Briefing

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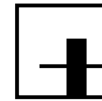

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The Autumn 2017 Budget has changed the VCT investment landscape

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The Autumn 2017 Budget has changed the venture capital trust (VCT) investment landscape, introducing changes to the regime designed to restrict VCT funds' ability to benefit from tax advantages when investing in companies perceived to be lower risk that the target market for VCT investment. This article looks at the evolution of VCT investments and identifies who the winners and losers are likely to be as a result of these changes.

What are VCTs?

VCTs have been around for over 20 years and are designed to encourage investors to invest in small, early stage UK companies by giving them certain tax advantages in order to help such companies develop and grow over the longer term. Such businesses' ability to attract funding might otherwise be stifled, given investors' and banks' reluctance to invest in small businesses with unknown management teams and unproven technologies.

The tax advantages offered by VCT investments are similar to those offered by Enterprise Investment Scheme (EIS) investments, however under the Enterprise Investment Scheme (and also the Seed Enterprise Investment Scheme (the SEIS)), investors will invest directly into a target company, whereas with a VCT they invest into the VCT (which is listed) and then the VCT invests in a number of target companies.

Broadly, the tax advantages for VCT investors include:

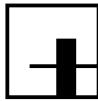
- no income tax on dividends paid by the VCT;
- exemption from capital gains tax on disposal of shares in the VCT; and
- 30% income tax relief on the amount subscribed for new shares, up to £200,000 per year (provided shares in the VCT are held for at least five years).

As these tax reliefs are fairly generous, the relevant legislation sets out certain criteria in respect of the business benefiting from the investment (e.g. the gross assets of the company must not exceed £15 million and the company must have fewer than 250 employees). As well as various conditions about the size and age of the company, there is also a list of various trades (such as the provision of legal services and farming) that do not qualify for VCT investments. Similar rules apply for EIS investments.

What have VCTs been used for?

VCTs are listed companies, with some of the more well known in the UK including funds managed by Albion, Triple Point, Hargreave Hale and Octopus Titan.

While the general principles behind the VCT rules have remained constant over time, the rules relating to the scheme (and in particular around the sorts of companies that can benefit from VCT funding) are constantly changing. Such changes are typically designed to ensure that investments are made into higher risk companies and that investors are not securing the fairly generous tax reliefs without taking on investment risk. For example, in 2015, changes were made to prevent investment into certain companies in the renewable energy sector (due to such companies already benefiting from other UK Government-backed support mechanisms for green energy such as the Renewable Obligation Certificate and Feed-in-Tariff schemes).



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Such changes have generally followed a 'sticking plaster' approach, with piecemeal changes being made to the rules to fix whatever perceived abuse HMRC had recently identified. In turn, as one low-risk investment opportunity closed, there would be a rush to identify possible alternatives, only for further changes to then be introduced to account for those new types of investment. This approach has led to the legislation becoming increasingly complicated, with compliance costs inevitably increasing as a consequence.

A new general restriction

In its recent Treasury paper *Financing Growth in Innovative Firms* the UK Government has clearly stated its view that "capital preservation" is central to the focus of too many VCT investments and that VCTs are being used for investment into businesses that are less risky than the initial target market.

These views have now translated into UK Government policy and changes to the VCT (and EIS and SEIS) rules were announced in the Autumn 2017 Budget so that, in future, a new overarching "risk to capital test" will apply to all tax-favoured venture capital investments. The proposed wording for the new test has been included in the recently published Finance Bill 2018. The risk to capital test has two parts, both of which must be met in order for an investment to obtain tax-favoured treatment:

- the company in which the investment is made must have objectives to grow and develop over the long term; and
- the investment must carry a significant risk that the investor will lose more capital than they gain as a return (including any tax relief).

HMRC has also published draft guidance on how it sees the new test applying, which notes certain matters will in future be looked at unfavourably, including:

- investments into special purpose vehicles set up for a single project;
- companies with guaranteed income streams or strong tangible asset bases; and
- companies that do not involve entrepreneurial management.

HMRC will also look at marketing material produced in relation to the investment to ensure the relevant investment is not being marketed as "safe".

The guidance also explains the risk to capital test "is a principles-based condition that depends on taking a 'reasonable' view as to whether an investment has been structured to provide a low-risk return for investors". If HMRC takes the view the investment falls foul of the new test, then tax relief will not be available. While the risk to capital test is not yet law, HMRC will no longer give advance assurance for investments that appear likely to fail the new test.

While the new test will be bad news for some, the draft guidance is clear it should not prevent young, innovative and entrepreneurial companies from qualifying. In other words, HMRC works to ensure relief is focused on those companies that the scheme was designed to benefit. In turn it may be that those companies will find it easier to secure funding under the venture capital schemes as the "safer" alternatives will no longer be available to investors looking to access the relevant tax reliefs. This could be advantageous for technology and healthcare businesses, as well as innovative disruptive companies.

We have heard feedback from clients involved in the VCT sector that, although VCT rules have been tightened, this has been a good year for VCT fundraising.

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