SPECIAL REPORT
VENTURE CAPITAL TRUSTS

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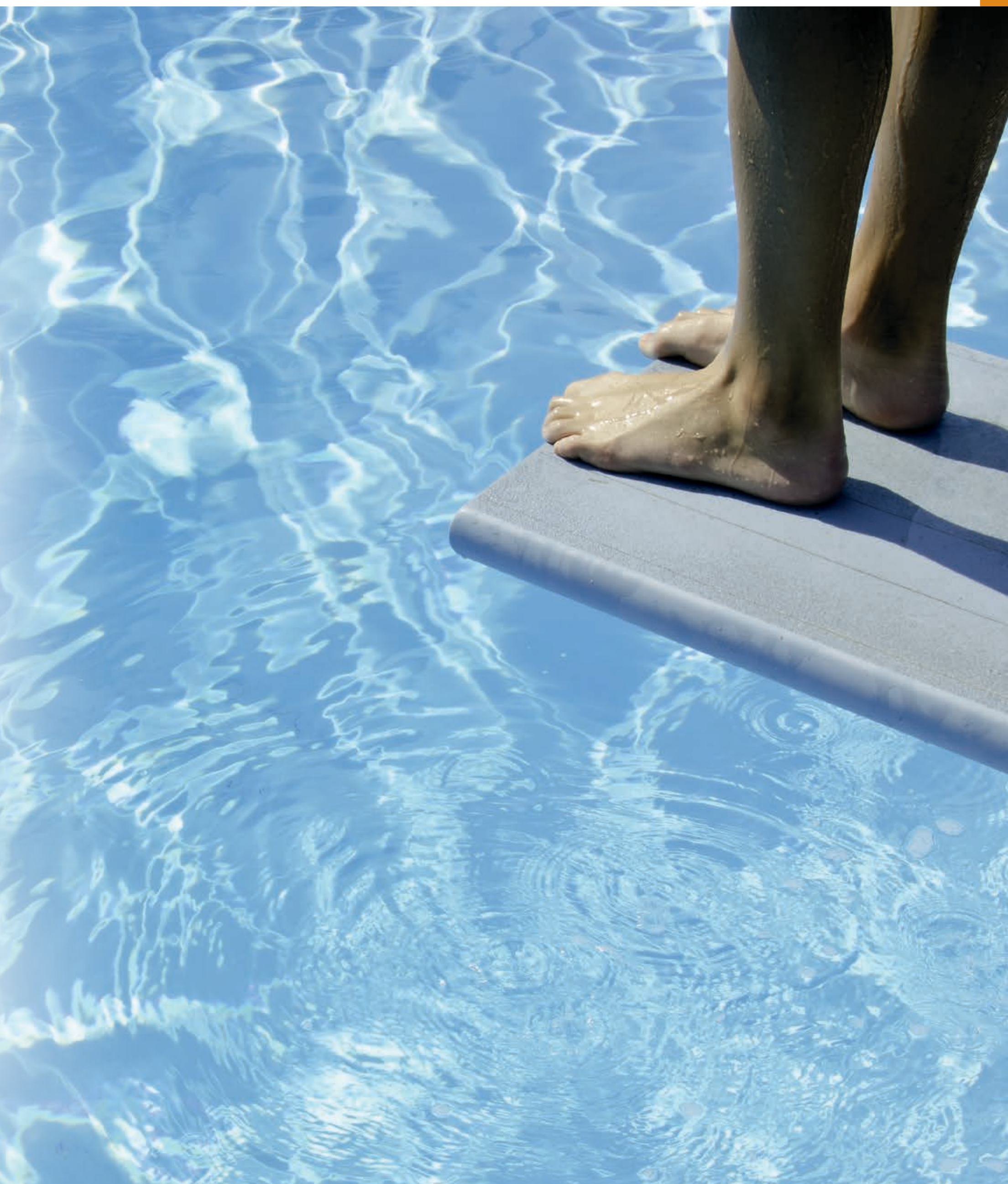

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Using Venture Capital Trusts

Fiona Bond talks to paraplanners about when and how they use Venture Capital Trusts and finds they remain an alluring prospect for wealthy clients

In the 25 years since their launch, Venture Capital Trusts have evolved into an attractive tax-efficient vehicle. Figures from the Association of Investment Companies (AIC) found that VCT investment reached £731 million in 2018/19, marking the sector's most successful year in over a decade.

Many have attributed the growing appeal of VCTs to the cuts to pension allowances that have plagued pension savers in recent years, as well as the introduction of the tapered annual allowance in 2016 for those on higher incomes.

Myka Simpson-Rivas, paraplanner team leader at Aspect8, explains: "The continual changes to pension funding have led to a greater number of wealthy investors – who would have previously received pension tax relief – with excess capital to invest elsewhere."

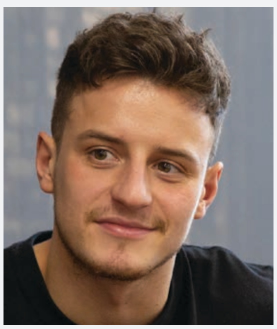
The tax breaks on offer are arguably a VCT's greatest attraction, says Simpson-Rivas, the most notable of which is the 30% upfront income tax relief. This relief is available on investments up to £200,000 per year, provided shares are held for at least five years. Investors also benefit from tax-free dividends as well as tax-exempt capital gains.

Lee Hastie, paraplanner, Para-Sols says: "We have seen a steady increase in VCTs being recommended over the last few years. It is important to remember that for high net worth clients, the £20,000 ISA allowance could only be a very small portion of their income/savings.

"The £2,000 dividend allowance is minimal and their pension allowance is likely to be tapered so clients earning significant amounts have to turn to specialised products to gain worthwhile tax breaks."

"There are a large number of VCTs on the market now with some established providers, and a number of good research tools such as MiCAP to help identify the most suitable ones"

Lee Hastie, Para-Sols



But VCTs should not be considered a like-for-like alternative for pensions and ISA investments, paraplanners warn. While the breadth and scope of sectors included in VCTs may have changed considerably over the past 25 years, their core purpose remains the same – to fund small, up-and-coming and therefore high-risk companies.

Sian Davies-Cole, paraplanner and director, Planworks, says: "VCTs are generally best suited to high net worth sophisticated clients who have experience and understanding of investing. These will be clients who have exhausted all of their tax allowances such as pensions and ISAs, are affected by the pensions taper, and who have extra capital to explore further options."

Davies-Cole says historically, VCT clients she has worked with have tended to be in their 50s and at a point where they have accumulated significant wealth and are in the process of finalising retirement plans, but she says suitability is much more dependent upon individual circumstances than age.

"For some clients investing in VCTs can be something of a final push as they approach retirement, and the tax-free dividends they offer can be very useful for generating income in retirement but suitability really depends on circumstances. You may have a young footballer earning vast sums of money and for whom a VCT investment is a natural next step. Ultimately, it comes down to capacity for loss and those who feel comfortable with the notion of high-risk investing."

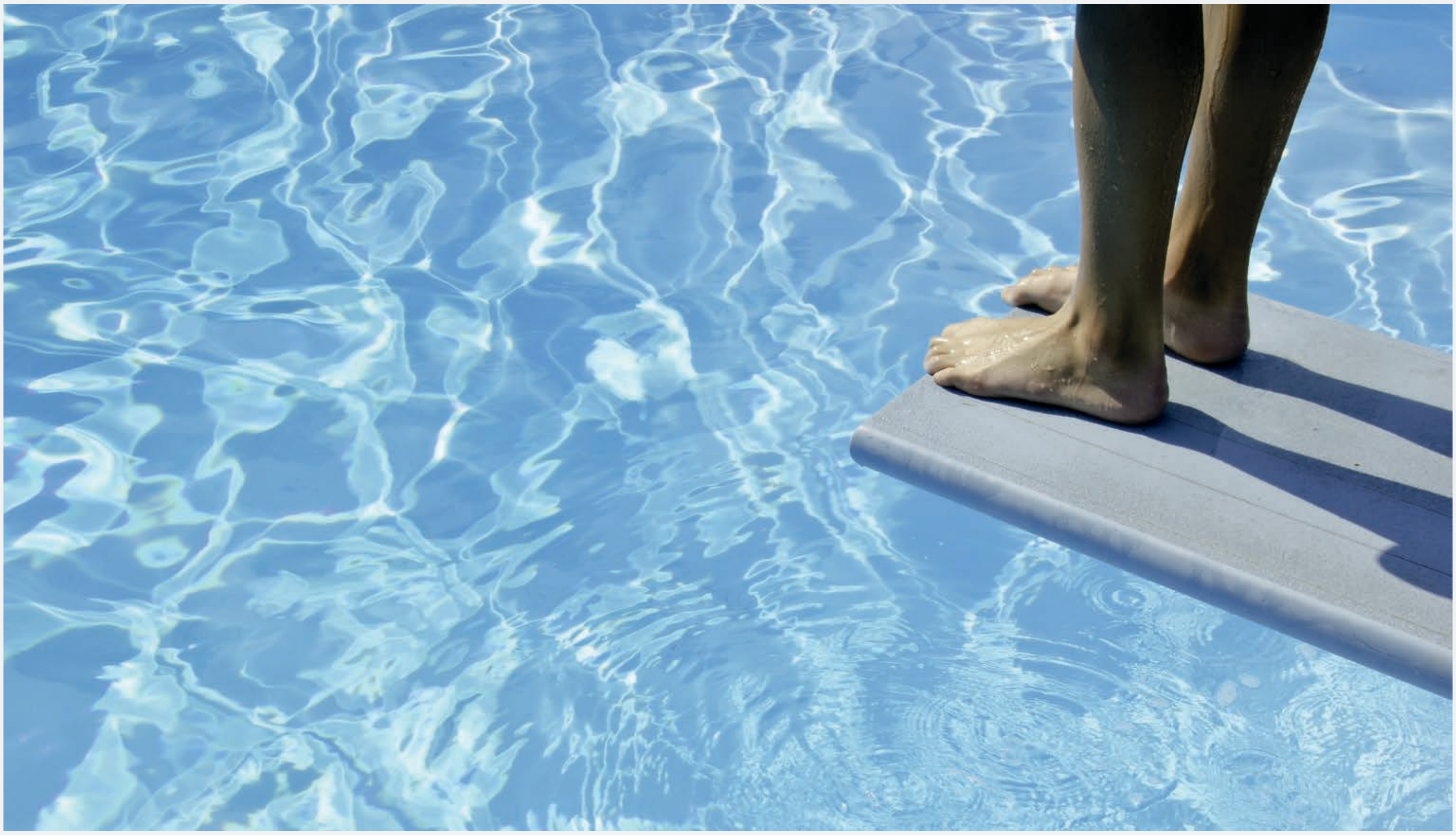
Backing early-stage companies

According to Davies-Cole, very sophisticated clients are often entrepreneurs themselves and therefore enjoy the idea of investing in other start-ups.

Indeed, for many clients, the diversification that VCTs offer and the opportunity to gain exposure to some of the country's exciting new companies can be an alluring prospect. Simpson-Rivas says: "There is certainly a vibe among investors that they like finding out about the companies they're investing in and they enjoy the innovation and development that comes with early-stage companies."

Since their inception in 1995, investors have ploughed more than £8.48 billion into VCTs and the sector has enjoyed various success stories, including household names Zoopla, Graze and Everyman Cinemas. According to the AIC, the social and economic impact of VCTs is also noteworthy, with VCTs responsible for generating over £1.4 billion of exports and creating more than 27,000 jobs over the past 25 years.

But as their popularity grows, successive Governments have been careful to introduce rule changes to avoid VCTs turning into a 'safe' investment used by investors for capital preservation purposes. In April 2018, VCT investments rules were amended to include a 'risk to capital' requirement,



while April 2019 saw the percentage of qualifying investments – those that are considered to meet the stringent rules – increase from 70% to 80%.

Amid this renewed focus upon riskier, early-stage companies, Hastie says clients need to be aware that some VCTs focus on young companies that might not be too profitable as of yet but which have strong potential. "Inevitably, with some of these companies it does not always work out," he says.

Unlike their larger, publicly-listed counterparts, the value of a VCT's underlying investments can also be harder to determine. This can make it difficult to sell VCT shares on the secondary market, although some VCTs offer a 'buy back' facility at a discounted rate. Simpson-Rivas says: "There is the risk that the companies they invest in may collapse, and investors must also be willing to accept their illiquid nature and the possibility that they may not be able to get their money out straightaway."

To mitigate the risk inherent in VCT investing, paraplanners say that diversification is paramount. According to Davies-Cole: "If you're looking at VCTs, you need to decide how many providers to opt for but that, of course, depends on the amount to be invested. Certainly, if someone was going to invest the full £200,000 you would want to ensure that you are dividing that amount between VCTs to reduce the risk."

Hastie says that first and foremost, the level of investment should only be a small portion of the client's overall wealth and should be spread across different providers. "One recurring strategy I have seen is utilising a number of providers for additional diversification. For example, spreading the £200,000 across four VCTs for £50,000 each. There are a large number of VCTs on the market now with some established providers, and a number of good research tools such as MiCAP to help identify the most suitable ones."

Simpson-Rivas adds: "The key is not to put all your eggs in one basket. It's about looking at the wider wealth of the client and ensuring that they are well diversified both in terms of their investment portfolio and within VCTs. "It's important to carry out due diligence and be comfortable with the experience of the VCT provider. We prefer Octopus for that reason."

As the UK seeks to recover from both the Covid-19 pandemic and Brexit, there will undoubtedly be growing attention on the vital role small businesses play in helping the UK economy recover. Against this backdrop, and with ongoing talk that pensions relief may well fall under the Chancellor's axe, it looks likely that VCTs will retain their appeal for the foreseeable future.

Venture Capital Trusts Q&A

Octopus Investments has years of experience of managing VCTs. Octopus manages around a quarter of all VCT money and its Titan VCT is the largest in the market. Rob Kingsbury spoke to Jessica Franks, Head of Tax at Octopus, about how VCTs can be used for clients and their importance in supporting UK smaller businesses

WHAT'S OCTOPUS'S PEDIGREE IN PROVIDING VCTS?

Octopus has a long history of providing VCTs for the market. We have four VCTs – the Titan VCT, which is the largest in the market, with 906m of assets under management; two AIM VCTs; and the Apollo VCT – the combination of which provides investors with a broad coverage of the VCT spectrum.

Titan VCT invests in over 80 smaller unlisted companies, across a diverse range of sectors, which have the potential for high growth. This is currently fundraising, with a 1% discount until 15 December.

Octopus AIM VCTs, which are open for fundraise, likewise feature around 80 established, maturing businesses from a diverse range of sectors. There aren't too many VCTs that are dedicated to investing in the AIM market and we are able to do so successfully, because we have a large specialist and experienced AIM team, including managers who have been investing in AIM since it began 25 years ago.

Apollo VCT invests in a portfolio of around 50 companies. It looks for businesses that have already brought their product or service to market successfully and therefore offers investors a different opportunity and is useful to diversify a client's portfolio of VCT investments. Apollo is currently fundraising, with a 2% discount until 15 December.

Sometimes funds under management can be a poor proxy for quality but this is not the case with VCTs. The larger the VCT, the more companies it is able to invest in, which on a stand alone basis increases diversification within the VCT. More established VCTs will also typically hold companies at various stages of maturity, from very early stage through to those closer to realising an exit, which can help to diversify the investment.

A lot of our investors really like the tax free income that a VCT can deliver. So investing in a VCT with a well-established, long running portfolio can give a greater degree of comfort that they will see a dividend stream, bearing in mind of course that these are higher risk investments.

WHY WOULD A PARAPLANNER WANT TO INVEST A CLIENT IN A VCT?

VCTs offer a way to invest tax efficiently. These investments offer income tax relief equal to 30% of the amount invested up to the first £200,000 of investment each year. This is in the form of income tax relief on newly issued VCT share offers, as long as the investment is held for a minimum of five years. They also offer tax-free capital gains and dividends, provided the VCT maintains its qualifying status.

These reliefs are offered by the government to incentivise investors to put money into the UK's early stage companies, which are higher risk investments and this has to be highlighted when recommending the investments to clients.

When investing in VCTs, there are two elements to consider from a performance perspective, first is the growth in the share price or NAV, and the second is the dividend stream.

HOW IMPORTANT ARE VCTS TO UK EARLY-STAGE BUSINESSES?

Data from the AIC show that VCTs invested more than 900m in 2018/19, which is a substantial chunk of capital going into the UK's smaller companies.

The same data shows that on average 45% of all the businesses invested in have fewer than 25 employees, which means the money invested is likely to have a big impact because of the small nature of these companies.

What's also important to remember, is that the VCT is taking a minority stake in the business, so they are coming in to support it and help it grow and be successful. It's not just the investment of money from which smaller companies can benefit.

A lot of the companies also want the exposure to the experience and knowledge of the investment management team. We work with the companies we back to make their success more likely. Sometimes this can be looking at a business plan and seeing where things could be changed for the better, based on the team's many years of working in this market. It can also include taking a seat on the board, helping them expand overseas or introducing them to industry experts.

IN A WORLD WHERE SMALL COMPANY DISRUPTORS ARE APPEARING IN ALL INDUSTRIES, ARE VCTS LIKELY TO BECOME MORE IMPORTANT FOR THE UK ECONOMY?

Thinking post Covid and post Brexit, smaller and early stage companies are often among the most flexible in the market. They can move faster than larger ones when adapting to new ways of working or new opportunities, so could come out of the crisis well positioned for the next few years. Smaller companies certainly have an important role to play in the coming months and years.

WHAT SHOULD PARAPLANNERS NEED TO BEAR IN MIND WITH VCT INVESTMENTS?

Diversification is the important point here, as is investing with a manager who has experience in the market and works with the companies it invests in.

You'll want to look for a VCT with a well-diversified portfolio that has managed concentration risk through various sectors. That's because it brings the potential for steadier performance across market scenarios. VCTs with a smaller number of investments might see a spike in growth and their share price if one of its companies does well, for example, but that works the same for downside as well.

And of course, do the due diligence as you would for any investment, on the manager, on the product. Don't focus on the tax reliefs, they are just part of the structure. It still needs to be the best product available for the individual client's needs.

Finally, and this may seem a strange one, make sure the investor claims the relief to which they are entitled. As these are long-term investments, it has been known for the tax relief claim to be forgotten.

WHAT RISK IS THERE THAT THE FAVOURABLE TAX TREATMENT OF VCTS WILL BE LOST OR DECREASE SIGNIFICANTLY?

The government undertook the Patient Capital Review three years ago, part of which was to assess the value of financial support for early stage companies and to ensure they would be able to continue to prosper following Brexit. The Review looked at tax relief including VCTs, and concluded that the reliefs available through VCTs were very valuable for smaller companies and in turn for the UK. The report was really encouraged by the positive ecosystem the UK provided for growing companies, of which reliefs such as VCT and EIS play an important part.

This review provides the most recent insight into support for VCTs, which was positive. With the potential impact of the Covid crisis on top of Brexit, logically we would consider reliefs that encourage investment in smaller companies to be very important and valuable.

WHAT LEARNING MATERIAL DOES OCTOPUS OFFER FOR ANYONE WANTING TO KNOW MORE ABOUT VCTS?

What we want to do is make VCTs as accessible as possible so paraplanners and advisers can see when and how they may be applicable to their clients. Octopus has a great team of experts based regionally that paraplanners can speak to; a client friendly guide to VCTs explaining what they are and how the tax relief works; we have client planning scenarios to help paraplanners and advisers better visualise the different client types for which VCTs may be appropriate; and we are running regular webinars which provide further insights from the investment teams running the VCTs.

"What we want to do is make VCTs as accessible as possible so paraplanners and advisers can see when and how they may be applicable to their clients"

Guide to Venture Capital Trusts

Jessica Franks, Head of Tax, Octopus Investments, provides an overview of Venture Capital Trusts, the tax reliefs, the range of investments, and why they have become more popular in recent years

Venture Capital Trusts have been around since 1995. They offer investors attractive tax benefits as an incentive to take on the risks of backing small, early-stage companies. A VCT is a listed company in its own right. It takes in money from investors and uses it to buy stakes in companies that aren't listed on the main London Stock Exchange. Each VCT will have its own mandate and its own set of objectives. So you should find out a VCT's investment strategy before deciding whether to recommend it.

There are three types of VCT: generalist VCTs, AIM VCTs and specialist VCTs. Around three quarters of VCTs fall into the generalist category. Generalist VCTs invest in companies across a broad range of sectors and industries. Some focus on early stage companies yet to make a profit. Others will buy stakes in businesses that are a bit more established.

AIM VCTs, as the name suggests, invest in companies listed on the Alternative Investment Market (AIM), the junior market for the London Stock Exchange. Unlike other VCT-qualifying companies, AIM-listed companies have a daily market price and have to meet certain regulatory requirements to maintain their listing. Because AIM is a stock exchange, VCT-qualifying shares listed on AIM are usually easier to sell than shares of privately owned, unlisted companies.

The third category is specialist VCTs. These invest in specific sectors like energy, infrastructure or biotechnology. This concentration on one sector means specialist VCTs may involve more specific investment risk. That said, they could also deliver higher returns than other types of VCT if the chosen sector does particularly well.

What tax reliefs do VCTs offer?

Investors can claim up to 30% of the amount they invest as upfront income tax relief, on investments up to £200,000. Capital gains and dividends are also tax-free. An investor must hold the shares for five years in order to keep any income tax relief claimed. In addition, tax treatment will depend on individual circumstances, and tax rules may change in the future. Tax reliefs also depend on the VCT maintaining its VCT-qualifying status.

Which companies can VCTs invest in?

There are several rules about whether a company qualifies to receive VCT funding. The rules state the maximum size and age of companies that can qualify, as well as limits on how much they can receive. The idea is to direct capital to those companies that can provide growth and jobs for the UK economy.

To receive VCT funds, a company has to have a permanent establishment in the UK and carry out what HMRC calls a 'qualifying trade'. Although most trades qualify, there are some that the Treasury believes are not in need of additional financing support. These include activities like land dealing, running hotels, farming, financial activities and energy generation. These types of businesses would not be expected to qualify for VCT investment.

The rules on company size state that a company can have gross assets of no more than £15 million at the time of investment to qualify for VCT funding. In addition, gross assets can be no more than £16 million immediately after investment. The company must have fewer than 250 full-time employees when the investment is made.

VCTs should invest in companies that are less than seven years old from the date of their first commercial sale. There are exceptions for follow-on investments, where a VCT invests more money into a company they already have a stake in. Another exception could cover an established company raising funds to enter a new product or geographic market. Companies that qualify can receive up to £5 million of VCT or other tax-efficient funding in any twelve-month period, with a cap of £12 million over its lifetime.

The limits above are more generous for what are called knowledge-intensive companies. These are companies that have a large proportion of highly skilled workers, for example scientific researchers, or that meet certain innovation conditions.

Knowledge-intensive companies can have up to 500 employees and up to twelve years in which to receive their initial VCT funding. There's also a more

generous lifetime investment cap of £20 million. In addition, the 2017 Autumn Budget announced an increase in the amount of tax-efficient funding knowledge-intensive companies can receive in a twelve-month period, from £5 million to £10 million.

Why VCTs have become more popular

Restrictions on pension contributions have left many clients looking for additional tax-efficient ways to invest towards their retirement. While it's true that fewer clients will be affected by the annual allowance after the threshold and adjusted income limits were raised this year, those that are face a lower tapered annual allowance.

Of relevance to more clients is the lifetime allowance, which appears to have been a motivation behind a lot of VCT cases in recent years. This rose to £1,073,100 this year, the lowest level to which the government could have increased it under current rules. The lifetime allowance remains a material constraint on tax-efficient pension saving for a lot of people. And of course, high earners who take advantage of any increase in their annual allowance can expect to find themselves butting up against the lifetime allowance sooner than they otherwise would have.

Clients will typically be in their accumulation phase for twenty to thirty years. High-earning clients could spend around half of this period making enough in income to use up their pension and ISA allowances, or worried about exceeding the lifetime allowance.

That's ten to 15 years during which such clients could benefit from making regular VCT investments, which represent another tax-efficient way to invest for retirement. Multiply that by the growing number of clients affected by the lifetime allowance, and you can see why an adviser who previously didn't consider VCTs worth their time might now decide to research them.

Understanding the risks

The first step with any client is to make sure they understand the risks before making any

> *"Restrictions on pension contributions have left many clients looking for additional tax-efficient ways to invest towards their retirement"*

investment. VCTs are high risk investments. The value of a VCT investment, and income from it, can fall as well as rise.

Investors may not get back the full amount they invest. Tax treatment depends on individual circumstances and may change in the future. Tax reliefs also depend on the VCT maintaining its VCT-qualifying status. Clients will also need to be comfortable with the idea of holding the shares for five years in order to keep any income tax relief they claim.

And they should keep in mind that VCT share prices can be volatile, and the shares may be hard to sell.

Venture Capital Trust case study: Extracting profits from a business tax efficiently

This tax-planning scenario is designed to help paraplanners and advisers develop appropriate planning strategies for their clients. Paraplanners and advisers should consider, among other things, the value of tax reliefs for their client. You will also need to consider the impact of charges (including initial fee and ongoing fees such as annual management charges) relevant to the products represented and/or any specific product you have chosen.

Vijay is an independent IT contractor. Because he works as a consultant for a number of different companies, he has established a limited company. Vijay chooses to pay himself with a combination of a salary of £9,500 (within his National Insurance Contribution threshold) and a dividend of £40,500. He owes £2,663 in tax, meaning after tax, he'll be left with £47,337 in available cash. Vijay also pays into his pension and chooses to invest in some new technology for his business. However, even after this, he is still left with surplus money which is building up in his business. Vijay is therefore keen to extract an additional dividend from his company but is wary about the additional tax he would owe.

Vijay talks to his financial adviser, who makes an assessment based on his risk profile, investment time horizon (of more than five years) and attitude towards smaller company investing. Given Vijay's goal of reducing his dividend tax by investing tax efficiently, his adviser suggests that he pay himself an additional £50,000 dividend and invest it into a VCT, holding this investment for at least five years.

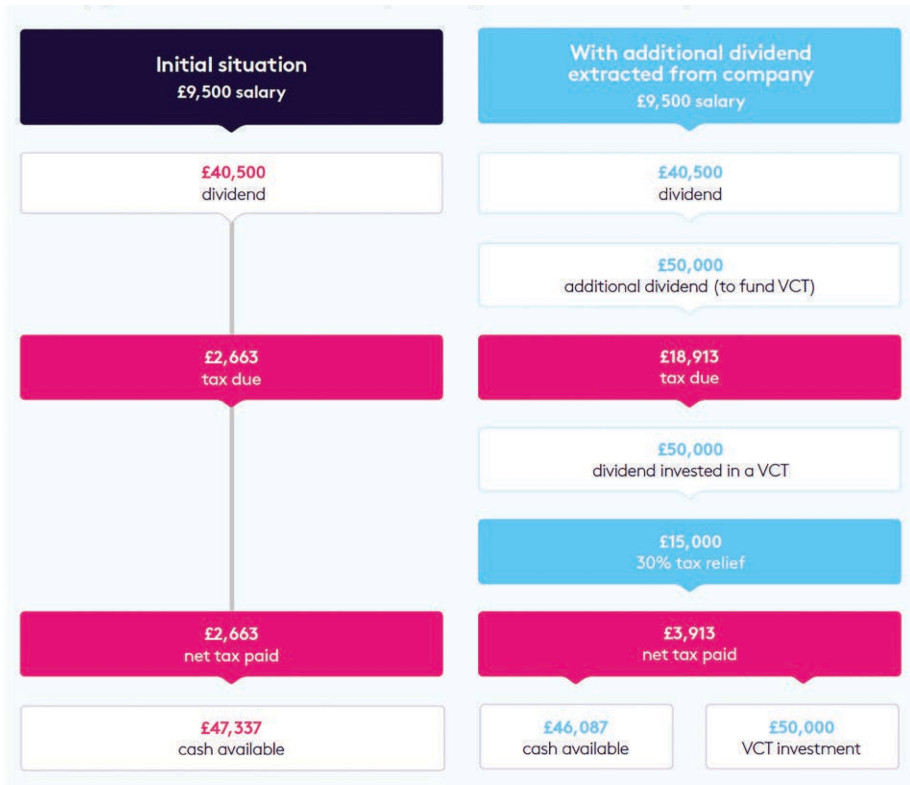
In the two decades since they were first introduced, VCTs have become increasingly popular with some investors, particularly those who already have personal pensions and Individual Savings Accounts (ISAs), and are comfortable with higher risk investments. They are proving even more popular with individuals like Vijay, following recent changes to dividend taxation. With a VCT, Vijay can claim up to 30% income tax relief on up to £200,000 invested in any single tax year, provided he holds his VCT shares for at least five years. Vijay can also benefit from tax-free dividends and no capital gains tax to pay when he sells the shares.

THE TAX BENEFITS OF INVESTING DIVIDENDS IN A VCT.

The diagram shows how a small business owner can take advantage of the tax benefits associated with investing in a VCT to offset some of their dividend tax bill. VCTs are high risk and if an investor needs guaranteed income, cannot tolerate loss or is uncomfortable losing immediate access to their money, then a VCT will not be suitable. Clearly everyone's circumstances are different, and VCTs 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.

HOW VIJAY REDUCED HIS INCOME TAX BILL BY INVESTING ADDITIONAL DIVIDENDS PAID FROM HIS BUSINESS

If Vijay extracted the extra dividend and didn't invest it into a VCT he would have paid £16,250 in tax.



Note: For purposes of this illustrative example, we have assumed no gain or loss on investments, and it does not take into account any initial fees or ongoing charges that will be incurred. VCTs are high risk and inherently different from pensions and ISAs. When clients choose to sell VCT shares, they are often sold at a small discount to the value of their underlying net asset value, so the impact of this should also be considered when assessing any specific products. Please note, 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.