

Venture Capital Trusts

Background

Venture Capital Trusts (VCTs) were first established in 1995 to encourage investment in vibrant smaller companies. Because such companies tend to be higher risk than large 'blue chips', the Government offers tax breaks as an incentive to attract investors.

For much of their life VCTs have been the preserve of wealthy investors, as the primary tax benefit was the ability to defer capital gains tax liabilities. However, the tax deferral was replaced with a 40% income tax rebate during the 2004/05 and 2005/06 tax years, potentially widening their appeal to investors without capital gains tax liabilities. This was reduced to 30% from 2006/07 onwards. Individuals can currently invest up to £200,000 per tax year.

The Nuts & Bolts of VCTs

VCTs are very similar to investment trusts. They raise money from individual investors and then pool this so that they can acquire a portfolio of different investments, which helps to spread the risk. VCT shares are listed on the London Stock Exchange, which lays down rigorous standards on the qualifications and experience of the managers.

Unlike investment trusts, VCTs are allowed to distribute their realised capital profits. This can occasionally result in a tax-efficient windfall for investors.

At least 70% of each VCT's portfolio must be represented by 'Qualifying' investments within three years of launch. These must be new issues of securities (which can include loans as well as shares) by qualifying companies. Qualifying companies must have 'gross assets' of less than £7 million prior to investment and less than £8 million immediately after investment, have fewer than 50 employees, have raised no more than £2 million from venture capital schemes over the previous year and their shares must not be listed on a 'recognised stock exchange'. The Alternative Investment Market (AiM) is not a recognised exchange, although a 2007 Budget announcement suggested this could change at short notice in future. These restrictions only apply at the time the investment is made. A few trades, such as nursing homes, hotels and property development are specifically excluded from VCTs.

The Pros & Cons

Pros	Cons
<p>30% Tax Rebate This is available on new issues of VCT shares (which must then be held for at least 5 years). You must have paid the amount of tax that is being rebated, but this does not have to be higher rate tax. If sold within five years you lose the tax rebate.</p>	<p>Higher Charges VCTs are more expensive than most other types of investment. The initial charge is typically 5% (but this can be substantially reduced by investing through Bestinvest) and the ongoing annual costs are typically 2.5-3.5%.</p>
<p>Ongoing Tax Relief Available on purchases of new and existing shares. No tax is payable on any dividends received. In fact they do not even need to be declared on tax returns. There is a notional tax credit attached but this cannot be reclaimed.</p>	<p>Greater Risk Most of a VCT's assets will be invested in small UK trading companies. These do not have to be start-up ventures, but you should regard the overall risk level as being higher than that of a unit trust investing in 'blue chip' companies. Risk varies between different VCTs, usually depending on their investment policy.</p>
<p>Exit Tax Relief There is no capital gains tax liability even if the VCT shares are subsequently sold at a profit.</p>	<p>Poor Liquidity & Share Price Discounts Although VCT shares are listed on the London Stock Exchange, the volume of shares traded tends to be low. The spread between buying and selling prices can be wide and most VCTs trade at a discount to their underlying net asset value. In April 2007 the average discount was 9% (Source: Fundamental Data Ltd).</p>

The combination of initial charges and the expected share price discount will typically result in shareholders initially losing 20% of their original investment – about two-thirds of the potential tax rebate. Because VCTs launched in the current tax year must invest in smaller companies than in the past, bear in mind that VCTs may no longer be appropriate for you even if they were in the past.

What Types Of Investment Do VCTs Hold?

VCT regulations allow the manager considerable scope for adopting different investment strategies. The main restriction is the limit on the gross assets (£7 million immediately before investment and £8 million afterwards). The new rule on qualifying companies having fewer than 50 employees also reduces the scope to invest in established companies within the services sector, traditionally a popular home for VCT investments.

VCT investments can be divided into the four categories listed below. Most trusts will specialise in one of these but some deliberately have a balanced strategy. The performance characteristics of each group have distinctive features.

Private Equity

Represents traditional venture capital activities and accounts for more than half of all VCT investment. Private Equity investment requires many different procedures compared with buying quoted shares. For example, since there is no immediate ability to sell the shares, the VCT manager needs to be extremely confident in the purchase decision. This requires extensive investigation (called 'due diligence') which can take several months, with the whole transaction process often taking six to nine months. Once the investment has been made the subsequent monitoring of the company can be very time consuming, hence it's not uncommon for groups to make only three or four investments a year. Most private equity returns tend to come in the later years of the underlying companies' development, so it's important to hold for the long term. Success rates also vary widely, so **investors should seek as much diversification as possible, without lowering the quality standards of the manager.**

AiM

Investing in AiM companies should give VCT managers greater flexibility. Research covering these companies is more widely available than for private equity, there is a daily share price and the ability (at least in theory) to sell the shares. However, the AiM admission rules do not require any minimum track record, so even start up companies can join. Risk can therefore be on par with private equity, or even greater in some instances. There are many AiM VCTs available and in the past there has been considerable overlap in some of their portfolios. This diminishes the potential diversification benefits of spreading your investment across several AiM VCTs.

Asset Backed VCTs

Although the obvious asset backed trades, such as hotels, nursing homes and property development have been specifically excluded from VCTs, there are still several sectors which can offer the investor the benefit of fixed asset security, such as public houses, nurseries, garden centres, golf courses or plant and equipment. VCT rules allow up to 90% of an individual investment to be structured as loans and the overall qualifying portfolio can have up to 80%. This approach will usually be adopted to maximise security and generate income. Asset backed VCTs should be able to sustain a more consistent level of dividends.

Specialist

Some VCTs concentrate on a specific sector, such as technology or healthcare. These trusts are usually riskier. Their ultimate performance will usually be reliant on whether just one or two of the individual investments proves to be successful.

Points to bear in mind

- Investing in VCTs will increase your portfolio exposure to UK smaller companies. Keep an eye on your overall portfolio balance to ensure it remains appropriate to your objectives.
- Diversifying risk by selecting several VCTs across the various types available is usually advisable.
- Assuming the VCT is not a top-up, will it likely succeed in raising a viable level of funding? If it fails to do so the managers may abort launch, leaving you little time to choose another VCT. Alternatively, they might go ahead with insufficient funds to achieve a sensible level of diversification, which could increase risk. Up to date monies raised data is available at www.bestinvest.co.uk/vcts.htm.
- Investing through Bestinvest not only saves you money, but allows you to benefit from our extensive independent research.

For more information visit www.bestinvest.co.uk or call us on 020 7189 9999.

Important Information

Venture Capital Trusts should be regarded as higher risk investments. They are only suitable for UK resident taxpayers who can tolerate higher risk and have a time horizon greater than five years. Past performance should not be seen as an indication of future performance. Nothing in this leaflet should be regarded as being personalised advice. If you have any doubts as to the suitability of VCTs you should request us to provide you with personalised advice. Levels and bases of taxation can change and the availability of tax reliefs will depend upon individual circumstances. The value of investments and the income from them can rise and fall.