Explanatory Note

Clause 26, Schedule 6: Venture Capital Trusts

Summary

1. The amendments make a number of changes to Schedule 6 mainly of a technical nature to: ensure the Venture Capital Trust (VCT) rules work as intended; align with the underlying EU rules; and interact with the underlying VCT rules. The amendments also: specify certain investments a VCT may make for liquidity management as part of their non-qualifying holdings; and make provision to allow follow on funding in older companies that received their first risk finance investment after the age limit because the investment was needed to support substantially new activities.

Details of the amendments to Schedule 6

2. All statutory references are to the Income Tax Act (ITA) 2007.

3. Amendment 46 replaces paragraph 3(3) of the Schedule with new paragraphs 3(3) to 3(5). The changes are being introduced to list certain types of investments a VCT may make for liquidity management purposes without breaching the investment limits, age limit and no business acquisition condition. The permitted investments will be non-qualifying holdings and allow VCTs to make short term investments of funds on hand where activities to make investments in new qualifying holdings are underway. Paragraph 3(5) provides a power for the Treasury to amend the list by regulations.

4. Amendment 47 aligns the language of section 280B(2) with the language in Part 6 of ITA 2007.

5. Amendments 48, 57, 58 and 59 make provision for any money used for the qualifying business activities of a subsidiary of the company, where that money had been raised by risk finance investments in the subsidiary's previous parent company, to count towards the annual and lifetime funding limits of the subsidiary's current parent company.

6. Amendment 48 inserts section 280B(3D)(a) which defines a relevant imported investment for the purposes of section 280B(3), (3A) and (3C) (the annual and lifetime funding limits). Amendments 27, 28 and 29 insert new sections 292A(2)(aa), 292AA(2)(aa) and 292AB(5)(aa).

7. Amendments 49 to 55 and 60 to 68 amend the rules in new sections 280C and 294A that allow a company to be eligible to receive a first risk finance investment even though the company breaches the permitted age limits. Broadly, the amount of risk finance investments in the company must be at least 50% of the company's annual turnover, averaged over the previous five years (the 50% turnover test). The amendments make three changes to the rules.

8. Amendments 50, 52, 61, 62 and 65 align the new rules more closely with the EU Risk Finance Guidelines by amending condition B in section 280C(5) and 294A(4) and making consequential provisions. Those amendments insert new paragraph (b) in sections 280C(5) and 294A(4) which adds a further requirement that a company must meet to be eligible for an initial risk finance investment by a VCT where the company exceeds the permitted maximum age limit of 7 years (or 10 years for a knowledge-intensive company).

9. As well as raising initial risk finance investments of more than 50% of its average annual turnover, the company must use the money raised for the purpose of entering a new product or geographical market. The amendments ensure the investments are used only for activities that effectively constitute a new business activity, where it may be difficult to raise investment from the market. The amendments do not define in detail what is meant by a new product or geographical market because that will depend on the specific circumstances of each company.

10. Amendments 50 and 63 introduce new condition C by inserting new sections 280C(5A) and 294A(4A). New condition C allows a company that has previously met condition B, by way of receiving risk finance investments from a Venture Capital Trust or under the Enterprise Investment Scheme (EIS), to raise follow on funding. The money must be used for the same activity or activities for which the money raised under condition B was used, that is to continue to support activities for entering a new product or geographical market. It cannot use the money for a new project or for its other business activities. However if the money raised under condition B was used for, say, two separate activities, the new money raised under condition C does not have to be used for both those activities. For example if one of the activities had already failed, any subsequent money raised could be used for the activity that has continued.

11. Amendments 51, 53, 54, 55, 64, 66, 67 and 68 amend the rules for determining what turnovers must be included when computing the annual turnover of a company to determine if the 50% turnover test in condition B is met, and make consequential provisions.

12. Amendments 51 and 64 substitute a revised version of new sections 280C(7) and 294A(6), which define "the average turnover amount" for the purposes of condition B in sections 280C(5) and 294A(4).

13. Amendments 53 and 66 delete the definition in sections 280C(8) and 294A(7) of "the total group turnover" which was used in the previous version of sections 280C(7) and 294A(6), now substituted by amendments 51 and 64. Amendments 53 and 66 define a new term introduced by revised sections 280C(8) and 294A(7), "the total relevant turnover amount", which is used to determine the average turnover amount of a company under sections 280C(5) and 294A(4). The amendments also define a "transferred trade" which is introduced by the definition of "total relevant turnover amount".

14. The "total relevant turnover amount" includes the turnovers over the previous five years, as defined by revised section 294A(7), of the issuing company and:

    - where the issuing company is not a parent company at the date of issue of the shares: any 51% subsidiaries it acquires after the shares are issued for which the

money raised by the issue of the shares is used; and the turnover of a transferred trade for which the money raised is used, to the extent that its turnover over the previous five years has not already been taken into account.

- where the issuing company is a parent company at the date of issue of the shares: any 51% subsidiaries it holds at the time of the date of issue and any 51% subsidiaries it acquires after the shares are issued for which the money raised by the issue of the shares is used; and the turnover of a transferred trade for which the money raised is used, to the extent that its turnover over the previous five years has not already been taken into account.

15. The purpose of the amendments is to ensure that, where a company depends on meeting condition B in sections 280C(5) and 294A(4), all the relevant turnovers of subsidiaries and trades that have been acquired both before and after the shares were issued are taken into account. However the turnovers of subsidiaries and trades acquired after the shares were issued are included only if the subsidiary or trade uses any of the money raised by the share issue.

16. Amendments 55 and 68 define the turnover of a trade carried on by a person other than a company by reference to the definition of turnover under the Companies Act 2006. Where only part of a trade is transferred, the turnover should be apportioned as is just and reasonable.

17. Amendment 56 aligns section 280D(2)(d) with the same provision in section 175(1ZA) in Schedule 5 (Enterprise Investment scheme) and section 293(5ZA).

18. Amendment 69 introduces new paragraphs 15A to 15C to Schedule 6. The amendments make provision for the new rules introduced by Schedule 6 to be incorporated in the exchange provisions in Chapter 6 of Part 6 of ITA. The share exchange provisions apply when shares in a new parent company have been exchanged for shares in a company that has raised VCT investments. Provided certain conditions are met, the new shares in the parent company are treated as though they were the old shares and the new shares are treated as qualifying holdings.

19. Paragraph 15A makes consequential changes to section 326 (restructuring to which section 327 applies).

20. Paragraph 15B inserts new section 326A which applies the share exchange provisions to the investment limits, permitted maximum age and no business acquisition conditions in Chapter 3 of Part 6 (VCT approvals). Provided the rules are met, and continue to be met, the new parent company will retain its status as a VCT.

21. Section 326A(3) to (6) ensure that the new parent company is treated as the relevant company for the purposes of the investment limits, permitted maximum age and no business acquisition conditions in section 280B, 280C and 280D.

22. Paragraph 15C amends section 327 which applies the share exchange provisions to the

investment limits, permitted company age requirement and the proportion of skilled employees requirement in Chapter 4 of Part 6 (qualifying holdings).

23. Paragraph 15C(4) inserts section 327(4A) to (4G) which apply the requirements to be met by a relevant company to the new parent company.

24. Amendment 70 inserts a new subsection in section 330B (powers to amend Chapters 2 to 4 by Treasury regulations). The new provision allows the rules to be changed retrospectively provided the changes are wholly relieving.

Background note

25. The VCT scheme encourages approved listed companies to invest in small, higher risk trading companies by offering tax incentives to their individual investors.

26. Schedule 6 to the Finance Bill includes a number of amendments to the VCT rules aimed at ensuring compliance with Articles 107 and 108 of the Treaty on the Functioning of the European Union. State aid approval for the VCT scheme and the EIS was received on 12 October 2015.

27. The amendments make a number of changes to Schedule 6 to correct technical flaws, align more closely with the underlying EU rules for risk finance investments and in response to comments on the Finance Bill provisions made by venture capital industry specialists.

28. The rules for VCTs are specified in Part 6 of ITA. Chapter 3 specifies the rules a VCT must meet to be approved as a VCT by HM Revenue and Customs and Chapter 4 specifies the rules that must be met for a VCT's investment to be a qualifying holding. The investment limit, permitted maximum age and no business acquisition conditions introduced by Schedule 6 apply for the purposes of both Chapter 3 and Chapter 4 and most changes to the rules require amendments to at least two separate provisions.

29. The changes generally reflect changes also being made to Schedule 5 (Enterprise Investment Scheme).