VENTURE CAPITAL TRUST (VCT)

What is it?

The Government introduced the Venture Capital Trust (VCT) Scheme on 6 April 1995 to encourage people to invest in smaller companies whose shares and securities are not listed on the main stock exchange with the aim of making capital returns, VCTs are themselves listed companies and are run by a fund manager.

There are very strict rules on how VCTs can invest the pooled funds which in turn provide a number of tax advantages for the investor, these are detailed below.

Eligibility

In order to receive the various tax reliefs a VCT must be approved by HMRC. Sometimes a new VCT will not meet all the necessary conditions at outset and is given a specific time period in which to comply with the conditions. If this doesn't happen, approval will be withdrawn and the tax reliefs clawed back. To retain approval, a VCT must continue to satisfy all the conditions during each later accounting period. It is important that the client is aware that all tax reliefs will be clawed back if HMRC conditions are not met and approval is withdrawn within the five year minimum period (reliefs, apart from income tax relief, will be clawed back if full approval is withdrawn after the five year period).

- At least 80% of the investment by value must be in qualifying unlisted trading companies (Qualifying Investments) which includes companies listed on the Alternative Investment Market (AIM). The shares or securities which meet the conditions of the scheme and which were issued to the company must continue to be held by it. From 6 April 2007, any money that a VCT holds will be treated as an investment for the purpose of these tests. This 80% requirement means that it is possible for up to 20% of the assets to be 'blue chip' share holdings.
- Not more than 15% of the fund must be invested in any single company or group.
- At least 70% of the VCT's qualifying investments by value must be in new ordinary shares in qualifying companies which, for shares issued after 6 April 2011 funded out of monies raised by the VCT after that date, must be in holdings of ordinary shares with no preferential rights to dividends or assets on winding up. The balance of the investments in qualifying companies can be in other shares or debt, such as debentures or some other fixed or variable interest stock.
- The VCT must not have retained more than 15% of the income it derived in the accounting period from shares or securities.
- In meeting these limits, a VCT cannot invest more than £5 million in total each year in any single qualifying unlisted trading company, the gross assets of which must not be more than £15 million before the investment and £16 million immediately after.
- The company must satisfy a number of other conditions broadly similar to Enterprise Investment Scheme (EIS) companies.
- HMRC will be able to give provisional approval to a VCT if it is satisfied that the conditions will be fulfilled within specified time limits. VCTs will initially have up to three years from the date of each share issue to meet both the 80% unlisted trading company and the 70% ordinary share requirements.
- A company no longer needs to have a qualifying trade carried out wholly or mainly in the UK but it is necessary for it to have a 'permanent establishment in the UK'.

Shares in companies that are 'in difficulty' will cease to be qualifying for the purposes of the VCT.

Contribution limits

The minimum contribution is normally £5,000, whilst the maximum investment that can qualify for income tax relief is £200,000 per tax year.

Taxation

Income tax relief is available at up to 30% on investments of up to £200,000 per tax year into newly issued shares provided the shares are held for at least five years. Maximum income tax relief is such amount as would reduce the investor's income tax liability in the relevant tax year to zero.

Any capital gain on disposal is free of Capital Gains Tax. This exemption applies both to disposals made by the individuals originally subscribing for the shares at issue, and to investors who subsequently 'buy in' to VCTs quoted on the stock exchange.

Dividends received by the investor in a VCT are exempt from income tax. Again, this exemption applies both to disposals made by the individuals originally subscribing for the shares at issue, and to investors who subsequently 'buy in' to VCTs quoted on the stock exchange.

All statements concerning the tax treatment of products and their benefits are based on our understanding of current tax law and HM Revenue and Customs' practice. Levels and bases of tax relief are subject to change.

Obtaining the tax reliefs

A VCT will provide each investor with a certificate that they may then use to claim their income tax relief – the claim can either be made immediately by contacting their Tax Office and obtaining an adjustment to the tax coding under the Pay As You Earn (PAYE) system or via completion of the annual tax return. Relief is not automatic and the client must be advised of the need to make a claim.

If the investor does not pay tax under PAYE but is due to make Self-Assessment payments on account, they can, subject to certain conditions, make a claim to reduce these. To receive the relief this way, the investor should contact their Tax Office and ask for confirmation of the qualifying conditions for making a claim to reduce payments on account. When making such a claim, the investor must bear in mind that HMRC will charge interest and / or penalties if the claim proves to be excessive.

Whichever method is used to claim income tax relief, the investor must enter details of the investment on a tax return for the tax year in which the VCT shares were issued.

Withdrawals

As VCTs have a five year qualifying period for the retention of full relief, the market for these investments is likely to be very illiquid, particularly in the early years, even though the shares will be listed. One of the main attractions of such investments is the tax relief which is not available to a re-purchaser. This affects the demand for such shares and further contributes to the illiquidity of the market in such shares.

Disposal within five years will lead to the loss of any tax relief previously obtained unless the disposal results from the death of the investor. On death there is no claw-back of income tax relief. Inheritance Tax may still apply of course where the estate is of sufficient size.

It is important for investors to bear in mind however that shares in VCTs are likely to trade at a substantial discount to net asset value and investors are therefore likely to find it difficult to realise what they consider to be the true value of their investment. Some VCTs do offer share buy back schemes so that investors finding themselves needing to make a forced sale do not suffer from an unreasonable discount so the existence or absence of such an arrangement should be taken into account when considering which scheme to use.

Risk considerations

There are a number of risk considerations that need to be taken into account. It is important that you are aware of these.

- Governments can and do change the rules on tax in respect of investments such as VCTs.
- VCTs are high risk investments and there may be no market for the shares should you wish to dispose of them.
- The market for these investments is likely to be very illiquid, particularly in the early years.
- The value of shares in VCTs can go down as well as up. Although VCTs are quoted on the stock exchange, at least 80% of a VCT's capital must be invested in unquoted securities. It is likely therefore that VCT shares will trade at a substantial discount to the Net Asset Value (NAV) of the Trust and you may find it difficult to realise the true value of the investment.
- Income tax relief is granted at the rate of up to 30% on subscriptions for new VCT shares up to an invested amount of £200,000 per tax year (maximum income tax relief is such amount as would reduce the investor's income tax liability in the relevant tax year to zero). However, HM Revenue and Customs will reclaim this tax relief if the shares are not held for at least five years or if the VCT is deemed by them to lose its qualifying status.
- VCTs typically invest in unquoted shares, for example in the new shares of privately owned companies and the new shares of companies traded on the Alternative Investment Market (AIM) and as such should be considered as high-risk investments. The availability of various tax reliefs should not cause you to overlook the risks inherent in such ventures.