GUIDE TO VENTURE CAPITAL TRUSTS (VCTs)

A tax-efficient but higher-risk way to invest

HARGREAVES LANSDOWN

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> VCTs can be an invaluable financial planning tool, both leading up to and in retirement. After ISA and pension allowances have been used, VCTs could be the next port of call for tax-efficient investing.

IMPORTANT INVESTMENT NOTES

This VCT guide is not personal advice. Investors will need to make their own assessment of their expertise and the suitability of a VCT for their circumstances. Those with any doubts should seek expert advice.

Neither capital nor income is guaranteed. The benefits of tax shelters will depend on personal circumstances and tax rules will change over time. The value of VCTs will fall as well as rise and you may not get back the amount invested. The prospectus will give fuller details of the risks and the VCT. Any decision to invest must be made purely on the basis of the prospectus. This information is correct as at 6 April 2019.

WHAT IS A VCT?

A VCT is a company whose shares trade on the stock market and, rather like an investment trust, aims to make money by investing in other companies. These are typically very small firms which are looking for further investment to help develop their businesses.

These companies make VCT investing very exciting, but as VCTs often invest in companies at an early stage of development they are higher risk. Therefore VCTs are regarded as very long-term investments.

As well as capital the VCT manager also provides advice and expertise to help the chosen firms expand more quickly, aiming to increase their value and potentially provide better returns for investors. Then, normally between three and seven years after investment, the VCT manager will look to sell their stake in the business and move on. Generally, any profits are paid out to the VCT investors as tax-free dividends and the original capital is reinvested in the next opportunity.

THEIR PLACE IN A PORTFOLIO
VCTs are only suitable for sophisticated investors with significant investment portfolios who can take a long-term view and are comfortable with higher risks. The Financial Conduct Authority (FCA) suggests a sophisticated investor is somebody with an annual income in excess of £100,000 or investable assets of more than £250,000. Even then we feel VCTs should account for no more than 10% of a well-diversified portfolio. VCTs are unlikely to be suitable for mainstream investors who may need access to their money in the short term, or for whom loss of the investment will cause financial hardship. We assume investors will make their own assessment of their expertise and the suitability of VCTs for their circumstances. Those with any doubts should seek expert advice and our Financial Advisers provide this service for a fee to those who meet the criteria above. Please contact us on 0117 900 9000 for more information.

WHY CONSIDER VCTS?

INVEST IN SOME OF THE UK'S UP AND COMING BUSINESSES AT AN EARLY STAGE OF THEIR DEVELOPMENT

VCTs allow investors to support some of the UK's small businesses. The money invested helps them grow and the VCT manager provides expertise to help them develop. This type of investment can be crucial to fledgling businesses. They often struggle to get the money (and as importantly, the advice and expertise) they need from traditional sources such as banks.

Young companies with a product or service with the potential to disrupt an entire industry, widespread consumer appeal, or the opportunity to expand into new markets may be able to grow strongly. However, the possibility of failure is also greater so VCTs are higher risk than mainstream investments.

TAX-FREE DIVIDEND YIELDS

Tax-free dividends are the primary source of return for VCT investors. Dividends are often underestimated as a source of return and the potential to earn tax-free dividends can be particularly attractive. Dividends are variable and not guaranteed and are not a guide to future performance.

EXAMPLE OF TAX-FREE DIVIDENDS

If a company with a share price of 100p pays a 5p dividend the yield is 5%. For an investment held outside an ISA or pension the net of tax yield is 3.4% for a higher-rate taxpayer and 3.1% for an additional-rate rate taxpayer; assuming the £2,000 dividend allowance has been used.

When a VCT with an initial share price of 100p pays a 5p dividend, the yield is higher because the VCT subscriber gets up to 30 per cent income tax relief, so the net purchase cost of the share is actually 70p in most cases.

A 5p dividend on an investment with a net cost of 70p results in a yield of 7.1%. However, because the dividend is also tax free, a higher-rate tax payer would need to achieve a yield of 10.6% from a taxable investment to achieve the same result. An additional-rate tax payer would need 11.5%. Please note these are just examples, and yields are always variable, not guaranteed, and not an indicator of future performance.

Read on to find out how VCTs may reduce or eliminate an income tax bill...

SEE LIST OF AVAILABLE VCTS →

THE TAX BENEFITS

In recognition of the risks and complexities of VCTs, and to encourage investment in an area vital to the economy, the government offers up to 30% income tax relief for subscriptions in new VCT fundraisings. For example, those investing £10,000 could either receive a cheque from the taxman for £3,000, or a £3,000 reduction in the tax they pay.

Note that this is a tax rebate, so it is restricted to the amount of income tax paid. The maximum which can be invested each year is £200,000, but if an investor has only paid £5,000 in income tax they would only receive a £5,000 tax rebate on a £200,000 investment. The shares must also be held for five years to permanently keep the tax rebate. This rebate is only available when investing in a new issue of shares in a VCT or a top-up, not on any VCTs bought on the open market. However, it is worth noting that VCTs bought on the secondary market count towards the £200,000 allowance for that tax year, despite the fact that they don't qualify for the income tax break.

When investors eventually dispose of a VCT any gain will be exempt from capital gains tax. Dividends paid by the VCT are also tax-free. These two reliefs also apply to shares bought on the secondary market.

Although the tax benefits are generous it is important that investments are made in order to gain exposure to the venture capital market and not just for the tax breaks. The potential tax benefits should be the icing on the cake as opposed to the rationale for investing. Please remember tax and VCT rules can change, and the benefits will depend on individual circumstances.

EXAMPLES OF VCT TAX SAVINGS

EXAMPLE A

Mr A decides to invest £200,000 in a VCT. In the 2019/20 tax year he anticipates that he will pay £90,000 in income tax.

Investment	£200,000
Tax rebate	(£60,000)
Effective net cost	£140,000
Tax rebate as percentage	30%

EXAMPLE B

In the tax year 2019/20, Mrs B decides to invest £10,000 in a VCT. She is a non-Scottish tax payer and earns £30,000 per year, so is a basic rate tax payer, and will pay approximately £3,500 in income tax. Please note Mrs B has a significant portfolio and this represents less than 10% of it in total.

Investment	£10,000
Tax rebate	(£3,000)
Effective net cost	£7,000
Tax rebate as percentage	30%

EXAMPLE C

Mrs C wants to invest £100,000. She is a non-Scottish tax payer and earns £60,000 per year, and so is a higher rate tax payer. She has calculated that she will pay £11,500 in income tax in the tax year 2019/20.

Investment	£100,000
Tax rebate	(£11,500)
Effective net cost	£88,500
Tax rebate as percentage	11.5%

In the final example Mrs C has not paid enough income tax to reclaim the full 30% relief therefore she is entitled to only £11,500 which is the tax she will pay. **All tax treatments are subject to change and so can vary. The exact value will depend on circumstances and the investment must be held for at least five years to retain the tax breaks. If the VCT Manager fails to meet the relevant investment rules, such as investing 70% of the fund within three years, the tax benefits could be withdrawn retrospectively.**

WHAT ARE THE RISKS?

Although some VCTs may be viewed as less speculative than others, investors should remember that as a whole they are exposed to substantially higher risks than mainstream equities.

They invest in smaller, sometimes fledgling, companies, some of which could struggle or fail altogether, meaning losses for investors. The VCT manager may also have trouble selling the underlying investments. Investors should also be aware that VCT shares are illiquid. This means they can be difficult to sell (and buy) on the secondary market. Although shares are fully listed on the London Stock Exchange, there might be only one 'market maker' for the shares, which means investors may have difficulty selling at a price that fairly reflects the value of the underlying holdings or, in extreme circumstances, at any price.

Often the VCT manager will offer to buy back investors' shares at a target discount to the value of the underlying holdings. Details of any such buyback schemes can be found in the prospectus. They are subject to conditions and not guaranteed.

A long-term horizon is essential with VCT investing. Aside from 'limited life' VCTs that look to wind up after a 5-7 year time period, a ten-year time horizon is desirable. This is because it takes time for expanding businesses to fully realise their potential.

Investors should also be aware of risks affecting specific VCTs and VCT types. For instance, a further issue arises from smaller VCT funds who fail to raise sufficient money at launch. The resulting portfolio of investments may be more concentrated and it could increase the risks and charges. It is also worth noting that all VCTs tend to have higher charges than other types of fund and usually have performance fees.

As well as investment risks, it is possible that HMRC could withdraw the tax status of the VCT if it fails to meet the qualifying requirements. If this happens any tax rebate may have to be repaid. Each VCT will issue a prospectus at launch which gives details of specific risks and it should be read thoroughly before considering an investment.

ASSESSING PERFORMANCE

The performance of a VCT is best shown through a combination of:

1. The Net Asset Value (which will give a more accurate view of how the underlying investments have performed, as opposed to the market value).
2. The dividends paid to date.

In most cases both of these details can be obtained directly from the VCT managers and are usually in the annual report and accounts. They are also often shown in the prospectus, for top-up issues.

Please note past performance is not a guide to the future and dividends are variable and not guaranteed. The value of investments and income can rise as well as fall so you could get back less than you invest.

HOW TO CHOOSE A VCT

There are several different types of VCT. The most common (and the most popular) are Generalist VCTs. These are relatively broad-based, usually investing in a range of unquoted companies in a wide variety of sectors and often in various stages of development. Limited Life VCTs are designed to be lower risk and lower return than other VCTs and aim to wind up and distribute assets to shareholders after 5-7 years – though there is no guarantee they can meet their objectives and if the manager finds the underlying investments difficult to sell this could extend the life of the investment.

AIM VCTs, as the name implies, primarily invest in companies listed on the Alternative Investment Market (AIM), the junior market of the London Stock Exchange. These shares are usually readily tradable, so the underlying portfolio is more akin to a smaller companies unit trust, albeit with the restrictions imposed by the VCT rules, and higher risks. Finally, Specialist VCTs invest in one sector or area such as healthcare or infrastructure.

Each VCT manager has a different style. Some will predominantly invest in companies that are earlier stage looking for the best growth, whilst others insist investee companies are profitable and more established. There are also varying policies in the use of loan stock in the portfolio. This is where rather than investing in the firm's equity, the VCT loans money to the business. Loan stock provides a regular income into the VCT, which can help pay dividends to VCT shareholders. It is also lower risk than equity because holders are higher in the pecking order of creditors in the event the company goes bust. Often the loans are secured against particular assets of the investee company such as property, especially in the case of limited life VCTs. However, by reducing risk in this way it does mean overall returns can be lower compared to taking a higher equity stake.

At least 70% of the VCT's money must be invested in qualifying companies. The other 30% can be invested in alternative assets. This may serve to reduce or increase the trust's risk, depending on where the manager invests. When a new VCT or VCT share class launches, the portfolio will largely be in cash as it takes time to make investments. This means it generally takes longer for returns from investments to come through. In contrast, top-up offers to existing VCTs provide access to a more fully invested portfolio, often including companies at various stages of development.

If you would like an expert to recommend a VCT suitable for your personal circumstances, our financial advisers may be able to offer this service.

Our Advisory Helpdesk (0117 317 1690) is able to provide more information, and arrange a free initial consultation with a financial adviser.

SEE LIST OF AVAILABLE VCTS →

APPLYING FOR VCTS

HOW TO APPLY FOR A VCT OFFER

Complete the application form found at the back of the prospectus. These are available to download by **visiting our website** and clicking on 'current offers'; or by telephoning our Helpdesk on 0117 900 9000. The prospectus and the Key Information Document (KID) should be read fully before investing.

WHEN IS THE DEADLINE FOR MAKING AN APPLICATION?

VCT deadlines are specified in the individual VCT's prospectus. Any early incentives or existing investor discount deadlines are also included in the prospectus, and are often earlier than the final deadline for making an application. Please note that popular VCT offers may raise their full target amount before the deadline and close early. When applying for VCTs through Hargreaves Lansdown we normally need to receive applications at least one working day before the deadline published in a VCT prospectus. This enables us to process the application and send it to the VCT manager to ensure our discount is applied.

WHO SHOULD MY CHEQUES BE MADE PAYABLE TO?

The cheque should be payable to the VCT as stated in the prospectus, not Hargreaves Lansdown.

IS IT POSSIBLE TO USE CASH IN MY HL ACCOUNT TO APPLY FOR A VCT?

It is possible to withdraw cash held in the HL Fund and Share Account and the HL Stocks and Shares ISA to subscribe to a VCT. To do this please include a signed letter of instruction with a VCT application form. Remember, withdrawing money from your HL ISA means this money cannot be replaced without using up part of your ISA allowance.

The cash must have settled in the HL Fund and Share Account or Stocks and Shares ISA and, to allow us time to raise a cheque, we require the application form and letter at least two working days before the relevant published VCT deadline.

It is not possible to use cash in the HL SIPP to subscribe to a VCT.

WHERE DO APPLICATION FORMS NEED TO BE SENT?

Completed application forms should be sent to Hargreaves Lansdown to ensure our discount is applied. Our address is: One College Square South, Anchor Road, Bristol, BS1 5HL.

WHAT HAPPENS NEXT?

We will confirm receipt of applications by letter, stating the discount applied. The share certificate and tax voucher will be sent directly from the VCT manager or their agent. This can take several weeks as most VCTs allot shares monthly or, sometimes, less frequently.

HOW IS THE DISCOUNT APPLIED?

VCT discounts are usually applied in the form of issuing investors with additional shares.

The total discount is applied to the amount invested and the sum is divided by the VCT's Net Asset Value (including the initial charge). Discounts can also be given by lowering the price paid for each share. The total number of shares allocated will be shown on the VCT share certificate.

MANAGING YOUR VCTS

HOW TO CLAIM TAX RELIEF
HMRC make this easy. There is a special VCT section on tax returns and income tax will be repaid by HMRC via tax codes, as a lump sum rebate or, if self-employed, a reduction in income tax.

CAN VCT SHARES BE HELD IN A HL FUND AND SHARE ACCOUNT?
Yes. To arrange for VCT shares to be added to your HL account please send the share certificates to us with a completed Share Account Transfer form and a signed Crest Transfer Form. Both of these forms can be requested by calling 0117 900 9000.

If VCT shares are held in a HL Fund and Share Account we are not able to reinvest dividends and investors will not receive the annual VCT Reports from the VCT manager. Instead, dividends will be paid as cash into the HL Fund and Share Account and the VCT reports should be accessible on our website.

VCTs purchased in the secondary market will not be eligible for the initial tax relief, although they will count towards the £200,000 allowance for that tax year.

HOW TO SELL VCT SHARES
VCTs should not be invested in with a view to selling the shares in the short-term. The net asset value and share price may differ significantly. Returns will normally come predominantly via the tax-free distributions. Any income tax relief would be lost if the shares are sold within five years.

If it is necessary to sell, there are two options. The simplest and quickest way is to sell the shares via a stockbroker. Hargreaves Lansdown can provide this service. Investors should be aware that only one market maker may be offering to buy the shares and this could have a negative effect on the price. Alternatively the VCT company may offer to buy the shares. It is always worth investigating which is the most favourable option, as market conditions may dictate which is the best at the time.

ANY QUESTIONS?

HOW WE CAN HELP

The specialists on our Helpdesk are available to answer any queries you may have:

Monday – Thursday 8am to 7pm

Friday – 8am to 6pm

Saturday – 9.30am to 12.30pm

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