Warner Goodman

The market for Venture Capital Trusts

Venture Capital Trusts (VCTs) appear to be becoming a more commonly exercised investment choice for an increasing number of high earners.

VCTs are tax-efficient, closed-end UK collective investment schemes that are listed on the London Stock Exchange. They invest in private and up-and-coming companies which are not themselves listed.

They were introduced in the 1995 Finance Act by the then government, in order to encourage investment in new UK businesses. As such, they carry certain tax advantages for the individual, although these are not meant to be the sole driver of investment. Because of the nature of the investments and their related tax benefits, VCTs are seen as long-term investments.

Their appeal has continued to grow and last year, data from the Association of Investment Companies (AIC) indicated that this alternative investment vehicle had raised £728 million during the 2017/18 tax year. This represented a substantial increase on the previous year's £542 million. It is worth noting that last tax year's figure is the highest annual amount invested since the reduction of upfront income tax relief to its current level of 30%.

As of 5 April 2018, assets under management in VCTs totalled £4.3 billion, again seeming to show that the appetite for these investments is significant.

Tax reliefs differ between investors in new shares issued by VCTs, and investors who purchase shares already available on the market (for example on the stock market).

Shares already on the market are exempt from income tax on dividends on ordinary shares in VCTs, and exempt from Capital Gains Tax on disposal of shares in VCTs.

The same reliefs are available for new shares, but also available is (as previously mentioned) income tax relief at the rate of 30% on the amount subscribed for the shares. This relief is available on investments of up to £200,000 in a tax year, as long as the shares are held for a minimum of five years.

It is therefore unsurprising that the price of VCT shares on the stock market tends to be lower than for new shares.

The value of the underlying investments can be uncertain, as they are often unquoted investments that do not have a readily available market price. It can also be difficult to sell VCT shares on the secondary market, although some of them do operate a buyback facility.

A VCT's board of directors uses valuation methods that are based on established principles, e.g. the British Private Equity and Venture Capital Association's Valuation Guidelines. These can only be estimates, and of course sales of shares depend upon there being a willing buyer.

While this backdrop, as well as the government's apparent attitude towards VCTs, is all positive, there is still a relatively small number of people using VCTs, and plenty that are not partaking of the investment opportunities, and tax relief, that they offer.

One of the biggest boosts for VCTs has been the reduction of the limits on pension contributions. The pension lifetime allowance, introduced in 2006, has subsequently been cut to £1.03 million, and although this is likely to now be increased in line with inflation (£1.055m for 2019/20) it means that high-earning investors have had to find new

ways to fund their retirement without incurring large tax charges. They are therefore making VCTs a core part of their retirement plans.

While VCTs are of interest for high net worth investors, VCT industry experts and advisers both agree that they are not a substitute for pensions. They see them as a companion to pensions rather than as an alternative.

It might even be considered that many people do not even know they need an alternative to their pension, as they are unaware of the pension allowance changes.

Changes to the treatment of buy-to-let investing may also lead individuals to consider investing in VCTs, as well as the continuing low-interest rate environment.

VCTs pay what might be deemed to be attractive levels of tax-free dividends (4.5%-5% on average).

However, returns are not guaranteed. The dividends may vary and the investor may get back less than invested, or even nothing at all.

On the other hand, a VCT is a relatively low-cost way to access the benefits of a professionally run portfolio, with the investment strategies employed by VCT managers differing enormously. VCTs fall into three broad sectors:

- Generalist (Private Equity including development capital)
- AIM
- Specialist, e.g. technology

As previously mentioned, VCTs tend to be considered as being towards the higher end of the risk scale for investment vehicles, due to the nature of the underlying companies they invest in. An Independent Financial Adviser would be able to consider the appropriateness of a VCT investment for an individual client's circumstances.

The industry does seek out and invest in incredibly interesting companies, some of which are potentially world class. The industry believes that VCTs have 'come of age', and that managers are capable of 'taking out some unnecessary risk' while capturing the gains.

Industry experience has seen that clients are not just interested in putting money into the underlying companies through a VCT. A number of VCT clients who have themselves been involved in running companies enjoy interacting with the chief executives of the companies in which they are investing, and like to see where their money is being directed. It is also about the resulting economic benefits for the UK, which was the reason why VCTs were introduced in 1995.

The average VCT is said to be up 147% over the past 10 years, (before consideration of any available tax relief).

Understanding the risks of investing in VCTs does not change the fact that investing in early-stage companies is inherently riskier than a more standard investment.

Most VCT portfolios will invest in 40 to 50 companies in order to be 'diversified portfolios', and most VCT managers have been in business for at least 20 years and therefore have a past track record that advisers and potential clients can study.

VCTs are listed companies subject to company law and listing rules, with an independent board overseeing their activities.

VCTs therefore tend to be considered as a longer-term investment for more experienced high net worth investors. They do carry certain tax incentives, but these should not be the sole driver of investment. They are also viewed as carrying greater investment risk in view of the nature of the underlying assets; however, as they are available for over 20 years, potential investors can study past performance, although this certainly should not be viewed as an indicator of future results.

Therefore, the involvement of an Independent Financial Adviser would seem prudent when considering the opportunities and risks presented by VCTs.

Enterprise Investment Schemes (EIS)

An alternative investment to VCTs, or one that could run alongside them, are Enterprise Investment Schemes (EIS). Launched in 1994 (a year before VCTs) EISs offer the opportunity to invest directly into small and developing companies in a tax-efficient manner.

The companies must be unquoted, have less than £15 million of assets, less than 250 employees and must have been trading for less than seven years. The monies raised cannot be for the replacement of capital, and the company must be carrying out what is defined as a qualifying trade. Different criteria exist for Knowledge Intensive Companies.

Although EISs carry similar tax benefits to VCTs, they allow for larger total investments into one or a number of qualifying companies of up to £1 million in a year. Total combined investment into EISs and VCTs cannot exceed £5 million in one year, or £12 million in a lifetime.

EISs carry the additional benefit of being able to use investments into them to defer CGT liabilities. A CGT liability incurred on a totally unconnected asset, where disposal of that asset took place in the period between up to 12 months prior to an EIS investment and 3 years afterwards, can be deferred by an EIS investment, namely a four year 'window'. This facility is available to both individuals and trustees. Where gains arise on the EIS investment, taper relief is available.

EIS investments can be used for tax-efficient profit extraction, as a replacement for Business Relief and to assist with possible IHT liabilities. The benefit of potentially reducing IHT liabilities means that EISs may hold a greater appeal for older clients.

The potential benefits of EISs and how they may be appropriate for an individual are best discussed with an Independent Financial Adviser, who will have a fuller understanding of the client's circumstances.