



HM Treasury



HM Revenue  
& Customs

# Venture capital trusts:

response to consultation and  
changes to scheme rules

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December 2013





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# 1

## Introduction

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**1.1** The government is committed to making the UK one of the best places in Europe to start, finance and grow a business. The government recognises the importance of private investment in generating growth, and the need to support SMEs to build the UK recovery. The tax-advantaged venture capital schemes play a key role in this, facilitating access to finance and providing support for smaller businesses that otherwise have difficulty finding the necessary finance to develop and grow. This government has expanded the Enterprise Investment Scheme (EIS) and the Venture Capital Trusts scheme (VCTs), as well as introducing the new Seed Enterprise Investment Scheme (SEIS). These reforms, legislated at Finance Act 2012, mean that the UK now supports a wider range of small and growing businesses via the venture capital schemes.

**1.2** The government has been clear that it is important the schemes remain effective, well-focused and supportive of business needs. At Budget 2013 the government highlighted concerns about the use of particular share buy-back arrangements for investment into VCTs. A technical consultation was held from 18 July to 28 September 2013.

**1.3** The consultation document provided context on the VCT regime and the government's concern that the recent increase in particular share buy-back arrangements might undermine the VCT regime as a whole, and set out some proposals for legislative change. The consultation document also asked about a related issue on the use of share premium accounts to return capital to investors.

**1.4** The government received just over 40 responses to the technical consultation document. Respondents included individuals who had invested in VCTs, VCT fund managers, tax and legal specialists and advisors, and representative bodies. Officials also participated in a number of roundtable and bilateral discussions with interested parties.

**1.5** The government is grateful to everyone who responded to, or participated in, the consultation process and has carefully considered the responses in deciding how to proceed. This document sets out the responses to that consultation and the government's decisions.

### Overview of key points

**1.6** Generally, respondents agreed that the government is right to take action to limit or prevent the use of particular share buy-backs. There were some suggestions for the government to offer more flexibility within the proposed changes to the rules, as well as some proposals for alternative approaches to the main option set out in the technical consultation document. The government has considered these comments carefully and has made some amendments to the proposed approach to restrict the tax relief relating to particular buy-back arrangements.

**1.7** Many respondents acknowledged that in some cases, the use of share premium accounts to return capital to investors could be damaging. This response document sets out further information about the government's concerns about this practice, and potential options for legislative change. The government will consult further to develop an appropriate proposal to address this issue.

**1.8** The government's intention is that these changes to the VCT regime should help to ensure that the regime continues to operate effectively, and that tax relief is used for genuine purposes where individuals are making risky investments into high-growth potential small and medium-companies.

**1.9** As announced at Autumn Statement, to help to facilitate investment into VCTs, the scheme rules will now also be changed to allow investment via nominees.

## Next steps

**1.10** Draft primary legislation on the changes to restrict particular share buy-backs, and to facilitate investment into VCT via nominee arrangements has been published alongside this document. There is a period of consultation on this draft legislation which will close on 4 February 2014. The draft legislation can be found at: <https://www.gov.uk/government/collections/finance-bill-2014> and includes explanatory notes and Tax Information and Impact Notes.

Comments on the draft legislation should be sent to:

Kathryn Robertson  
HMRC  
3/63, 100 Parliament Street  
London SW1A 2BQ  
Or  
[kathryn.robertson@hmrc.gsi.gov.uk](mailto:kathryn.robertson@hmrc.gsi.gov.uk)

**1.11** The government will consult informally with the industry with a view to considering any further changes needed to secondary legislation as a result of allowing nominee investments to qualify. VCTs are required to make returns to HMRC of their investors, and HMRC will need to be informed of the identity of the beneficial owners of any shares subscribed for by a nominee.

**1.12** The government will run technical workshops with the industry to consult on the best way to address the use of share premium accounts to return capital to investors in January 2014. The Government intends that legislative change on this issue is also introduced in Finance Bill 2014, and will therefore publish legislation in draft soon after technical workshops have taken place.

**1.13** Requests for participation in the workshops on share premium accounts should be sent to Sarah Adams: [sarah.adams@hmtreasury.gsi.gov.uk](mailto:sarah.adams@hmtreasury.gsi.gov.uk) or to Kathryn Robertson, details above.



# 2

## VCT share buy-backs

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### Context on share buy-backs

**2.1** The government's aim is for a tax system that is fair, competitive, and which rewards high value business investment and real economic activity. The government is committed to retaining confidence in the tax system by taking a robust approach against abuse of the system, while supporting business innovation and growth. It is clear that a robust and well targeted tax system is also a key concern for taxpayers and industry.

**2.2** It is therefore important to ensure that the tax incentives offered for investment in Venture Capital Trusts (VCTs) and the other tax-advantaged venture capital tax schemes are well targeted, so that they remain credible and represent good value for money.

**2.3** Although the government remains supportive of the VCT industry and values the role that it plays in encouraging investment by retail investors who are interested in investing in smaller, higher-risk trading companies, the government's view is that the use of some share buy-back arrangements has not been in keeping with the intention of the VCT regime.

**2.4** The technical consultation document explained that the government has concerns about arrangements involving VCTs' repurchasing their shares when that repurchase is connected with the investor re-investing in the same VCT within a short space of time. Rather than facilitating investor exits, these arrangements appear to be designed to allow those investors who want to remain invested in the same VCT to obtain a fresh round of tax relief although their investment behaviour has not changed in any way.

**2.5** The document also described recent activity, stating that it has been fairly common for some VCTs to make an offer to investors to buy back shares at the same time as issuing a prospectus for a new share issue. This has been making it possible for some investors to exit their investment and subscribe for new shares in the same VCT at or around the same time.

**2.6** In addition, a number of VCTs have "enhanced" their buy-back offers, by offering a favourable price to investors who commit to immediately subscribing for new shares in the same VCT. There have also been some more aggressive variants on this approach, including the so-called "cascade" arrangements, where VCTs recycle their cash reserves to allow several investors to benefit from tax relief on their underlying investments again.

**2.7** Before setting out potential changes to VCT rules, the document asked whether this description was fair.

**Question 1:** Does this description accurately reflect the range of VCTs' interventions in investors' share sales?

## Consultation responses

**2.8** The vast majority of respondents agreed that the description was an accurate representation of recent activity in the market. A number of respondents also commented on the importance of “normal” buy-back arrangements in secondary markets. Some responses also commented that the government should perhaps consider the types of investments made by VCTs and whether they were genuinely high-risk and supporting the market, rather than focusing on share pricing and potentially aggressive use of buy-backs.

**2.9** A number of respondents stated clearly that they felt that the use of so-called “enhanced” share buy-backs had been disproportionately high recently and that it was right that the government was taking action. Some respondents stated that they felt that these arrangements amounted to tax avoidance, and others that they were undermining the VCT industry as a whole by placing pressure on VCT fund managers to match activity elsewhere.

*“In our view using enhanced share buy backs in this way is against the spirit of the legislation and it provides little or no benefit to small companies”.*

*“[We] recognise the Government’s desire to avoid duplication of tax relief on the same underlying investment assets”*

*It is evident that ESBs [enhanced buy-backs] violate the fundamental concept of a VCT, which is to raise new funds to invest in early stage businesses...ESBs are blatant tax avoidance schemes”*

## Government response

**2.10** The government believes that this context **underlines the case for action to address the use of particular share buy-backs.**

## Proposed action on share buy-backs

**2.11** The consultation document then went on to describe the government’s proposed course of action, explaining that there were a number of important principles behind any reforms:

- to continue to support the tax-advantaged venture capital schemes as an important route to encouraging investment into SMEs;
- to provide a solution that is sustainable and which itself is not open to further abuse, specifically;
  - to ensure that upfront income tax relief is given only in respect of a new investment in VCT shares, rather than in respect of money recycled into the same VCT or another from the same fund management group; and
  - to provide a solution which is straightforward to operate and which does not have unintended adverse consequences.

**2.12** The document explained that the government’s initial view was that any change should apply at investor level, rather than at the level of the VCT. The document proposed that an effective approach would be to impose a restriction either:

- where an investor subscribes for shares in a VCT within a certain period of a sale of shares held in that VCT or another VCT managed by the same fund management group; or
- where a VCT’s re-purchase of shares is subject to any understanding that the investor will re-invest in the same VCT or another from the same fund management group.

**Question 2:** Do you believe that the approach described in paragraph 3.6 would meet the policy aims set out at paragraph 3.2?

**Question 3:** Would this approach impact adversely on VCTs' ability to raise new funds from investors, as well as preventing recycling of existing investments? If so, please explain why, if possible including quantitative evidence.

**Question 4:** Would this approach have any other unintended adverse consequences? If so, please describe.

**Question 5:** Is six months an appropriate period for a time limit, or should a longer or shorter period of restriction apply?

**Question 6:** Is there a simple way of defining a fund management group in this context?

## Consultation responses

**2.13** The majority of consultation responses felt that an approach focussed on restricting the relief on the investor was most appropriate. Some respondents however, favoured alternative models that would set new conditions on VCT investment behaviour and in particular conditions relating to the proportion of qualifying investments made. These responses are discussed in more detail in paragraph 2.27 onwards.

**2.14** Some responses, particularly those from individual investors, expressed concern that this change might have a wider impact on VCT fundraising. Others suggested that it would be important that any change did not have an adverse effect on dividend reinvestments. Some also raised concerns about potential knock-on impacts on the secondary market. Further, most consultation responses stated that it was very important to keep the changes as simple as possible so as to limit any wider impact on fundraising. In this context, some respondents emphasised that they felt that any impact on individual investors was unfair and seemed complex.

**2.15** There were mixed responses about whether six months was an appropriate time limit. Some respondents felt that a 30 day rule would be more reasonable, or alternatively that three months was more appropriate. However, other respondents felt that six months would still allow some opportunities for misuse of the rules. Others agreed that six months was a reasonable balance.

**2.16** Some responses suggested alignment with EU and FCA rules for definition of a fund management group. However, many respondents felt that targeting a fund management group, rather than an individual VCT, was unnecessarily restrictive particularly where different funds might have very different investment strategies.

## Government response

**2.17** The government agrees that the approach set out in the consultation document to restrict tax relief for investors buying shares in certain circumstances is the best way of meeting the policy aims. Draft legislation published alongside this response document sets out the proposed changes in more detail.

**2.18** The government recognises some of the concerns raised by respondents. It was not the intention of the proposal to impact on dividend re-investment plans, or on investors operating purely in the secondary market. **The government's intention therefore is that investors taking part in dividend re-investment plans, and investors who buy shares only on the secondary market, will not be affected by the change in legislation.**

**2.19** On balance, the government does not believe that it is reasonable to change the proposed time limit for reinvestments. Several respondents suggested that the 30 day rule used in the capital gains tax bed-and-breakfasting legislation would be an appropriate benchmark. However, this rule is not related to substantial income tax reliefs and is used in an entirely different context. Given that some respondents suggested that even a 12 month window might still allow some misuse of the rules to continue, the **government's view is that a six month limit is appropriate**. The six month restriction will apply by reference to any purchase or sale within six months of a linked sale or purchase. This will not apply for six months with reference to the sale, and a further six months with reference to the purchase – the restriction will be six months, not 12 months in total.

**2.20** Some respondents were concerned that the proposed restrictions would be difficult for investors to understand, and would therefore deter investment in VCTs. The government's view is that VCT investment tends to be undertaken by relatively sophisticated investors, who should understand that the generous tax reliefs afforded by the scheme need to be appropriately balanced with restrictions around the circumstances in which relief will be available. It is anticipated that VCT managers as well as investors will modify their behaviour, so that the burden of recognising when a restriction may be likely to apply should be manageable.

**2.21** The government recognises that within one fund management group there may be different VCTs and different fund managers with different strategies. Therefore **the government has decided that tax relief will only be restricted where there is a reinvestment into the same VCT**. The government does however want to ensure that VCTs that have merged are treated as the same VCT.

## Related issues with share buy-backs

**2.22** The consultation document was clear that the government wanted any legislative change to be sustainable and not to give rise to other routes by which investors were able to benefit from multiple rounds of tax relief on the same underlying investment. The purpose of the tax relief is to reflect the investment risk taken on when investing into SMEs.

**2.23** The document specifically referred to a related issue whereby VCTs could effectively return capital to investors by using converted share premium accounts to make substantial tax-free payments to investors. The document also asked about other behavioural responses that might undermine the policy change proposed.

**Question 7:** How best could the behaviour described at paragraph 3.10 be prevented?

**Question 8:** Are there any other ways VCTs or investors could get around a rule of the type described at paragraph 3.6?

## Consultation responses

**2.24** Responses to these questions were mixed. Many fund managers and advisors commented that VCTs regularly convert share premium accounts to distributable reserves to maintain steady "dividend" payments to investors, and that this mechanism could be used to return capital to investors as an alternative to buying back shares. Some respondents suggested that this behaviour was effectively a market "norm" and therefore the rules should not be changed. A number of respondents also noted that it was difficult to identify different use of reserves within VCT accounts, particularly where there have been a number of fundraisings over time.

## Government response

**2.25** The government acknowledges that the use of share premium accounts to pay “dividends” has been a feature of the market for some time. However, the government’s view is that such payments are more appropriately described as returns of investors’ capital rather than true “dividends”, as they do not represent profits generated by a VCT’s investments.

**2.26** This mechanism could be used to return capital to investors after tax relief has been given on that capital but before the end of the minimum holding period for the shares. Therefore it could result in the proposed restrictions on share sales and reinvestments being circumvented. This is discussed in more detail in Chapter 3.

## Alternative approaches to addressing problems with share buy-backs

**2.27** The consultation document set out at a high level an alternative approach that would limit the operations of VCTs, and asked whether this mechanism or any others might be preferable to the main option outlined in the document.

**Question 9:** Do you believe that any of these other solutions described at 3.11 onwards would be effective in meeting the policy aims set out at paragraph 3.2? If so, would they be preferable to the changes proposed?

**Question 10:** Can you suggest any other legislative solutions which might better deliver the desired policy aims?

## Consultation responses

**2.28** A number of respondents proposed some alternative approaches. In particular, some respondents suggested that a cumulative requirement applying by reference to funds raised by the VCT, should be imposed in addition to the existing requirement that 70 per cent of a VCT’s investments be in qualifying holdings. Some other respondents suggested that a cap on the level of buy-backs permitted could be introduced, or that the overall balance of tax reliefs for VCTs was adjusted so as to place less emphasis on the upfront tax-relief and potential short-term investment. Others suggested that the government should try to stimulate the secondary market.

## Government response

**2.29** The government considered all of these proposals carefully. However, on balance, the government believes that the approaches proposed relating to cumulative investment limits would add more complexity to the rules and is concerned that they would not effectively deter the types of buy-back activity intended.

**2.30** In response to questions raised about the secondary market, the government does not believe that it is appropriate to offer new tax relief for individuals investing only in secondary market shares, because they are not taking on a similar amount of risk. The VCT legislation already offers tax relief on dividends paid on secondary market shares, and on capital gains on the disposal of shares acquired through the secondary market.



# 3

## Legislative change and next steps

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**3.1** Alongside this consultation, draft legislation to address the use of particular buy-back arrangements has been published. The government intends that this legislation forms part of the Finance Bill 2014.

### Case for action on share premium accounts

**3.2** As set out in Chapter 2, the process of consulting on share buy-backs has highlighted the current use of share premium accounts by some VCTs. The government is concerned that use of share premium accounts to return some monies to investors is not in keeping with the intention of the legislation, and that investors are receiving a tax-free return that has no relation to the investments made in SMEs.

**3.3** The VCT legislation requires a VCT (after a period of grace of around three years) to have at least 70 per cent of its investments in “qualifying holdings” in SMEs. That 70 per cent figure is calculated without taking account of any payments made to investors, whether those payments are by way of dividend generated out of a VCT’s profits, or whether by way of return of investors’ capital.

**3.4** The current rules mean that a VCT can repay investors’ capital after the investors have had tax relief on that capital, but before the end of the minimum holding period for the shares. That in turn means that investors can obtain tax relief for committing less capital to the VCT, and for a shorter time, than was intended by the five year minimum holding period requirement. In the worst case scenario, a VCT could repay all funds raised by investors, after the investors had had tax relief on their investment, but before the VCT had made any investments at all.

**3.5** The government is concerned that this could result in misuse of the scheme, by allowing investors to obtain tax relief and then have their capital returned to them within a short space of time. This risk is potentially increased by the fact that restrictions on share buy-backs will not apply to any dividend re-investment plans. Further, the government is concerned that payments made out of capital in this way, rather than out of profits generated on investments, diminish the funds which a VCT has available to invest in SMEs.

**3.6** The response to the share buy-backs consultation showed that many VCTs have been taking advantage of this to some extent. For example, over the last few years most VCTs have committed to paying “dividends” of at least 5 per cent per annum of the amount invested to investors. In many cases these “dividends” have been paid not wholly out of profits which the VCT has realised on its investments, but rather wholly or partly out of share premium accounts. Recently one VCT paid out tax-free “dividends” totalling over £600,000 from its share premium account within its first 18 months of issuing the relevant shares. This was while showing a loss of £47,000 on its accounts and before it had met the 70 per cent requirement as to investments in “qualifying holdings”.

**3.7** In this example, the VCT was returning money tax free to investors that had no relation to underlying profits realised by the VCT on its investments, after the investors had received 30 per cent tax relief on the capital invested. The government does not believe that the use of share

premium accounts to return capital to investors in this way is appropriate, and is concerned that the restrictions on share buy-backs may give rise to similar examples.

**3.8** The government does not wish to introduce changes that are overly punitive or that might reduce investments into relatively high-risk but high growth potential SMEs. Further, the government is aware that the market for VCTs is relatively limited and that any change in this area might impact on more established VCTs differently to newer entrants. However, the government also considers that the VCT legislation gives VCT managers scope to invest in a range of different types and ages of companies, from early stage companies which are high-risk but which have high growth potential to more established companies with up to £15 million assets, and via different types of investment instrument. This should allow fund managers to make a range of investments capable of delivering a range of returns at different times.

## **Potential legislative change on share premium accounts**

**3.9** With those points in mind, the government believes that there are various ways in which the use of share premium accounts to return capital to investors might be addressed. Some options might include:

- removing a VCT's approved status if it returns any capital before at least 70 per cent of the funds raised have been invested in qualifying holdings;
- treating VCT capital distributions out of share premium accounts as taxable in the hands of the recipients, in certain circumstances; and
- limiting the level of capital distributions that VCTs can make out of share premium accounts.

**3.10** The government does not intend in any circumstances to prevent VCTs continuing to pay tax-free dividends out of profits realised by VCTs on their investments. The government also recognises that transitional arrangements may be needed to ensure that any changes in this area can be introduced smoothly and with minimal disruption.

**3.11** The government will run technical workshops with the industry to consult on this issue and appropriate solutions in January 2014. The government intends that manipulation of share premium accounts is also prevented with legislation introduced in Finance Bill 2014, and will therefore publish legislation in draft soon after technical workshops have taken place.

## **Proposed legislative change on nominee investment**

**3.12** Following representations made by investors and fund managers, the government also intends to amend the VCT primary legislation in Finance Bill 2014 to allow individuals to qualify for VCT income tax relief if their subscription for shares is made via a nominee, in the same way as is possible for EIS investments.

**3.13** The government will consult informally with the industry with a view to considering any further changes needed to secondary legislation as a result of this. VCTs are required to make returns to HMRC of their investors, and HMRC will need to be informed of the identity of the beneficial owners of any shares subscribed for by a nominee.



# 4

## List of consultation respondents

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**4.1** In addition to comments from several individual investors, the following representative and professional bodies responded:

Amati Global Investors

Association of Investment Companies

Baronsmead VCT plc

Baronsmead VCT 2 plc

Baronsmead VCT 3 plc

Baronsmead VCT 4 plc

Baronsmead VCT 5 plc

Compound Growth Ltd

Clubfinance Ltd

Downing LLP

Foresight Group LLP

ISIS Equity Partners

Jensons Solutions Ltd

KPMG

Longwall Venture Partners

Mobeus Equity Partners LLP

NVM Private Equity Ltd

Octopus AIM VCT plc

Octopus Apollo VCT plc

Octopus Eclipse VCT plc

Octopus Investments Ltd

Octopus Second AIM VCT plc

Octopus VCT 3 plc

Oxford Technology

Pricewaterhouse Coopers LLP

SGH Martineau LLP

St James's Place Wealth Management

UK Individual Shareholders Society Ltd



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