Update on changes to Venture Capital Trusts

The government believes that the venture capital trust (VCT) regime plays a key role in facilitating access to finance for smaller businesses with growth potential. The government is supportive of the VCT regime and the other tax-advantaged venture capital schemes and has made some specific changes to the VCT regime to ensure that the tax relief offered to VCT investors continues to be used appropriately, reflecting the risk taken on when investing into relatively small and unproven companies.

Use of share premium accounts to return capital to VCT investors

At Autumn Statement, the government confirmed action to limit opportunities to engage in particular share buy-backs that could result in taxpayers receiving multiple rounds of tax relief on the same underlying investment, and also set out concerns about a related issue on use of share premium accounts to return capital to investors. The response document set out some possible options for legislative change, to address the use of share premium accounts to offer investors a tax free return with no relation to the investments made. The document explained that the government wants to keep the VCT rules well-targeted, but does not want to introduce changes that are overly punitive or that might reduce investments into relatively high-risk but high growth potential SMEs.

Technical consultation exercise

Officials held technical workshops with VCT fund managers and professional advisers, coordinated by the Association of Investment Companies, to consult on the issue and appropriate technical solutions in January 2014. Officials also met with a small number of stakeholders and received a small number of comments in writing.

It was clear from this exercise that while the majority of the industry recognised that there have been some examples of misuse of share premium accounts to return capital, this practice is not widespread. The government understands that many managers only use share premium accounts as a small "buffer" to smooth returns for investments, and those that operate generalist funds in particular do not have an incentive to return capital that does not relate to real profits because the impact of this will be a reduced net asset value of the fund. Overall, the government believes that where misuse of share premium accounts does occur it tends to be within the first years of fund raising, when VCTs may promise high "dividends" to attract investors before actually making any investments.

The workshops also demonstrated that VCTs may often operate different accounting and record-keeping practices, meaning that their records about how they have used share premium accounts have varied even where equivalent fund raisings and distributions have been made. The government recognises that an option that targeted particular use of share premium accounts by placing a charge on an investor or VCT could have quite different impacts on different VCTs depending on their accounting practices, and that some of the options set out in the response document might be particularly burdensome. The government also believes that taxing certain payments made from share premium account could have a damaging impact on investment.

Response to consultation and what we're annoucing

The government has decided that the most suitable action to limit inappropriate returns of capital is to **introduce a simple rule that focuses on the use of these accounts when funds are initially raised and where VCTs may not have made qualifying investments**. The government will therefore introduce a new rule limiting a VCT's ability to return share capital that does not represent profits made on investments, within 3 years of the end of the accounting period in which funds are raised. VCTs will then need to comply with existing rules for investment into small and medium enterprises, in accordance with the "qualifying holdings" rules. This approach was discussed at the VCT workshops and most participants believed that it would be a sensible policy change that would maintain the integrity of the VCT regime without creating damaging impacts.

This **new rule will apply only in respect of new shares issued on or after 6 April 2014, and will not limit VCTs paying dividends from realised profits at any time**. Given the difficulties in placing charges directly on a VCT, and in keeping with existing legislation, any VCT which breaches this condition will have its approved status withdrawn.

In order to ensure the restriction operates as needed, the change will not be restricted to reserves created from share premium accounts, but will apply in respect of any payment representing a return of share capital. That will include the situation where share capital is used to pay up the issue of new bonus shares to shareholders. The restriction will not apply where funds are used to redeem or repurchase shares already in issue, nor will it apply in respect of assets distributed in the course of a VCT winding up.

Summary

The government believes that the introduction of a simple rule to limit new returns of capital is proportionate, simple and that it should effectively address aggressive use of converted share premium accounts to return capital to investors before qualifying investments have been made. However, the government will continue to monitor activity in this area to ensure that the VCT legislation is continuing to work in the way intended.

The government is grateful for the constructive engagement of VCT fund managers, advisors and representative groups during this consultation exercise.