

2. Whether there is a significant risk that there could be a loss of capital to the investor of an amount greater than the net return.

The legislation contains a non-exhaustive list of the factors that may be considered. Even if one or more indicators of potential capital preservation are present, this does not necessarily mean that the risk-to-capital condition will not be met in a particular case.

A judgement about whether capital preservation activity is taking place will depend on the overall context of the investment.

Likewise, even if none of the indicators listed in the legislation are present, the risk-to-capital condition may NOT be met if the wider circumstances of a case suggest that capital preservation is taking place.

Ultimately, a judgement will depend on the level of risk posed to investors' capital and whether the company has genuine intent to grow and develop in the long term.

The risk-to-capital condition sits above the other existing eligibility requirements for the venture capital schemes. Even if the condition is met, all other requirements must also be met for an investment to be eligible for tax relief under the schemes.

Examples how risk to capital condition applies

With the rule changes , a VCT may well have a portfolio of existing investments that would not currently qualify if being made as new investments. of what would and would not curTo the right are some illustrations of how the risk to capital condition has impacted the eligibility criteria of VCT investments.

The UK has a strong track record in very early-stage seed investment. This feeds the pipeline of growing companies which go on to attract venture capital funding and eventually float, and provides a rich ecosystem of diverse innovation which allows the next generation of ideas to be identified and to flourish. This ecosystem has been very substantially supported by tax incentives – in particular the Seed Enterprise Investment Scheme (SEIS), the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs)."

CHRIS PHILP MP, MINISTER FOR TECH AND THE DIGITAL ECONOMY, DEPARTMENT FOR DIGITAL, CULTURE, MEDIA AND SPORT

X **Example 1:** Unlikely to meet risk to capital condition

A company is set up and finds investment to build a property and contracts subcontractors to carry out the trading activities for which the building will be used. As soon as the qualifying holding period ends, the company will sell on the building and trade to a previously identified buyer.

The investors are funding the creation of an asset that has intrinsic value which is not intended to be used as a substantial part of the company's continuing trade and was always intended for sale. This signifies a lower risk profile than VCTs generally target.

X **Example 2:** Likely to meet risk to capital condition

Postgraduate students set up a company to exploit their research, which they expect will eventually have wide commercial value. Their plans are high risk, long term and the company has no track record, but they need to acquire their own laboratory and technician to start working and expand.

The entrepreneur directors want minority investment to increase their employee numbers with long term plans to grow and develop a new product which will be the company's main trade. There is significant risk for the VCT investors in the company as there is no certainty at the time of their investment that a commercial product can be developed or will be successful.

Thought Leadership

TIME TO BROADEN THE HORIZON FOR VCT PLANNING?

JACK ROSE
HEAD OF SALES, TRIPLE POINT

With the changes to pension allowances earlier this year, some advisers could be questioning whether VCTs are still a suitable fit within their client bank. However, it's still possible to use VCTs to help clients solve a number of other financial planning challenges. It might therefore be worth taking another look and asking the following questions.

Do you have clients with rental properties?

There are some 2.7 million landlords in the UK, it is likely that you have several clients who – alongside their pensions – have invested in property to help fund their retirement. But many landlords have a dilemma, as their rental income results in an income tax burden, it can't be put into their pension, and selling the property would trigger an unwelcome capital gains tax bill.

Those clients might therefore be interested to know that unlike pension contributions, VCT income tax relief can be offset against any income tax, including earnings from property.

Do you have clients with shorter-term financial commitments or goals?

One of the biggest drawbacks some clients have with making large pension contributions is that they have to wait until turning 55 before they can access some of their pension pot. And while many VCT investors are in retirement, high-earning younger clients may not be willing to tie up more money for another 10-20 years, especially if they have impending short-term needs.

There's also another important aspect to consider when it comes to taking large sums out of pensions. Although the lifetime allowance (LTA) has been removed, the maximum tax-free lump sum is still frozen at £268,000 (25% of the previous LTA). Some clients may therefore be disappointed when they discover as they near 55 that more of their cash is tied up in their pension than they had expected.

While encouraging clients to increase their pension contributions is obviously a good thing, a VCT could offer a more flexible solution. It gives them the opportunity to claim income tax relief on their investment and participate in the growth potential of early-stage companies – helping them to meet their shorter-term life planning goals without having to wait until retirement before seeing their money again.

Do you have clients paying tax on pension drawdowns?

Some of your retirement-age clients may have found it sobering when they first learned that the money withdrawn from their pension savings as flexible income (aka drawdown) counts as ordinary income and is taxed 'on the way out' again.

But for clients in this situation, the VCT income tax relief can be used to reduce the tax paid on their pension drawdowns, while also offering them a potential regular tax-free income in the form of VCT dividends. And by making recurring investments into VCTs annually, it's possible for pensioner clients to take care of their income tax liability and become non-taxpayers for life – something many clients who feel aggrieved at paying tax on retirement income will likely thank you for!

Rather than imposing restrictions, regulatory changes can often highlight new opportunities to demonstrate the value of proper financial advice. Last year's pensions changes are no exception. As the above examples demonstrate, recommending VCTs to your client bank hasn't got harder, it's just a question of discussing the advantages of VCTs with clients that have different problems to solve.

https://vct.triplepoint.co.uk

IMPORTANT INFORMATION: Investors' capital at risk. Tax treatment depends on the individual circumstances of each client and is subject to change. Tax reliefs depend on the VCT maintaining its qualifying status. This article has been approved by Triple Point Administration LLP, which is authorised and regulated by the Financial Conduct Authority no. 618187, of 1 King William Street, London, EC4N 7AF.

Rules governing the size and type of company

There are rules which set out in detail the criteria for firms that wish to issue VCT-qualifying shares. In summary, a qualifying company must:

1. NOT be in financial difficulty*
2. Be unquoted (however, the AIM market is not a recognised exchange for this purpose).
3. NOT control another company which is not a subsidiary of the company; and it cannot itself be controlled by another company and there can be no plans in place at the time of the share issue that would jeopardise this independent status).
4. Have a permanent establishment in the UK (the company does not need to be a UK company, however).
5. Have fewer than 250 employees (or 500 for a knowledge-intensive company).
6. Have gross assets under £15m immediately before shares are issued and under £16m immediately after shares are issued However, the company can continue to grow afterwards.
7. Not have been trading for more than seven years (ten years for a knowledge-intensive company) unless specific conditions are met.
8. Be operating in a qualifying trade, preparing to trade and commence trade within two years, or conducting research and development. Most trades qualify, however, there are a number of exclusions:
    - Dealing in land, commodities, futures, securities or financial instruments (including investment activities)
    - Dealing in goods other than normal retail or wholesale distribution
    - Banking, insurance, hire purchase, money lending, and other financial activities
    - Leasing
    - Receipt of royalties or licence fees
    - Legal and accounting services
    - Property development
    - Farming and market gardening
    - Forestry
    - Operating or managing hotels or residential care homes
    - Coal production, steel production and shipbuilding
    - All energy generation activities (from 6 April 2016)

! Excluded activities must not be a 'substantial' part of the company's trade. HMRC take 'substantial' to mean more than 20% of the company's trading activities.

*HMRC's interpretation of the fnancial health requirement requires consideration of whether a company which has been trading for more than seven years and has lost more than half of its subscribed share capital. Since adjusted HMRC guidance in December 2022, this requirement will only be applicable for companies outside their 'initial investing period'. For 'knowledge intensive companies' the 'initial investing' period is ten years, and for other companies the 'initial investing period' is seven years. This ensures that knowledge intensive companies that are between 7 and 10 years old meet the fnancial health requirement.

Rules governing the raising and spending of funds

There are rules governing the amounts that qualifying companies can raise and how quickly that money must be deployed within the business.

The funds raised by the issuance of VCT-qualifying shares must be employed by the issuing company, or by a qualifying subsidiary which is at least 90% owned by the company, within two years of the share issue.

The funds must be used either for carrying on a qualifying trade, or for preparing to carry on a qualifying trade which is then begun within two years of the share issue. They cannot be used to acquire the shares, goodwill or intangible assets of another company, even if that company is carrying on a qualifying trade.

In calculating the maximum amounts that can be raised, funds raised from any of the UK's tax-advantaged venture capital schemes must be counted. The FOUR schemes are:

- The Enterprise Investment Scheme
- The Seed Enterprise Investment Scheme
- Social Investment Tax Relief
- Venture Capital Trusts

In addition, any other relevant approved risk finance State Aid must also be counted. This includes Enterprise Capital Funds and certain Regional Development funding.

12-MONTH INVESTMENT RAISE LIMIT	£5m
12-MONTH INVESTMENT RAISE LIMIT (KICS)	£10m

The maximum amount that a firm can raise from tax-advantaged venture capital schemes and any other form of risk finance State Aid in any 12-month period is £5 million (although for investments made on or after 6 April 2018, the 12-month maximum amount of funding that knowledge-intensive companies can receive increased from £5 million to £10 million).

LIFETIME INVESTMENT RAISE LIMIT	£12m
LIFETIME INVESTMENT RAISE LIMIT (KICS)	£20m

The maximum amount that a firm can raise from tax-advantaged venture capital schemes (and risk finance explained above) cumulatively over the firm's entire lifetime is £12 million (or £20 million for a KIC).

Knowledge-intensive companies

Knowledge-intensive companies (KICs) are considered to be a special case and more generous rules apply. Broadly, these are:

- In at least one of three years prior to investment, the company or group has spent at least 15% of operating costs on research and development or innovation; or
- In each of those three years it has spent at least 10% of operating costs on research and development or innovation;
- either of the following conditions is also met:
  1. The **'innovation condition'** – When the relevant shares are issued, the company is engaged in the creation of intellectual property from which, within 10 years, it is expected, will derive the greater part of the company's or group's business.
  2. The **'skilled employee condition'** – At least 20% of the company's employees are 'skilled' and are engaged directly in research and development or innovation activities carried on by the issuing company or any qualifying subsidiary of that company. The definition of 'skilled' relies on higher educational attainments.

Since 6 April 2018, knowledge-intensive companies have been able to choose whether to use the current test of the date of first commercial sale or the point at which turnover reached £200,000 to determine when the 10-year period has begun.

What is research and development?

R&D for tax purposes takes place when a project seeks to achieve an advance in science or technology.

The activities which directly contribute to achieving this advance in science or technology through the resolution of scientific or technological uncertainty are R&D.

Certain qualifying indirect activities related to the project are also R&D.

More generous rules for knowledge-intensive companies

10YRS	£20m	499	£10m
AGE LIMIT	LIFETIME CAP ON TAX-ADVANTAGED VC	EMPLOYEE LIMIT	12-MONTH RISK CAPITAL FUNDING LIMIT

Advance assurance

Companies can apply to HMRC in advance of issuing shares to a VCT to check that the proposed share issue meets the qualifying criteria for VCT purposes and that, once issued, the investment will be regarded as a 'qualifying holding' for the VCT.

Requests for such assurances are made to the Venture Capital Reliefs Team (VCRT) of HMRC.

The advance assurance service is discretionary and non-statutory. There is no requirement for a company to obtain an advance assurance before receiving an investment or issuing shares to investors.

The advance assurance service allows the company to provide information about its intentions; about its structure and activities, about the proposed investment and about how the monies raised will be used.

As mentioned, there is no obligation upon firms to go through this advance assurance process, but it does provide an opportunity to spot any problems before the shares are issued and an assurance from the VCRT is useful for companies to show to potential investors.

Advance assurance is NOT a guarantee that a share issue qualifies or that the company will continue to qualify. If something important was not disclosed to the VCRT or, if between receiving advance assurance and the share issue something changes, it may be that the share issue or company is no longer qualifying.

However, if nothing has changed, advance assurance is normally considered binding on HMRC (although VCT tax reliefs are also subject to the circumstances of the individual investor, which HMRC will not opine on in advance).

Nevertheless, most VCT investments are now made without seeking advance assurance. This is HMRC's preference as stated in Venture Capital Manual VCM60410: "In general, companies seeking an investment from a VCT should not need an advance assurance from HMRC. VCTs should be able to rely upon their professional advisers to determine if a prospective investment is qualifying or not." And "Provided that the VCT has taken reasonable steps [like consulting a professional adviser] HMRC will not withdraw approval from the VCT if the investment subsequently turns out to be non-qualifying. HMRC will accept that the breach was outside the control of the VCT."

From early 2018, HMRC has declined to consider speculative applications. Confirmation of who the likely investors are is required before HMRC will give an opinion. If details can't be provided HMRC rejects the application.

HMRC does not identify which companies qualify as knowledge-intensive companies at the time of advance assurance review unless this status is relevant to the proposed investment (for example if the company is raising more than £5 million from VCT investors in a tax year).

Rules for VCT-qualifying companies

	MAXIMUM AGE	7 years unless total investment represents more than 50% of the company's average turnover over the preceding 5 years and the company is using the funds to enter a new product or geographic market, or it received previous risk finance within its first 7 years
	LIFETIME CAP	£12m
	12-MONTH INVESTMENT LIMIT FROM ANY COMBINATION OF VCT, EIS OR CERTAIN OTHER GOVERNMENT INCENTIVES	£5m
	EMPLOYEE LIMIT (FTE)	Fewer than 250 FTE
	THE USE OF VCT MONEY FOR ACQUISITIONS OF BUSINESS	Rules to prevent VCT funds being used to acquire existing businesses or part of a business (including intangible assets that have already been used in a trade)
	CARRY BACK/FORWARD	Income tax relief can only be claimed for the year of VCT investment. Dividend tax relief is automatic in the year of receipt. The same applies to disposal relief, in the year of disposal.
	RISK TO CAPITAL CONDITIONS	A company seeking VCT qualification for a share issue must have objectives to grow and develop over the long term and there must be a significant risk that there could be a loss of capital to the investor of an amount greater than the net return.
KNOWLEDGE-INTENSIVE	MAXIMUM NUMBER OF TRADING YEARS	10 years. From 6 April 2018, a knowledge-intensive company is able to use the date from which its annual turnover exceeded £200,000, instead of the date of its first commercial sale, when determining the date from which the end of the initial investing period is calculated
KNOWLEDGE-INTENSIVE	12-MONTH INVESTMENT LIMIT	£10m
KNOWLEDGE-INTENSIVE	LIFETIME CAP (ALL TAX ADVANTAGED VC)	£20m
KNOWLEDGE-INTENSIVE	EMPLOYEE LIMIT	Fewer than 500 FTE
KNOWLEDGE-INTENSIVE	INNOVATION	A company seeking Knowledge-intensive company qualification must have spent at least 15% on R&D or innovation in at least one of three years prior to investment or at least 10% in each of those three years, and either meet the innovation or skilled employee condition.

Claiming the tax reliefs

Process for claiming income tax relief

VCT income tax relief can be used to reduce or offset any UK income tax liability for the tax year in which the VCT shares are issued (unlike EIS income tax relief, VCT income tax relief cannot be carried back to a prior year).

In any single tax year investors cannot claim more income tax relief than the amount of income tax owed, and investors can only claim tax relief on the first £200,000 invested. Investors should therefore carefully consider the merits of investing more than they need to in order to cover their tax bill in the current year.

Once the shares are issued, the VCT's Registrar will send tax and share certificates to investors.

Investors can then either claim the tax relief:

- by reducing their monthly tax bill through PAYE (if they are employed); or
- via the self-assessment tax return process.

Some VCTs enable regular direct debit subscriptions from investors, spreading the subscription over a period of time. While this reduces 'lump-sum' investments, it will result in multiple tax and share certificates, where shares are allotted on more than one date. This will result in multiple start and end dates for the five year minimum holding period.

To claim through PAYE

Investors can call HMRC but may also need to write a letter to them including their national insurance number, form P60 (if they have one), and a copy of their VCT tax certificate.

To claim via the self-assessment process

Investors need to complete the additional information form SA101 and enter the total value of their VCT investments in the appropriate section of the form.

> Investors in VCTs can claim income tax relief up to four years after the end of tax year of assessment in which they made the investment.

Tax-free dividends

Investors who receive exempt dividends do not have to declare them on their tax returns.

Many VCTs have automatic reinvestment schemes, which allow investors to use the VCT dividend (which is ordinarily tax-free) to buy more shares in the VCT. With some exceptions, usually the shares are newly-issued rather than bought in the market, meaning that the amount reinvested qualifies for 30% income tax relief as a fresh VCT subscription.

Again, this will result in multiple tax and share certificates as the investments of dividends are made and multiple start and end dates for the five year minimum holding period.

Tax-free growth

If disposal relief is due, an investor won't have to pay CGT on any gain made on the disposal of VCT shares. For both tax-free dividends and tax-free growth there are a number of conditions that have to be met, including:

- Relief is limited to acquisitions not exceeding £200,000 worth of VCT shares in any one tax year;
- The investor is an individual (not a trustee);
- The investor is aged 18 or over at the date of disposal.

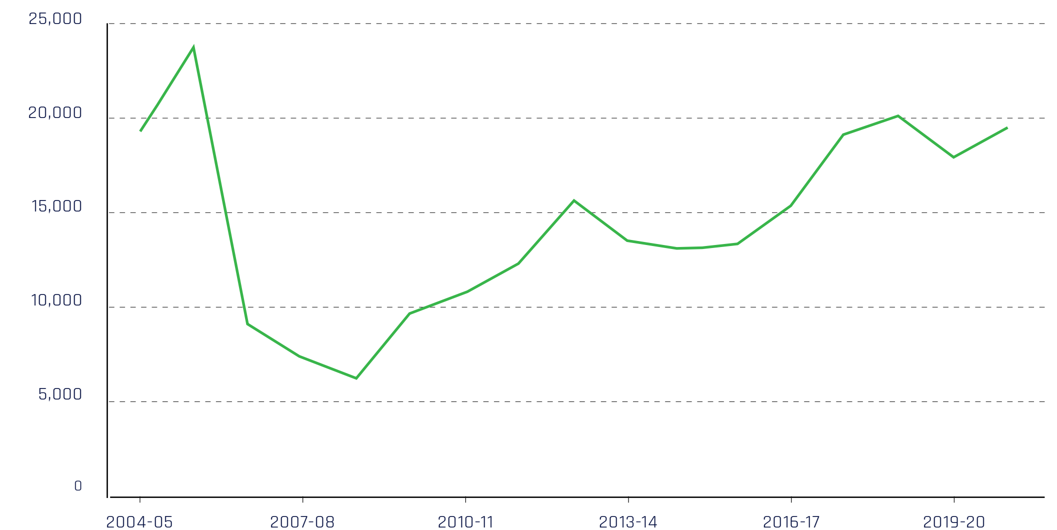
To claim tax-free growth, the company must be an approved VCT both when the shares are acquired and when the investor disposed of them. Any loss made on the disposal of VCT shares isn't allowable for capital gains purposes.

An investor should fill in the Capital Gains Tax summary pages of their self assessment form if:

- they disposed of VCT shares and those shares plus any other assets they disposed of in the 2023/24 tax year were worth more than £50,000, or,
- they disposed of VCT shares and those shares plus any other assets they disposed of produced total chargeable gains before taking off any losses of more than £6,000.

To claim VCT disposal relief, the investor should use code OTH in box 36 on page CG2 in HMRC's Capital Gains Tax summary form SA108, and provide details of the claim in the 'Any other information' box, providing a clear statement that they are claiming VCT disposal relief.

NUMBER OF INVESTORS CLAIMING VCT RELIEF VIA SELF ASSESSMENT, 2004-05 TO 2020-21



SOURCE: WWW.GOV.UK

Interaction with pensions and other wrappers

VCT income tax relief interaction with other investments

VCT income tax relief is limited to an amount that reduces an investor's income tax liability to NIL.

Advisers and clients should be aware that the amount of VCT income tax relief that the investor can claim could be reduced by any other transaction that effectively benefits from income tax relief, such as a Gift Aid payment.

This is because, certain transactions, including Gift Aid payments to charities, for example, are treated as having been made after deduction of income tax. As a result, HMRC requires the donor to have paid enough income tax or CGT in that year to cover the tax the charity can claim from HMRC.

In this scenario, if VCT income tax relief is used to reduce a client's income tax bill to NIL for a year in which that investor has no CGT liability but has made Gift Aid donations, the client may have to pay an additional amount of income tax to cover the amount of tax reclaimed for the year by all the charities to which the client has made Gift Aid donations.

Generally speaking, VCT income tax relief is given before EIS income tax relief and tax advice should be taken as to optimising any claims made (for example, EIS relief could potentially be carried back to a prior year, leaving just VCT income tax relief in consideration for a particular year).

VCTs and ISAs

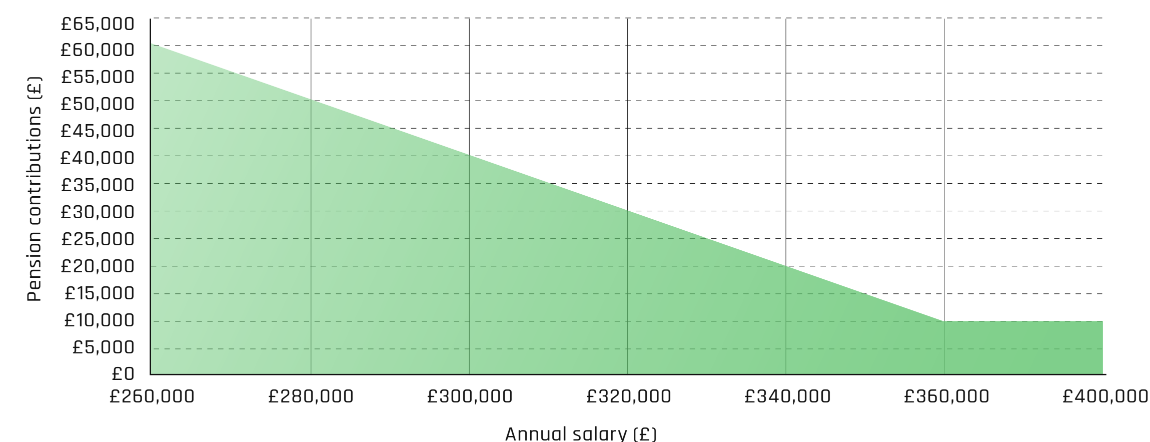
Some VCT providers offer VCT investment via an ISA, whereby an investor could choose to transfer their existing ISA to a VCT ISA (so no new cash investment is needed to fund the investment and the investor can still benefit from 30% VCT income tax relief on the investment, subject to the permitted maximum).

While there would be no change to the tax position on dividends for those who subscribe to the VCT within the annual permitted maximum (currently £200,000), it would theoretically enable an investor to subscribe more than the VCT annual maximum and receive tax-free dividends on the additional level of the investment held within the ISA.

However, as mentioned, an investor is only able to claim tax relief on up to £200,000 invested in a VCT in any single tax year.

VCTs and pensions

An investor may wish to use a VCT to complement existing pension and retirement planning strategies. However, it should be remembered that a VCT (which invests in what most would classify as high-risk companies) should NOT be considered as a replacement for pension investments, which will typically be lower risk.



From 6 April 2023, those who earn more than £260,000 per year have their annual pension allowances reduced by £1 for every £2 extra income earned. For those earning over £360,000, their annual pension allowance is capped at £10,000 (increased from £4,000 from 6 April 2023). The annual tax free pension contribution limit was also raised from £40,000 to £60,000 from 6 April 2023.

If an investor exceeds the annual allowance in a year, they won't receive tax relief on any contributions that exceed the limit and will be faced with an annual allowance charge. High earners may be concerned that they can't get enough money into their pension as a result of this restriction. In this situation, an investment into a VCT alongside the pension could provide an appropriate longer-term and tax-efficient investment.

TAX WRAPPER OPTIONS SUMMARY	ISA	Pension	VCT	EIS	SEIS
ANNUAL MAX	£20,000	£10,000 - £60,000	£200,000	£1m (£2m for KICs)	£100,000
LIFETIME MAX	X	N/A	X	X	X
INCOME TAX RELIEF	X	√	30%	30%	50%
POTENTIAL FOR LOSS RELIEF	X	X	X	√	√
POTENTIAL FOR IHT RELIEF	X only available for AIM	it depends	X	√	√
CGT FREE GROWTH	√	√	√	√	√
CGT DEFERRAL	X	X	X	√	X*
TAX TREATMENT OF INCOME	No further tax to pay for higher rate taxpayers; Interest: tax-free.	No further tax to pay for higher rate taxpayers; Interest: tax-free – but only in roll-up phase; Payouts from annuity or drawdown will be taxable.	Dividends within £200k annual maximum subscription: tax-free.	Dividends: taxable.	Dividends: taxable.
TAX-FREE LUMP SUM	√	Up to £268,275**	√	√	√

* However, where an investor disposes of an asset that would give rise to a capital gain, and reinvests all or part of the gain in shares which qualify for SEIS income tax relief, 50% of the gain reinvested will be exempt from CGT.

** Under limited circumstances where there is entitlement to a higher lifetime allowance or pension commencement lump sum protection, this may be higher.

VCT charges and practicalities

Typical fees and charges

One of the challenges with making a meaningful comparison between different VCTs is the range of different fees and charging structures.

Typically a VCT will have:

INITIAL FEES – Initial fees to cover the marketing and promotion of a particular offer for investment – these are taken from an investor's cash subscription so as not to penalise existing investors in the VCT. As a result, the amount of a client's subscription available for tax relief will vary;

Most commonly applied fees

INITIAL FEE	2.5% - 7.5%
AMC	0% - 2.5% of the investment amount
ANNUAL RUNNING COSTS	Average of 2.51% of a VCT's net asset value (including AMC)
ANNUAL PERFORMANCE FEE	20% of profits above a certain hurdle

SOURCE: MICAP (AT JUNE 2023)

AMC – An annual management charge (AMC) which is paid by the VCT to the VCT Manager for managing the investment strategy of the VCT;

PERFORMANCE FEE – A performance fee paid to the VCT manager to reward performance in excess of a certain hurdle, which will be set out in advance;

RUNNING COSTS – A VCT will also have its own running costs (including its operating costs, directors' fees, and administration fees). These will include the annual management charges explained above, but the overall quantum of running costs is often capped by a VCT.

Low fees in one area may be offset by higher fees in another area, so, when comparing charges, it is important to look at them in total. Many VCTs offer discounts to the initial fees via 'early bird offers' when the offer first opens or loyalty discounts to existing investors, in order to incentivise investment.

For some fees, most notably the initial fee and the AMC, the total can be made up of a portion charged directly to the investor and a portion charged directly to investee companies. If fees for the investor are too high, they can eat into the amount of capital that qualifies for the relief. If the fees for the investee companies are too high, they could hamper growth potential, and eat into returns. If overall fees are too low, questions may be raised about the amount of due diligence a VCT investment manager is reasonably able to conduct.

Minimum subscription

Minimum subscription levels typically range from £3,000 to £5,000.

Typical target return

Some VCTs quote specific target dividends. These typically range from 3% to 5% per year, net of fees. Sometimes this is quoted as a fixed amount per share (e.g. 5p per share).

While the overall risk profile of VCT investments has gone up as a result of the risk to capital condition, the risk profiles of the offerings still vary. Returns must be placed in the context of the risk, liquidity and level of charges when choosing the most suitable VCT for a client.

Performance information

VCTs must produce full audited accounts and interim reports at a minimum, which offers a good amount of transparency. Some VCTs may issue quarterly reports as well, although this is not a requirement. However, VCTs generally invest in small, unquoted companies which are illiquid and hard to value. The VCTs will generally value their assets in line with international private equity guidelines or similar, which can involve estimating a fair value for these illiquid investments, based on what someone might be prepared to pay for the business in an arm's length transaction. However, VCTs may only value their portfolio every three or six months, and the valuation is an estimate of unrealised value. The purchase prices of similar businesses sold recently are sometimes used as a guide. This is less of an issue for AIM VCTs, because the underlying investments are publicly traded.

VCT market seasonality

VCT offers tend to open and close during the tax year and VCT managers make their own timetables for opening and closing their offers.

Obviously, as the tax year progresses, there is likely to be increasing competition for the best offers as there is less time for investors looking to mitigate an income tax bill in the current year. In years of high interest in VCTs, some offers that would normally be open at the end of the tax year to accommodate this demand, may have already closed, leaving less opportunities for later investors.

Target Fundraises

The amounts raised by VCTs in new rounds varies considerably but the average is around £22 million. This is based on the availability of new investment opportunities that satisfy the defined selection criteria of the particular VCT. On top of the stated target, VCTs can also specify an over-allotment amount which can be triggered if the VCT's board notes strong demand that is likely to exceed the original target, where suitable investment opportunities can be identified.

ESG

Although VCTs fit in the defined scope for listed issuers under the Sustainability Disclosure Requirements (SDRs) implemented by the FCA on 1 January 2022, these rules do not apply to them. The FCA's view is that the rules for listed entities align better with those for asset managers. Consequently, from 1 January 2023 VCT managers have been required to annually produce an entity-level and a product-level disclosure –but not every product will have both. The entity level disclosure sits on the firm's website and explains how they take ESG and Impact considerations into account while managing investments. The product level-disclosure should also be available on the website and potentially in client communications. It must contain consistent and comparable disclosures about the product in question and report back on key metrics. But currently, only those managers with more than £5 billion of AUM across their funds and portfolios will be within this scope. However, the relevant calculation relates to any activity that is in scope of the regulations, thereby widening the net: For example, if a manager is the AIFM of a £3 billion Enterprise Investment Scheme, delegated manager of a £1.5 billion Business Relief portfolio and has an ongoing advisory mandate for another £0.5 billion with a VCT, the disclosure rules will apply to all the entities that these mandates relate to because they hit the £5 billion threshold. Any fund and portfolio managers not caught by the rules are under pressure from investor and FCA expectations to comply.

Legal and regulatory status

All existing VCTs are listed on the LSE, which means they must comply with UK company law (including the VCT directors' compliance with their fiduciary duties) and the LSE's Listing Rules (including the disclosure and transparency requirements and the Prospectus Rules). VCTs, which can be marketed and sold to ordinary retail investors, are also funds, which means that they will have certain regulatory requirements:

PRIIPs

Under the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation, VCTs are classified as PRIIPs. This means that the VCT must issue a Key Information Document (KID), designed to help investors to better understand and compare the key features, risk, rewards and costs of different PRIIPs. From 1 January 2023, PRIIPs manufacturers have been required to change their KIDs to reduce the risk of inconsistent and misleading information generated by the prescribed requirements of the legislation. Performance scenarios have been removed from KIDs and replaced with a narrative description of expected performance and the factors that could impact this. There is now also a requirement for PRIIPs manufacturers to upgrade their product's Summary Risk Indicator (SRI) score if they consider that the risk rating produced by the methodology is too low. However, VCTs are singled out with the rules requiring that,"a VCT must be assigned a minimum risk score of 6." This is problematic because a single score that applies to the whole industry does not reflect the different risk profiles associated with different types of VCTs. In July 2023 it was announced that PRIIPs is to be revoked under the Edinburgh Reforms and replaced by a new retail disclosure regime in 2024.

AIFs

VCTs are also alternative investment funds which gives them certain obligations, such as the requirement to provide investors and regulators with complete transparency over the risk profile of the fund.

RDR

For the purposes of the Retail Distribution Review (RDR), all VCTs are considered to be retail investment products and, therefore, advisers cannot receive adviser commissions. However, VCTs may facilitate adviser charging, as agreed between the investor and their adviser.

Unregulated

As VCTs are not FCA regulated funds, an investment into a VCT is not covered by the FSCS. The underlying investments are not covered by the FSCS. However, the VCT itself will be covered by both the FSCS and FOS in the event of it not being able to meet liabilities of investors and a claim is upheld.

Consumer Duty

"A new Consumer Duty that will set higher expectations for the standard of care firms give consumers," was implemented by the FCA on 31 July 2023. It requires all of those in the investment value chain to be significantly more proactive in taking steps to ensure the best outcomes for clients, from the data they use to design products to meet the needs of the target market they are focused on, to adjudicating fair pricing, ongoing oversight and any relevant actions required to undertake additional consumer support and better communication. Regulated firms, including financial advisers and investment managers are required to evidence that they have met the new criteria.

Suitability

Suitability is a large and important topic, and what follows are guidelines to bear in mind when considering whether a VCT investment is a suitable investment for a client.

Investments into smaller, unquoted companies are high risk and advisers need to spend time thinking about suitability and documenting the thought process in suitability reports when recommending a VCT.

Vulnerability

The FCA has been placing a growing focus on vulnerable clients and ensuring that they receive the best outcomes, particularly in the Consumer Duty which explicitly requires advisers and investment managers to provide additional care to ensure they meet the needs of 'vulnerable customers'. For example, the FCA's January 2023 Financial Lives cost of living survey found that the mental wellbeing of 54% of UK adults was negatively impacted by the cost of living crisis. It is within the context of identifying these clients, and assessing whether they have additional or different needs to those without characteristics of vulnerability that advisers must now operate when offering and providing any services to clients.

FCA classification

VCTs are classified as alternative investment funds and retail investment products. An adviser who wants to advise their client to invest into a VCT requires retail permissions to advise on securities. They will have to determine whether an investment into listed securities is suitable for their client.

Further information on legal and regulatory status is also set out on page 36.

Tax capacity

Although tax benefits alone should not be the primary driver for the investment, a prospective investor is likely to be an individual who is in a position to take advantage of the tax reliefs available from investing in VCTs.

Therefore, if they are planning to purchase newly-issued shares in a VCT, the client should have an income tax liability that could be offset by the upfront income tax relief available for VCT investors.

The client should also be aware that the tax reliefs can be withdrawn and that the shares might, at some point in the future, be worth less than they initially cost, although, where the reliefs are retained, income tax relief can limit losses.

As people face these financial challenges, we have a vital role to play, along with the firms we regulate. We can't change the economic circumstances, but we want to maintain a flourishing UK financial sector: One where customers are treated fairly and supported if they get into financial difficulty, get fair value, and are equipped with the information they need to make good decisions."

SHELDON MILLS, EXECUTIVE DIRECTOR, CONSUMERS AND COMPETITION, FCA, FEBRUARY 2023

Attitude to risk

In general, a VCT investment is likely to be suitable for clients with a high tolerance for risk. Where succession planning is relevant, you should also make the client's intended heirs aware of the risks involved.

While some VCTs may be riskier than others, all VCT investments should be considered as carrying the potential of a capital loss for investors. While this will never be a 100% capital loss when the income tax relief is taken into account (if it isn't withdrawn for some reason), and while it may be that, given time, the VCT will recoup any losses, clients should be comfortable taking on this level of risk with the funds they have allocated to VCT investing.

Capacity for loss

If a loss of the capital they have earmarked for VCT investment would have a materially detrimental effect on the client's standard of living, then they should be advised against investing in VCT shares.

Attitude to risk and capacity for loss should be assessed independently of each other. They measure the risk an individual is willing to take (attitude to risk) and the risk an individual can afford to take (capacity for loss). Attitude to risk is subjective and based on a client's personal opinions. This differs to capacity for loss, which is objective in nature and based on fact.

It is also worth remembering that CGT loss relief is not available should the shares be sold at a loss.

Suitability Client Considerations

OBJECTIVES

- Reduce or eliminate income tax liability up to £60,000
- They have a requirement for tax-efficient investment for capital growth
- They have a requirement for tax-efficient investment with tax-free dividends

CLIENT PROFILE

- They have surplus capital
- They are aware of the potential to lose all of the investment
- They are aware the reliefs could be withdrawn or clawed back

WARNINGS

- Limited market for the shares
- Likely to trade at a discount to the NAV (true value)
- Five-year holding period to retain income tax relief although a five to ten-year holding period is more realistic
- Tax relief isn't an excuse for high risk nature

Liquidity and investment horizon

Although VCTs are listed, their shares can suffer from low levels of liquidity. In addition, the minimum holding period to qualify for the upfront income tax relief is five years. Therefore VCT investments should be viewed on a five to ten year investment horizon. If clients anticipate an urgent need for their investment capital at any point sooner than this, they should be advised against investing in VCT shares.

Knowledge and experience

Investors (or their representatives) must have the capacity to understand the nature of VCTs and the associated risks.

In general VCT investors will have experience of investing in a portfolio of more conventional retail investment products, and/or experience in business or a profession and, therefore, be in a position to make informed decisions about investing in VCTs.

Portfolio balance and diversification

It is highly unlikely that it would be appropriate for a client to concentrate their wealth in VCTs and, in the majority of cases, VCT investors will already have a substantial portfolio of conventional investments that meets the majority of their investment objectives.

Investors should not be over-exposed to high risk investments, illiquid assets or unquoted securities.

The risks and disadvantages of VCT shares should be more than offset by the rest of the portfolio.

Typically, VCT managers will deploy an investor's subscription across multiple companies. The target number varies by manager, but typically is between 20 and 60.

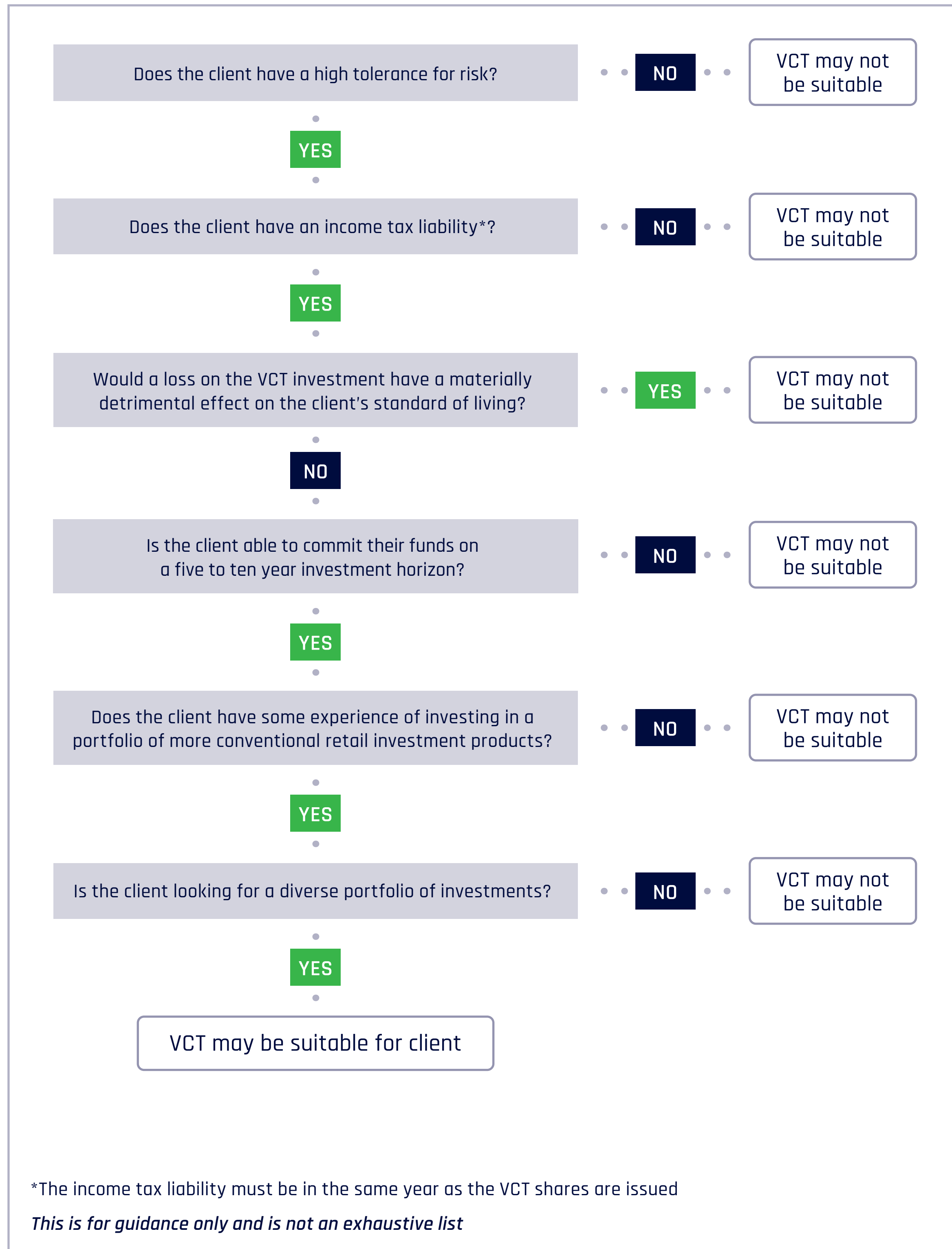
It is also important to diversify a client's VCT investments across different VCT fund managers and VCT offerings. There are varying methodologies for selecting potentially successful investments across managers and the objectives and strategies of investment offerings also vary.

ESG Goals

Despite some surveys reporting a drop in the prioritisation of ESG investments by UK investors, Environmental, Social and Governance (ESG) goals remain high on the agenda of a large proportion of the UK public who now want their money to go towards making a positive difference to people or planet. What's more, political pressure on the UK financial services sector to actively engage in the journey to net zero, has never been greater.

It is now possible to combine tax efficiency and high growth goals with an ESG focus by way of some VCTs. However, it is important to understand the specific ESG concerns the client wishes to address and the ESG targets and strategy applied by individual VCTs in order to understand whether they are compatible.

Indicators of when a VCT recommendation may be right



Research and due diligence

Types of VCT

Although all VCTs have the same structure and their investments are governed by the same rules, there are THREE common types of VCT.

Generalist - which covers private equity, including development capital;

Specialist sectors - for example, technology or healthcare;

AIM - predominantly investing in companies issuing shares quoted on AIM.

Some VCTs previously operated as limited life VCTs. These aimed to invest capital and then wind up within 5-10 years. Given the 'risk-to-capital' condition most VCTs now operate one of the other three strategies.

However, within these categories, managers employ a wide range of investment strategies, with different levels of diversification, targeting different levels of growth and income, with different risk profiles and investing in companies at different stages of development.

The most common type of VCT is Generalist, investing in unquoted businesses with no sector preference.

	PROS	CONS
GENERALIST VCTs Predominantly investing in unquoted companies (excluding companies on AIM) across a broad range of sectors	• More influence on investee companies • Not generally correlated to public markets	• Lower liquidity
AIM VCTs Predominantly investing in companies issuing shares on AIM	• Greater liquidity • High diversification • Publicly available information on investee companies	• Managers are not the dominant shareholder
SPECIALIST VCTs Predominantly investing in a specialist sector, for example technology or healthcare	• Specialist skills and technical knowledge • Not generally correlated to public markets	• Can be less diversified

Assessing VCTs

As well as assessing clients' suitability for a VCT investment or investments, advisers must also assess the range of offers available in the market, carry out due diligence and select the most appropriate investments for their clients.

In assessing VCT offers, there are a number of areas advisers need to cover and advisers should document their assessment of each of them to create a thorough research and due diligence process on record.

Advisers can rely on factual information provided by other EEA-regulated firms as part of their research and due diligence. However, they should not rely on the provider's opinion, for example, on the investment's risk level."

THE FCA'S THEMATIC REVIEW ASSESSING SUITABILITY: 'RESEARCH AND DUE DILIGENCE OF PRODUCTS AND SERVICES' FEBRUARY 2016

Step 1

The first step is to assess the VCT managers operating in the marketplace and the VCT offers that are open to investment.

A lot of VCT managers are likely to offer EIS and perhaps Business Relief (BR) investments as well (and their assets under management may reflect this), so their boards and investment committees will be looking at this wider horizon of investments, tax wrappers and investment sectors.

Step 2

The next step is to assess the performance history of the VCT (if it has one). However, past performance is not a guide to the future and while many VCTs have a 'target dividend', dividends are variable and are not guaranteed.

A VCT offer comprises new shares in:

- A new VCT;
- An existing share class in an existing VCT; or
- A new share class in an existing VCT.

The performance of a VCT can be assessed by considering the dividends previously paid by the VCT. However, dividends paid should not be considered in isolation – if the VCT's Net Asset Value (NAV) per share or traded share price has fallen more than the amount paid in dividends, then the investor may have made an unrealised loss over that period.

Evaluating the manager

The following aspects are specific to the VCT Manager:

Financial stability – as VCTs are designed to be held for a minimum of five years, the financial stability and trading history of a VCT's investment manager can be a consideration. However, as VCT investment managers must be authorised and regulated by the FCA, they will have minimum capital adequacy requirements.

Their **deal-flow access** and **investment selection process** – do they see enough of the market to get the best deals and how much consideration is given to the merits and potential of the companies. If there is not sufficient deal flow, there is a temptation for the manager to invest in opportunities that do not fit their stated investment mandate, that are riskier than deals they would normally invest in or at higher valuations (making it harder to earn returns).

Any support beyond finance provided to investee companies

Experience – the investment manager's experience in this field, along with that of their investment committee, is critical. The changes in VCT rules announced in the Autumn 2017 budget have also introduced the possibility of some managers that previously focused on VCT investments targeting low risk, capital preservation strategies, having to pivot their activities. This means it is important to review the relevance of their track record to their current investments.

Relevant sector expertise and **ability to adapt to changes** in rules and regulations.

Their **track record** of investment performance, exits and ensuring their investments retain VCT-qualifying status.

Transparency on any **ESG credentials** – even for VCT managers that are not obliged to comply with the SDRs there are pre-existing ESG-related disclosure obligations that are likely to apply, such as those in corporate governance codes, the Companies Act 2006, the Prospectus Regulation Rules and the FCA's Principles for businesses.

And any lack of openness or clarity about any ESG-related claims they are making is an important indicator that greenwashing may be taking place.

Their **commitment to the market** and level of **adviser support**

Their **investment philosophy** – the manager's particular approach to maximising fund returns

Evaluating the VCT

Other areas of research and due diligence on VCT investments could include:

VCT PROSPECTUS, FACTSHEETS AND ANNUAL REPORTS – These documents contain key information about the offer as well as the VCT as a whole, the parties involved, investments held and past performance.

KEY INFORMATION DOCUMENT (KID) – A three page overview of a fund's main features including its objectives, summary risk indicators, charges and performance scenarios. However, be aware of the difficulties presented by VCT risk ratings in KIDs (see page 36 for more information)

PORTFOLIO STRATEGY – The investment strategy of a VCT defines what it will invest in, such as what sector investee companies are involved in, how established they are and whether they are quoted on AIM. It will also discuss the sector and subsector (there is a range of general and specific VCTs). These factors will determine the potential risks and rewards that the VCT is exposed to.

PORTFOLIO COMPOSITION – Is the portfolio of investments concentrated or diversified? The level of diversification across underlying investments varies, but advisers should assure themselves that it is in line with the investment objective and is commensurate with the nature of the underlying investments.

LIQUIDITY – Liquidity at an investor level is concerned with how readily and at what discount an investor can liquidate their investment outside of any pre-determined realisation strategy. In addition, VCTs' shares are not widely traded and they often trade at a discount to their Net Asset Value (NAV). VCT managers do often offer share buyback schemes to enable divestment, but these are usually at a discount to the underlying asset value and are not guaranteed.

ANTICIPATED DIVIDENDS/RETURNS (WHERE STATED) – advisers should assess how returns (without tax reliefs) are generated and take a view on the likelihood of those returns being achieved in different economic conditions.

HMRC COMPLIANCE AND MONITORING – Failure to adhere to the rules could result in the VCT losing its approved status, which would result in a clawback of tax relief for any investors who have held their shares for less than five years. Most VCTs have appointed professional advisers to monitor the VCT and the investments it makes.

ESG CREDENTIALS OR SUSTAINABILITY STRATEGY – Many investments are now offering an element of Environmental Social Governance, sustainability or impact investing with additional goals and motives beyond pure profit. There has been a significant amount of overstating at best and greenwashing at worst, drawing substantial attention from the FCA.

PERFORMANCE METRICS

Two main metrics are used to measure and compare the performance of VCTs:

- The share price total return – the value of any dividends paid plus the difference between the current share price and the price at which the shares were issued, expressed as a percentage of the original investment amount;
- The Net Asset Value (NAV) total return – the value of any dividends paid plus the difference between the current NAV per share and the NAV per share when the shares were issued, expressed as a percentage of the original investment amount.

Where a share price total return or NAV total return is calculated, it sometimes assumes that dividends are reinvested. However, some VCT managers may publish their NAV returns as a cumulative return, i.e. with dividends added but not reinvested. Whatever method is used, it is important that comparisons are made on a like-for-like basis.

DISCOUNTS AND PREMIUMS

When investment company shares are traded on a stock market, the share price may be higher or lower than the NAV. The difference is known as a discount or premium.

- Buying shares at a discount means you pay less than the NAV.
- Buying at a premium means you pay more than the NAV.

FUNDING STAGES

The VCT rules generally restrict companies that can receive VCT funding to smaller companies that have been trading for seven years or less (ten years or less for KICs, although a KIC also has more flexibility regarding when this ten-year point starts – see page 27 for more information on KICs). In commercial terms, this means that the companies in a VCT portfolio are all 'early stage'. But, within this classification, there are various stages of fundraising depending on the development stage of the investee.

The funding stage definitions are not fixed, but are typically:

Seed: Seed rounds are among the first rounds of funding a company will receive, generally while the company is young and working to gain traction and build a product from an idea. It is likely to be pre-revenue.

Series A: The company may have some established revenues and is typically pre-profit. At this stage, it is seeking to identify the commercial viability of its product or service (product-market fit).

Series B: The company may be making small profits but is looking to scale and has growth aspirations outside current revenue streams.

Therefore, the funding round is an indicator of risk, with earlier stage funding likely to be higher risk, but lower cost. This brings the opportunity for higher returns, but also greater potential for losses.

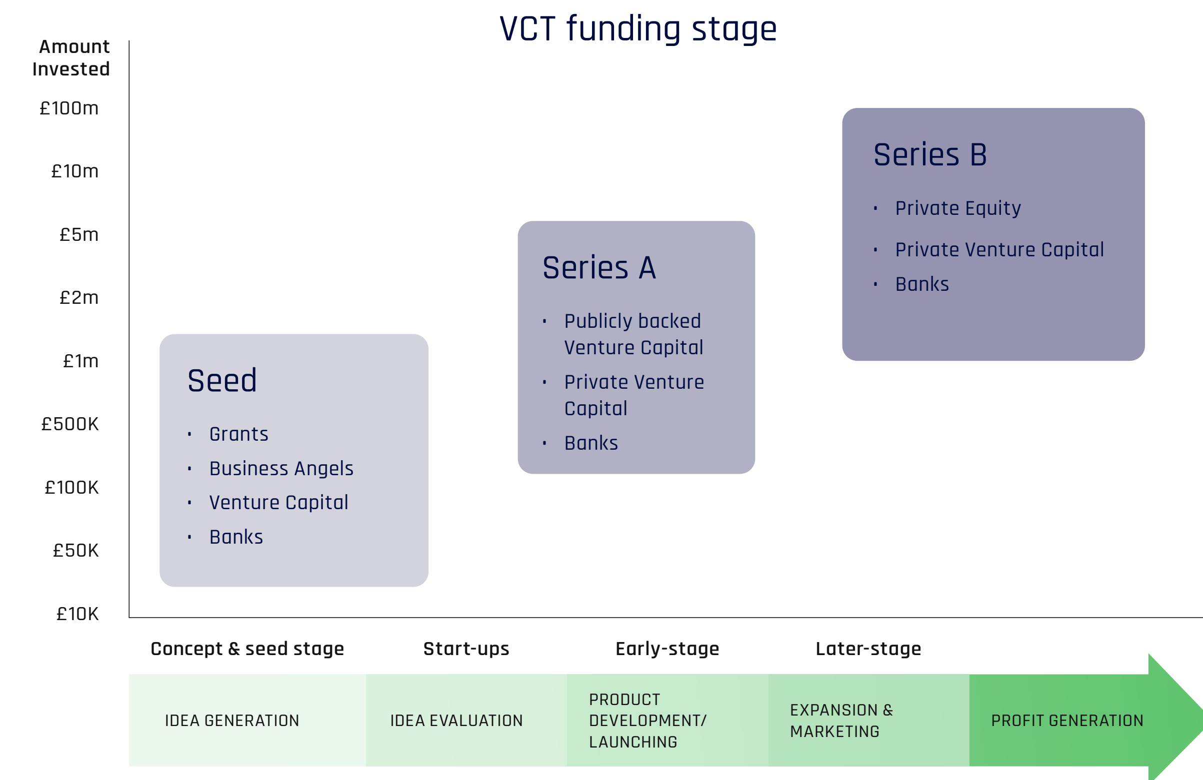
It is not unusual for VCT managers to diversify across funding stages. Some also reinvest in the same company at a later stage as it develops and proves its value.

It is also worth noting that follow on investment, by any party, can dilute the shareholding of earlier stage investors if they are not prepared to invest in the new round of funding. Shares issued to a VCT can't have anti-dilution rights. Consequently, each time equity investment is taken by the company, new shares are issued. As a result the total number of shares in issue increases, meaning that an existing shareholder, such

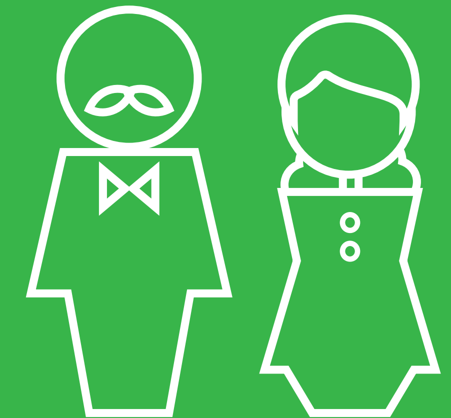
as a VCT, that does not invest in the new round (which would increase the number of shares they hold) will hold a smaller percentage of the new total number of shares.

Nevertheless, if the company is doing well, even without participation in follow on rounds, the smaller percentage of the company held by the shareholder should have a larger value than before the investment round. This is because the price of shares in new funding rounds is likely to rise as the company becomes more successful and this valuation is applied to the business as a whole.

In terms of investees, as a general rule, the riskier the underlying investments are, the greater the level of diversification should be. However, some research suggests that beyond a certain point diversification can go too far and that the additional costs incurred do not bring any additional diversification benefits. Advisers need to be confident that the VCT is not overly-diversified.



Case studies



Disclaimer

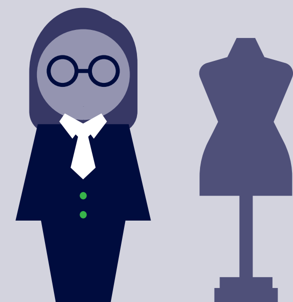
The following case studies are designed to demonstrate a number of different scenarios that might apply to certain prospective investors. Nothing here should be viewed as advice. Advisers should consider, among other things the impact of charges (including any initial fees as well as annual charges) and the quantum of tax relief that might be available to a particular prospective investor. Any suitability decisions should be based on a comprehensive review of a client's objectives, needs, capacity for loss, investment experience and attitude towards risk.

1

Client looking to extract money from a business tax-efficiently

Oksana is a higher rate taxpayer and looking to be more tax-efficient with the funds she withdraws from her company. She is a sophisticated investor with both a high capacity for loss and high attitude to risk. She has experience of investing in small start-up companies.

So, when her adviser suggests VCT investment, she is happy to proceed.



Oksana runs her own clothing company and draws a salary of £12,570 per year tax-free*

*within the personal allowance

£80,000
Dividend, of which:

TAX-FREE
£1,000
Dividend allowance

8.75% TAX
Next
£36,700
(Basic rate of 8.75% = £3,211.25)

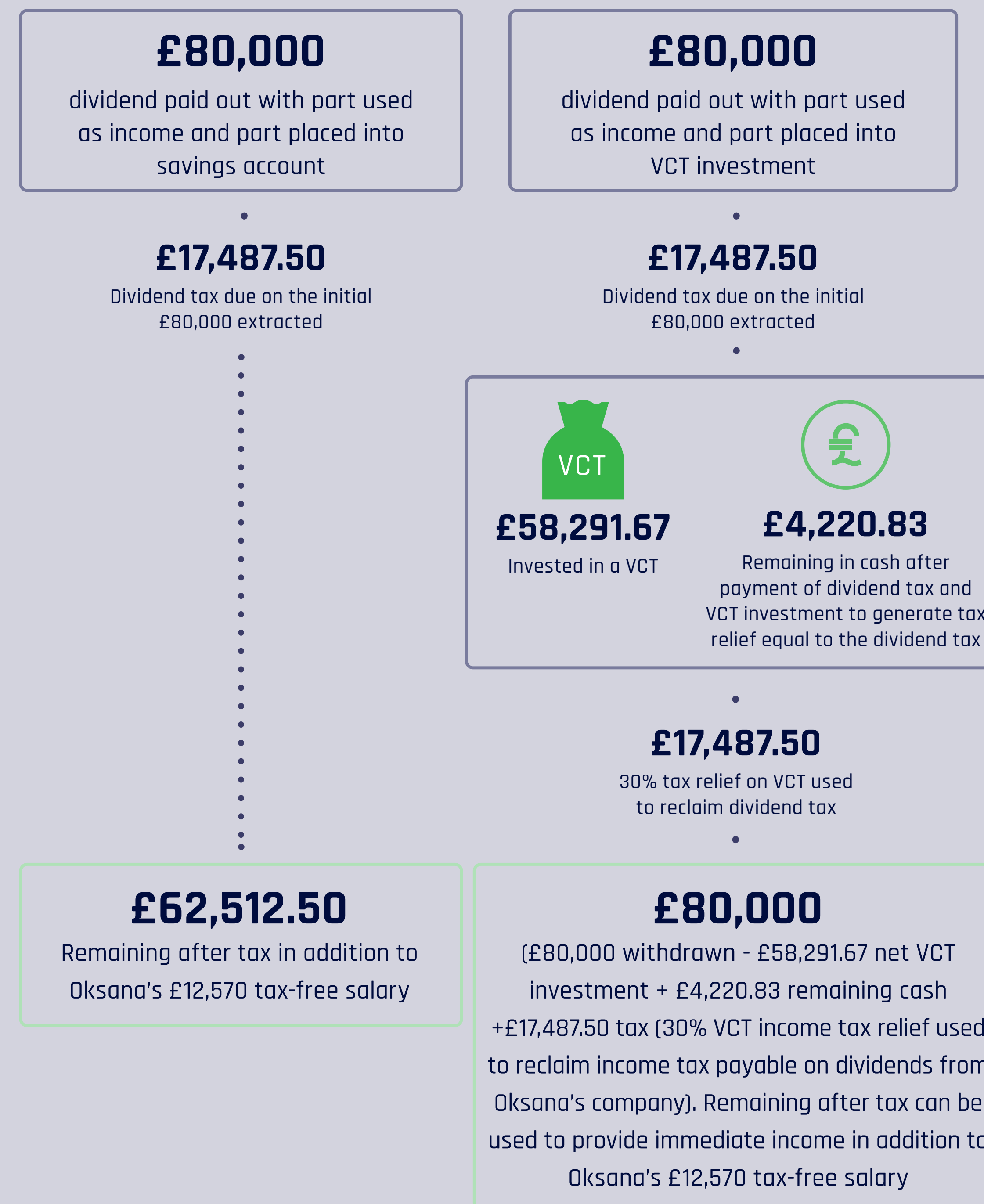
33.75% TAX
Remaining
£42,300
(Higher rate of 33.75% = £14,276.25)

£17,487.50 TOTAL TAX BILL

Adviser recommends VCT investments to get the benefits of investing money withdrawn from a small business into a VCT

The diagram below illustrates how Oksana could use the money withdrawn from her company to invest in a VCT during the 2023/24 tax year. There are two versions depending on whether Oksana invests her net dividend into a savings account or whether she uses some of the dividend to invest into a VCT

The tax benefits of investing money withdrawn from a small business into a VCT



2

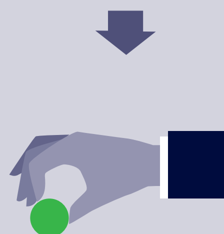
Tax efficient extraction from pension

Sajid has been retired for three years and is financially comfortable in retirement.

Following the birth of his second grandchild and, with pension freedoms, Sajid would like to use some of his pension to assist with the future education of his grandchildren. David is keen to plan well ahead and is investigating options to take money out of his pension in a tax-efficient manner.

*Note, in the lower rate taxpayer example, the £7,650 income tax relief only applies if David has at least £7,650 of income tax to offset in total in the tax year. If not, based upon the tax due on the pension withdrawal, only £4,500 of it can be offset against income tax due. The remaining £3,150 will be lost.

Sajid would like to use his pension to assist with the education of his grandchildren



Following a discussion with his IFA and a suitable recommendation, Sajid invests in a VCT.

VCT invesment benefits:

up to 30%

Income tax relief
on up to £200k p.a

+

TAX-FREE

Dividends and capital gains

HIGHER RATE TAXPAYER (40%)

This illustration assumes that Sajid has other income which means he pays the higher rate of tax

£30,000
withdrawn from pension

£9,000
tax due on pension:
25% tax-free, 75% at higher rate

save remaning cash in savings account

£21,000
remaining after tax

£21,000
invested into a VCT

£6,300
30% tax relief

£27,300
remaining after tax

LOWER RATE TAXPAYER (20%)

This illustration assumes that Sajid is basic rate tax payer that takes him above the £12,570 personal allowance

£30,000
withdrawn from pension

£4,500
tax due on pension:
25% tax-free, 75% at basic rate

save remaning cash in savings account

£25,500
remaining after tax

£25,500
invested into a VCT

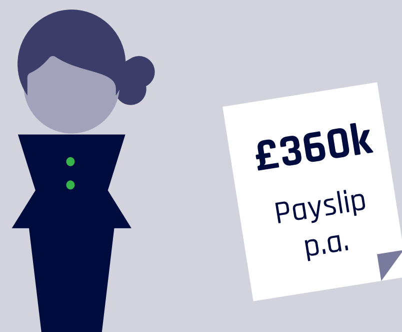
£7,650
30% tax relief

£33,150
remaining after tax

3

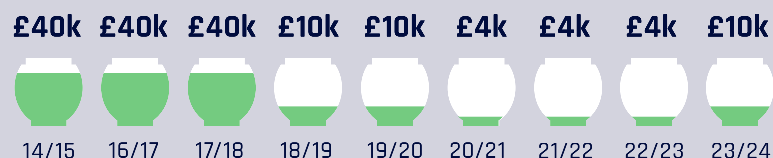
VCT dividend reinvestment

Imani earns £360,000 per year and therefore, with her savings income, pays tax at the 45% additional rate.



She has fully funded her pension, historically setting aside at least £40,000 a year. However, due to the tapered annual allowance Imani is now restricted to just £10,000 annual pension contributions

Imani annual pension contributions



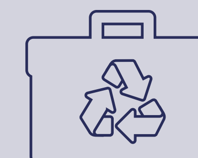
£30,000 p.a.

Looking for a tax-efficient home for Imani's future

Adviser recommends VCT investment

£30,000 p.a.

Imani invests £36,000 p.a into VCTs for the next five years



She reinvests the dividends

To create a tax-free pot when she retires, with VCT dividends being tax-free and any profits on the sale of her VCT shares being exempt from capital gains tax

The diagram below illustrates how Imani invests £30,000 into a VCT over five years, and reinvests dividends (at a rate of 4% per annum paid from the fourth year onwards). It assumes no gains or losses on the VCT or any adviser charges and that Imani chooses not to reinvest her tax relief.

	Year 1	Year 2	Year 3	Year 4	Year 5	TOTAL
Investment	£30,000	£30,000	£30,000	£30,000	£30,000	**£150,000**
Tax relief (30%)	£9,000	£9,000	£9,000	£9,000	£9,000	**£45,000**
Dividends	-	-	-	£1,200	£2,448	**£3,648**
Tax relief on reinvested dividends	-	-	-	£360	£734	**£1,094**
Value carried forward	£30,000	£60,000	£90,000	£121,200	£153,648	
Total return (including tax relief)						**£199,742**

It should be remembered that each VCT investment must be held for 5 years in order for the income tax relief provided not to be withdrawn

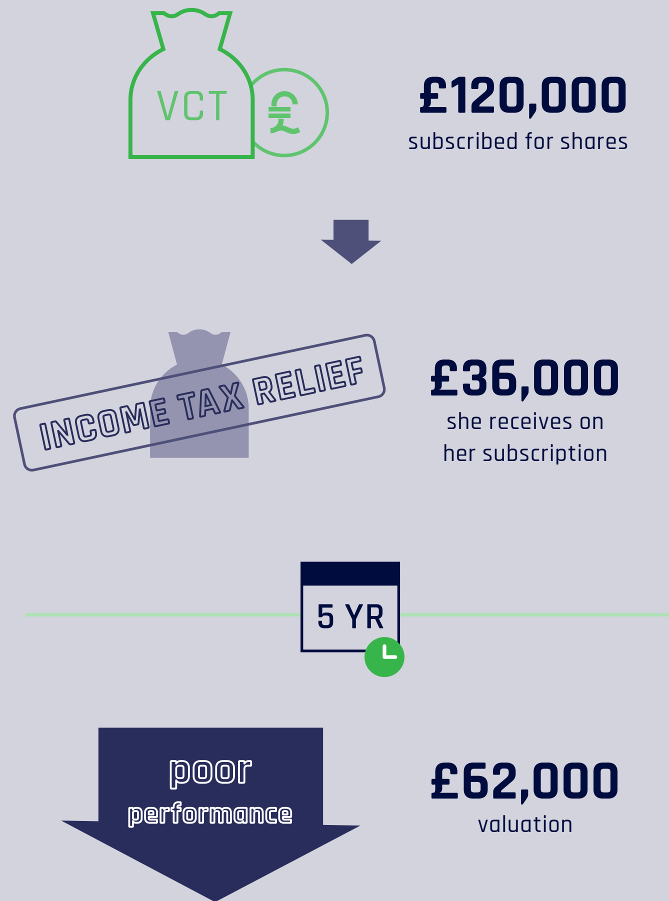
4

VCT income tax relief cushioning the blow of any losses

Pilar has maximised her pension contributions and has income tax liabilities she wishes to mitigate.

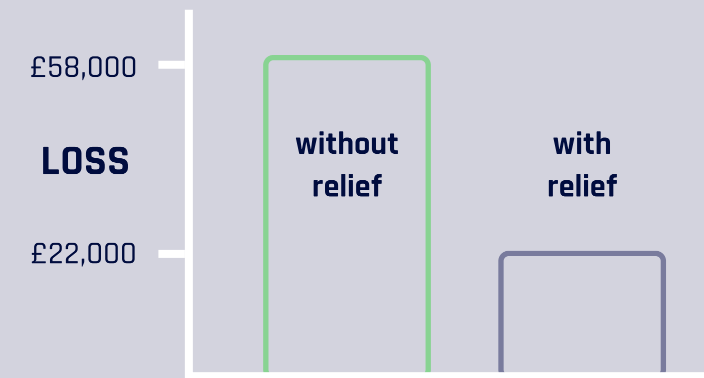
She subscribes for shares in a VCT at a cost of £120,000.

Pilar takes professional advice as she is looking for a tax-efficient investment. Her adviser recommends investing into VCTs



The underlying companies in the VCT perform poorly, and the VCT investment is now worth £62,000.

She retains her shares for five years to ensure she retains her tax relief and then sells them for £62,000. But her total proceeds, including her £36,000 tax relief, are £98,000.



The tax relief limits the loss

The tax relief has meant that her losses are much less severe (without the tax relief she would have lost £58,000, however, in this situation she has lost £22,000).

It should be remembered that any loss made on the disposal of VCT shares where the conditions for VCT Disposal Relief were met are not allowable for capital gains purposes.

5

A married couple with regular income and assets

John and Sarah have been married for 30 years and they plan on retiring in 10 years' time. John is a higher rate taxpayer and has a good level of pension provision.

Sarah, on the other hand, doesn't have a significant pension pot but does have a residential property which she lets out. She has always seen this as being 'her pension' and she doesn't wish to sell the property and be left with a large CGT bill. Sarah earns £36,000 of net rental income and has other income up to her personal allowance. She expects to pay £7,200 income tax in the 2023/24 tax year (20% x £36,000).

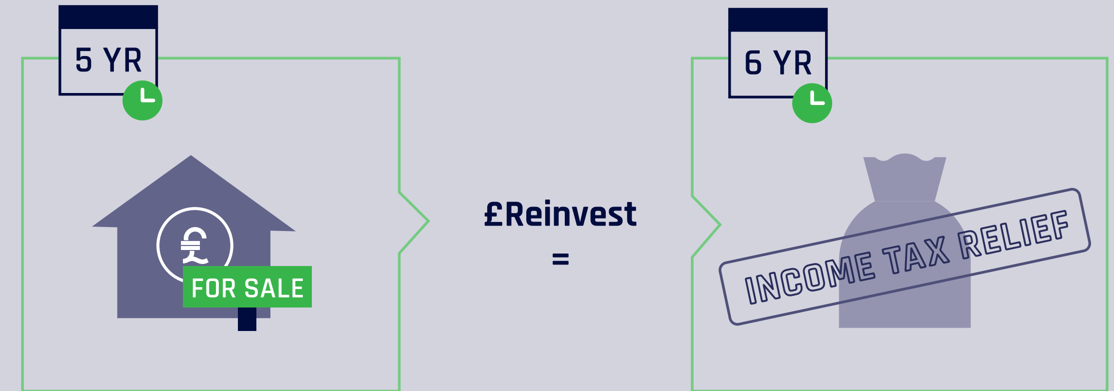
The initial income tax relief Sarah receives on her VCT investment (£7,200) would eliminate the £7,200 annual income tax she's required to pay on her rental income. VCT shares must be held for at least five years in order to continue to qualify for the initial income tax relief (should Sarah sell the shares before the end of five years, she'd have to repay the income tax relief to HMRC).

Sarah doesn't have a significant pension pot but owns a residential property she lets out earning £36,000 income

Following discussions with her IFA, Sarah plans on investing £24,000 annually into VCTs for the next five years

£24,000 p.a.
for the next five years

£7,200
per year



The following diagram illustrates how Sarah could claim income tax relief on a series of VCT investments over several consecutive tax years. The illustration shows a period of eight years as an example, but Sarah could use this method to keep investing and claiming income tax relief indefinitely, subject to the rules remaining the same and certain conditions.

Tax benefits of investing annually into a VCT

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8
VCT Investment	£24,000	£24,000	£24,000	£24,000	£24,000	£24,000	£24,000	£24,000
Cumulative investment	£24,000	£48,000	£72,000	£96,000	£120,000			
30% income tax relief	£7,200	£7,200	£7,200	£7,200	£7,200	£7,200	£7,200	£7,200
Cumulative income tax relief	£7,200	£14,400	£21,600	£28,800	£36,000	£43,200	£50,400	£57,600

The illustration assumes no gain or loss on the investment and doesn't take into account an initial or ongoing fees.

After six years, Sarah has claimed £43,200 income tax relief from a total £120,000 investment. It is worth noting however that, under current rules, after selling shares in a VCT it is not possible to claim tax relief on new shares bought in the same VCT within six months of the initial sale.

6

Saving tax-efficiently for medium-term goals

Philip has an annual salary of £260,000 and maximises his ISA savings and pension contributions each year. He has a goal of doing a luxury tour of the world in ten years time before he retires. But he does not want to have to dip into his pension pot or ISAs to fund his trip. He wants to use a tax-efficient opton and is comfortable with the associated risks of investing in a VCT.

Following discussions with his adviser, Philip plans on investing into VCT for the next few years

Year 1	£25,000
Year 2	£25,000
Year 3	£25,000
Year 4	£25,000
Year 5	£25,000

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9
VCT Investment	£25K	£25K	£25K	£25K	£25K	-	-	-	-
Cumulative investment	£25K	£50K	£75K	£100K	£125K	-	-	-	-
30% income tax relief	£7.5K	£7.5K	£7.5K	£7.5K	£7.5K	-	-	-	-
Cumulative 4% dividends taken annually from year 3	£0K	£0K	£1K	£2K	£3K	£4K	£5K	£5K	£5K

The final outcome after an investment totalling £125,000 is £25,000 of tax-free dividends and £37,500 of income tax relief on top of the investment amount.

Philip uses the £37,500 income tax relief he earns over his five years of investing to offset income tax liabilities he has. But remember that VCT income tax relief can only be claimed for the same year as the year of investment and against tax actually paid.

VCT shares must be held for at least five years in order to continue to qualify for the initial income tax relief. He exits all his VCT investments in year 9 when he has held all for a minimum of five years. The illustration assumes no gain or loss on the investment (although it is common for VCT shares to be sold at a discount to NAV), and doesn't take into account any initial or ongoing fees or costs associated with selling the VCT shares.

7

Clients who are additional rate taxpayers

Keir is a doctor who earns an income of £360,000 per year.

His annual pension contributions are now restricted to £10,000 per year, as he has reached the upper limit of the tapered annual allowance.

Keir earns an income of £360,000 per year

Keir is concerned he may not earn at this level until retirement and that pension contribution restrictions mean he won't have enough money put aside for his retirement

Following a suitable recommendation from his adviser, Keir invests in a **VCT:**

- √ Up to 30% Income tax relief on up to £200k p.a. in the tax year of the investment (subject to five-year minimum holding period)
- √ Tax-free dividends and no CGT to pay when he sells the shares

	ISA	PENSION	VCT
Upfront income tax relief on initial investment	None	20-45%	30%
Annual personal limits	£20k	£10k - £60k	£200k
Lifetime personal limits	None	N/A	None
Minimum holding period	n/a	No access until 55+	Five years
Ongoing tax benefits	Tax-free growth and dividends	Up to £268,275 is tax-free	Tax-free growth and dividends

It's worth pointing out that VCTs are high-risk and inherently different to pensions and ISAs and shouldn't be compared on tax benefits alone. One investor's circumstances will be different to another and a VCT investment won't be suitable for all, but the attractive tax benefits mean that VCTs could be considered as part of a portfolio for some people, alongside pensions and ISAs.

VCT INVESTING

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Learning objectives

How did you do?

- ***Describe the main rules that govern the VCT reliefs available:*** Rules are covered from pages 17-29, with practicalities on pages 34 - 36.
- ***Explain the main risks associated with VCT investment:*** Investment risks; liquidity; and tax risks. More detail is on pages 8-9.
- ***Define the key aspects to be taken into account when considering client suitability:*** Covered on pages 37-40, including a flowchart indicating when an investment may be appropriate.
- ***Evaluate the main due diligence considerations for a VCT investment and investment provider:*** The research required is covered on pages 41-46.
- ***Identify some of the real-life situations for which VCTs can fulfill client planning needs:*** A series of case studies appears on pages 47-59.
- ***Ascertain the circumstances in which VCT reliefs can be withdrawn:*** Covered within the Rules section on pages 17-29, these include instances such as an increase in non-qualifying activities.

Steps after reading

Claim your CPD

This guide is accredited for structured CPD by the CII and PFS and readers of the guide can claim one hour of CPD for each hour spent reading the guide, up to a total of four hours. In order to claim CPD, readers will need to complete a short online test. For more details on claiming CPD go to:

- intelligent-partnership.com/cpd

Educational content is also available from Intelligent Partnership, which produces regular CPD accredited VCT industry updates. They are available at:

- intelligent-partnership.com/research-format/publications

Provide Feedback

Intelligent Partnership actively welcomes feedback, thoughts and comments to help shape the development of this guide. This guide is produced on a regular basis. Feedback can be given on the website or via email:

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- Guides@intelligent-partnership.com

Participation and feedback are gratefully received

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In the context of high inflation, slashed income tax, CGT and dividend tax thresholds and a squeezed growth context, VCTs have understandably garnered increasing interest. But it's proper VCT knowledge and understanding that makes for the best VCT recommendations." **GUY TOLHURST**, INTELLIGENT PARTNERSHIP

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