

## Introduction

VCTs provide private investors with a tax efficient method of investing in **small to medium sized unquoted trading companies** in the UK.

By 'unquoted' we mean that the companies are not listed on a recognised stock exchange, and for this purpose AIM and Plus (formerly Ofex) are not recognised exchanges. This is a market that the private investor would normally find it difficult to use.

Please note at the outset that VCTs are by their nature **complex products with features that vary from issue to issue**. The differing structure and investment plans of the trust managers invariably impact on the risk of each trust.

This is an investment that all but the most experienced investors should only make after taking advice from an independent financial adviser (IFA) with experience in this field.

## What is a VCT?

A VCT is a fully quoted public limited company whose purpose is to invest the majority of its shareholders' funds in unquoted growth companies **with a view to making substantial capital profits** when those investments are subsequently realised by flotation or trade sale.

By investing in a VCT, you spread the investment risk over a number of companies.

To help stimulate investment into smaller unquoted companies **the Government granted substantial tax benefits to VCT investors** when they were first introduced in the 1995/96 tax year. Those tax reliefs have been altered from time to time but have remained attractive.

Prior to investment in individual companies, funds are usually invested in **fixed interest securities and bank deposits**. These investments are sold as and when required to provide the necessary funds for investment in suitable companies.

Within three years the VCT manager will seek to **invest at least 70% of the funds** raised in 'qualifying companies'.

"Around 1,300 UK businesses receive private equity investment each year. Together, these are some of the fastest-growing, most innovative companies in the UK. At one end of the spectrum venture capital helps take brilliant ideas and turn them into a business. At the other, private equity takes mature businesses and re-focuses them, concentrating on growth areas, making them much more productive.

The UK private equity industry is the largest and most dynamic in Europe. It makes a significant contribution to the financial services industry and in helping to keep London the leading financial centre in the world."

The British Private Equity & Venture Capital Association (BVCA)

## The Tax Benefits

VCTs have quite rightly been referred to as Super ISAs. Tax reliefs are only available to **individuals aged 18 years or over** and not to trustees, companies or others who invest in VCTs.

The main tax benefits of a VCT are:

- **Income tax relief at 30%**. The shares must be **new** ordinary shares. You can get this relief for the tax year in which the VCT shares were issued, provided that you hold the shares for at least five years.

The income tax relief at 30% is available to be set against any income tax liability that is due, whether at the basic or higher rate, on investments **in new VCT issues up to £200,000**. The investor needs an income tax liability to utilise some, or all, of this relief.

For example **an investment of £10,000 will attract £3,000 tax relief** (giving a net cost of only £7,000).

It is important to note that **the tax relief in this example would only be given** if the investor has an income tax liability of at least £3,000 in that tax year.

If the investor only has a tax liability of, say, £2,400 then that is all the tax relief they will get on their VCT. They might, therefore, wish to consider investing just £8,000 in a VCT in the current year and the balance in the next tax year to pick up the rest of the tax relief.

If the VCT is **held for less than 5 years** the tax relief is reclaimed by the Revenue. If, before the disposal, the VCT had been transferred to a spouse, then the income tax relief will be withdrawn from the spouse who makes the disposal.

- **Tax Free Capital Growth**. Private investors will not be liable to capital gains tax on any gains arising from the disposal of their VCT shares (**whether acquired as new shares or subsequently**), provided they were purchased within the £200,000 annual limit. You should note, however, that **any realised loss on the disposal of VCT shares** cannot be used to create an allowable loss for capital gains tax purposes.

Prior to 6th April 2004 it was possible to defer capital gains made on other investments if a VCT was taken out within 12 months before, or after, that event. In such a situation there will be a liability to capital gains tax on gains that have previously been deferred.

However even here it might be possible to reduce the gains by use of the CGT Allowance, or by passing the VCT to a spouse to make use of their CGT allowance, or by setting it against a further qualifying investment under the Enterprise Investment Scheme (EIS).

- **Dividends paid by a VCT are free of income tax** in the hands of the investor. Unlike an ordinary investment trust **capital gains may be distributed by way of dividends to investors**.
- A transfer of shares in a VCT **between spouses is not deemed to be a disposal** and therefore all tax reliefs will be retained.

"The only reason that private equity exists is because investors, especially pension funds, choose to invest in it. Pension funds invest in private equity because they get good returns, which benefit millions of pensioners."

The British Private Equity & Venture Capital Association (BVCA)

## Conditions for VCT Approval

The main conditions a company must satisfy to be approved as a VCT are that:

- its income must be **wholly or mainly from shares** or securities
- **at least 70%** (by value) of its investments must be **'qualifying holdings'**. Shares or securities in a company which ceases to be unquoted, can continue to be treated as being comprised in the VCT's qualifying holdings for the following five years.  
  
From 6 April 2007 any money that a VCT holds will be treated as an investment for the purpose of these tests
- **at least 30%** (by value) of its qualifying holdings must be **holdings of ordinary shares** with no preferential rights to dividends, or to the company's assets on its winding up, and no right to be redeemed
- at no time must **its holding in any company represent more than 15%** (by value) of its investments
- its ordinary shares must be **listed on the London Stock Exchange**
- it must **not retain more than 15% of the income** it derives from shares or securities.
- the value of a qualifying company's **gross assets must not exceed £7 million immediately before** the VCT makes its investment, and **£8 million immediately afterwards**. If the company is a member of a group, the limits apply to the gross assets of the group, taken as a whole.

Provisional approval can be given to a new VCT, but the 70% and 30% conditions must be met within three years. To retain approval, the company must continue to satisfy all the conditions.

"Investment in private equity-backed businesses has grown much faster than the national average. In the five years to 2006/7 investment in private equity-backed companies rose by 11% compared with a national increase of 3%."

The British Private Equity & Venture Capital Association (BVCA)

## The Issue of Risk

Before considering an investment into a VCT there are **a number of areas to do with the issue of risk** that you need to consider as follows:

- VCTs are considered to be **a high risk investment**. They will, therefore, only be suitable for you if **you have an adventurous or aggressive attitude to risk**, or you have a balanced or moderate attitude to risk but are happy to invest at least part of your capital in a high risk investment. We will assess your attitude to risk before offering you advice.
- There are many different types of investment. Are you clear as to **why you wish to invest in a VCT?** It is possible that there is another, lower risk, investment that would also meet your objectives. As independent financial advisers we are aware of a range of different types of investment and their advantages and disadvantages.
- Are you comfortable with the fact that **VCTs are an illiquid investment?** A VCT has to be **held for 5 years** to qualify for the associated tax breaks. However, even after 5 years you may find it difficult to sell your VCT.

Some VCT managers promise to buy your shares from you but **a promise is not a guarantee** and it will usually be at a discount of around 10% to the asset value at the time.

Because of this you should generally not invest in a VCT unless you **happy to invest your money for at least 7 to 10 years**. Some VCTs set an objective to **wind up after a set period** so you will want to be aware of these if this is important to you.

- As has already been mentioned, the features and risks associated with each VCT will vary. There are three main divisions within VCTs and in order of increasing relative risk these are:

**Generalist** VCTs - A generalist VCT will have a relatively lower risk because of investing across a number of sectors of the market.

**AIM** VCTs - AIM is a form of company listing which does not meet the more stringent requirements of the London Stock Exchange listing. AIM companies will tend to be younger growing companies although some very large successful companies choose to be listed on AIM.

**Specialist** VCTs - A specialist VCT might cover technology companies, or the healthcare sector, or entertainment etc. The lack of diversification increases the risk.

- You need to be aware of **the investment strategy of the VCT manager** and particularly as it relates to **the 30% of the trust's assets that do not have to be invested in 'qualifying' companies**.

As has already been mentioned, at least 70% of the trust's funds have to be invested in 'qualifying' companies within three years.

The other 30% can be invested in a range of different asset classes, not necessarily cash or bonds, and **this feature will affect the overall level of risk** to which your capital is exposed.

- You should have some idea of the **potential size of the VCT**. The larger the VCT the larger the deals that can be made and the greater the spread of investments.

In this respect **some VCT managers are running a number of different VCTs so that larger investment can be made in total** into the same companies.

- You should be aware of the **initial and ongoing costs** of the VCT that you are considering in comparison to those charged by similar VCTs from other managers.
- Would you **prefer to invest in a brand new VCT** so that your money is fed into the underlying investments over a period of three years and in the meantime much of it will be held on deposit or in other lower risk investments?

Alternatively, would you **prefer to invest in a 'C' or 'S' share offering?** These allow existing VCTs to raise additional capital. The advantage to you is that your money is put to work in the underlying companies as quickly as possible, and there may be a saving in costs as some charges may be shared with the original VCT.

**'C' shares** - this is the most common way of topping up an existing VCT. Here your money is initially allocated to temporary C shares. These are then converted on a net asset value (NAV) basis into the existing class of shares, once the new capital has been invested.

This avoids flooding the existing portfolio with cash, which could unfairly dilute the short-term performance of the existing shares to the disadvantage of the original shareholders.

**'S' shares** – these are not commonly available but do appear from time to time. Here your money is allocated to permanent S shares. These form a distinct and different portfolio which remains separate throughout the life of the VCT. S shares have separate price quotes and net asset values.

Speed and cost are the main advantages of launching S shares over launching a new VCT. An S share has been described as a perpetual C share.

- VCTs are listed companies in the UK and their 'business' is to invest in other companies which may be listed on AIM or unquoted.

In this respect it is important to be aware that **VCTs are not regulated by the Financial Services Authority (FSA)**. You will therefore not have the same protection as if you invested in a unit trust company or UK life assurance company.

- As we have seen, VCTs offer **extensive tax reliefs**. Such relief will tend to reduce the risk of capital loss. It is important, however, 'not to allow the tax tail to wag the investment dog'.

## The Place of VCTs in Financial Planning

In view of the staggered investment period within the VCT **clients should be willing to accept a minimum investment period of 7 years** compared to 5 years for a typical unit trust, OEIC or Stocks and Shares ISA. However the **tax relief is not lost provided encashment is not within the first 5 years**.

VCTs are an obvious choice for **investors who want to invest in UK smaller companies** because of the additional tax incentives, although it is important to realise that **the type of companies in a VCT are very much smaller than those found in a typical UK smaller companies unit trust**, or other such collective investment.

VCTs can also be suitable for **higher risk clients approaching retirement**, who want to build up an additional source of tax-free retirement income. Such income is very erratic, unlike pension income or more usual forms of investment income. However, **it is rather nice to receive unexpected tax free payments from time to time**, as a top up to other forms of retirement income.

The **typical £5,000 minimum** investment for a VCT brings them within reach of a large number of investors. It also presents an opportunity for investors to build up a portfolio of VCTs over time using a mix of different investment styles.

Because the ordinary shares of a VCT are listed in the Official List of the London Stock Exchange, **you can sell them** in the same way as any other listed investment.

## If Full VCT Status is Not Received

This could be a serious issue for investors and emphasises the importance of **only using those VCT managers who have experience of issuing previously successful VCTs**.

If full VCT status is not received and no further action is taken, investors will face repayment of the 30% tax relief, have to face a capital gains tax liability on capital gains, and pay income tax on dividends.

The solution, however, for VCTs that find themselves in this situation is to merge with another VCT that already has approval.

"Over 90% of companies in which private equity has invested say that without private equity their businesses would not exist or would have grown far less rapidly.

Private equity is more than just the provision of capital. Nearly half of all businesses that have received private equity backing identified strategic direction, financial advice and help with contacts as key support they received from their private equity backers."

The British Private Equity & Venture Capital Association (BVCA)

## The Situation on Death

If an investor dies within 5 years of making an investment in a VCT, the transfer of shares on death is **not treated as a disposal** so the initial income tax relief is not withdrawn.

Other points to note are:

- The shares will become **part of the deceased's estate** for inheritance tax purposes.
- The executors are **free to deal with the VCT shares** in any way they see fit.
- The beneficiary of the VCT shares **will be entitled to tax-free dividends and will not pay capital gains tax on any disposal**.
- Any deferred capital gains, where VCTs were taken out prior to 6th April 2004, **do not become chargeable** on death.

## British Venture Capital Association

The British Venture Capital Association (BVCA) website **www.bvca.co.uk** (or telephone **020 7025 2950**) has a lot of background information about the venture capital industry, this type of investment, and particular VCTs.

## Risk Factors

You should be aware that **you should view a VCT as a high risk and long term investment**. The tax incentives being offered to investors should warn you that **these are necessary because of the high risk of loss**. By 'long term' we mean at least 6 years, but you would be **well advised to consider it as a 7 to 10 year investment**. The underlying assets in a VCT are by nature **highly illiquid**. This means that **you may have difficulty in selling your shares for anything like their underlying net asset value**.

Please make sure that you clearly understand each of the main risks of investing in VCTs:

### VCTs invest in small UK companies

Investment in AIM traded and other unquoted companies **may involve greater risk** than investment in companies traded on the main market of the London Stock Exchange. VCTs invest in companies with gross assets of not more than £7 million prior to investment. Such companies generally have **a higher risk profile than larger 'blue chip' companies**.

The spread between the buying and selling price of such companies' shares may be wide and thus the mid-market price used for valuation may not be achievable in the event of sale.

Furthermore, **the failure rate of these is typically much higher** than that of larger companies. Smaller companies often have **limited product lines, markets or financial resources** and may be dependent for their management on **a smaller number of key individuals**. Proper information for determining their value or the risks to which they are exposed may also not be available. Smaller companies are less likely to have multinational markets for their products or services than large companies and, as a result, may be **more exposed to national economic cycles** rather than global economic cycles.

### VCTs are inherently illiquid

There is currently **no effective secondary market** for VCT shares, primarily because the initial income tax relief is only available to those subscribing for newly issued shares. Therefore, there will most likely be **an illiquid market and investors may find it difficult to realise their investment**, especially during the early years of the life of the fund. The underlying investments are primarily in small companies, either unquoted or listed on AIM (Alternative Investment Market) or OFEX. The fact that a share is traded on AIM or OFEX does not guarantee its liquidity. There may be **fewer buyers and sellers of securities** in smaller companies than of securities in larger companies, bringing with it potential difficulties in acquiring, valuing and disposing of such securities. This compounds the difficulties shareholders may encounter when attempting to sell VCT shares.

These investments may be extremely difficult for fund managers to realise at fair value, and therefore shareholders **may not be able to dispose of shares at a price that reflects the value of the underlying assets**. Any **buy-back policies in place are always subject to liquidity**. The future realisation of shares at, or close to net asset value can never be guaranteed by a VCT manager.

### VCTs must be held for at least 5 years

If shares are sold within this period, **the initial tax relief will be required to be repaid**. Whilst it is the intention of the Directors of a VCT that the fund will be managed so as to qualify as a VCT, **there can be no guarantee that it will qualify**, or that such status will be maintained.

A failure to meet the qualifying requirements **could result in the fund losing the tax reliefs previously obtained**, resulting in adverse tax consequences for investors including a requirement to repay the income tax relief. VCT managers have three years from the issue of shares to invest 70% of the fund's assets in qualifying companies.

If this is not achieved the fund's status as a VCT is risked meaning investors could lose their tax relief. There are also additional requirements that VCTs must meet - if these are not met HMRC may withdraw the fund's status as a VCT and associated tax reliefs. **There can be no guarantee that the trust's VCT status will be achieved** within the three year limit.

Levels and bases of, and relief from, taxation are subject to change and their value depends on an investor's individual circumstances. Such changes could be retrospective.

### VCTs are long term investments

VCTs are designed to give shareholders **their capital gain through a tax free dividend stream**. There is, however, no certainty that any dividends will be paid.

Although investors may be free to dispose of their holding after 5 years (in order to retain their initial income tax relief) investors should expect to retain their shares for no less than 6 years, and we recommend that investors expect to consider this as a **7 to 10 year investment**.

### VCTs usually trade at a discount

VCTs are quoted on the stock exchange and, like investment trusts, **usually trade at a discount to net asset value**, which reflects the likely realisable value of the assets at any given time relative to the net value of the assets.

### VCTs may not have sufficient critical mass

Investors should be aware that a VCT **usually requires assets of at least £10 million** in order to achieve a spread of investments and thus lower company specific risk within the portfolio.

To the extent that a relatively small level of funds is raised by the particular VCT, the manager **may not be able to diversify its portfolio sufficiently**. This in turn increases the risk and such a VCT is likely to prove **more costly to manage**. There can be **no guarantees that the VCT will meet its objectives** or that suitable investment opportunities will be identified.

### VCTs are complex investment products

The investment strategies employed by VCT managers differ enormously. VCTs are complex investment products and are **only suitable for sophisticated investors**.

To understand the likely nature of the underlying investments, timeframe and return expectations, we strongly recommend individuals considering a VCT investment to **contact us for independent advice**.

There may be **sudden and large falls** with this type of investment. There is a risk that investors **might not get back any of their original investment**. The past performance of VCTs generally, or any one VCT in particular, cannot be taken as a guide to possible future performance.

The value of shares in a VCT and the income from them **may fall as well as rise** and investors may not get back the amount originally invested. Investors should **always read the full VCT Securities Notes** and pay particular attention to the risk warning notices which they contain.

Please note that **this information does not constitute personal advice** and should not be treated as a substitute for specific advice based on your circumstances. This Guide is simply designed as an introduction for you to venture capital trusts. It cannot cover every possible aspect of investing in VCTs and is not meant to be exhaustive.

Information given relating to tax legislation is based on our understanding of legislation and practice currently in force. Whilst we believe our interpretation of current law and practice to be correct in these areas, we cannot be responsible for the effects of any future legislation or any change in interpretation or treatment.

In particular you are warned that levels of tax and tax reliefs are subject to alteration and, in any case, the value of such reliefs and benefits may depend on an individual's circumstances.

If you are in any doubt as to whether an investment in a venture capital trust is suitable, then **you should discuss the matter with a suitably qualified independent financial adviser** such as ourselves.

### For personal advice

If you would like to discuss whether an investment into a venture capital trust might be appropriate for you please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**  
Email: **enquiries@arch-fp.co.uk**  
Online: **www.arch-fp.co.uk**

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guides\venture capital trusts 05.08