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Tax year-end planning considerations

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We're just weeks away from the end of the tax year, and more of your clients could be considering ways in which they can reduce their tax liabilities. We wanted to remind advisers of some of the key considerations to be aware of when discussing Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS) with clients and product providers.

Ask when investment funds will be deployed

While both the EIS and VCTs allows investors to claim up to 30% of income tax relief, only an EIS lets investors 'carry back' relief and reclaim income tax paid in the previous tax year. If your client intends to make use of 'carry back', it's important to determine not just when your client plans to make their investment, but also when the product provider will deploy those funds. Carry back can only be applied to tax paid in the previous tax year, so the EIS manager needs to deploy funds in the current tax year in order for income tax relief to be allocated to the current and/or the previous (2019/20) tax year.

Next, it is also well worth asking the EIS manager whether they are capable of making investments in the current tax year or whether the clients' money will be invested across different tax years, which could impact any tax planning considerations you have discussed with your client. In addition, when it comes to EIS and tax year-end, discussing diversification with EIS providers is crucial. Many providers will practice diversification by targeting at least eight companies for your client's investment to be spread over – so that exposure to any one investment is limited. But when you ask providers how many of these companies will be invested ahead of the tax year-end, this can often be as low as just four.

Offsetting income tax from other assets

For clients considering either a VCT or EIS investment to offset income tax paid when converting another asset into cash (such as encashment of an offshore or onshore bond) it is important to understand whether the encashment could potentially see their taxable estate exceed the combined nil-rate band/residence nil-rate band – triggering a potential 40% inheritance tax (IHT) liability.

If this is a factor, and the client is suitable, then EIS might be the better option. Not only could an EIS investment help offset the income tax due but, after the investment has been held for two years, it will also have the added benefit of IHT relief via qualification for Business Relief.

Deferring a CGT liability

While an EIS is able to offer capital gains deferral, and therefore capital gains tax (CGT) deferral, the gain cannot be deferred until the client receives their EIS3 certificates. Investors must complete the claim form attached to the EIS3 certificate received from the company they have invested in, and attach the form to the CGT summary pages of their self assessment tax return.

Also, an EIS3 certificate will be issued for each underlying trading company within the EIS, not just one certificate to cover the entire amount invested. Therefore, certificates may all be issued at different times. In all cases, a client should expect to pay their CGT and then submit their EIS3 certificates once they have received them if this is after the corresponding tax return has been submitted.

Your clients may be looking to defer a capital gain, but given they have up to three calendar years to invest in EIS from the date they make that gain, they may be able to take advantage of combining CGT deferral with income tax relief. In cases where the client does not have a sufficiently large income tax liability in one particular tax year to benefit from this relief fully, a strategy of investing in EIS across different tax years, although still within the three-year period, may prove beneficial.

New VCT or old VCT?

As a reminder, VCTs were created to encourange greater investment flow into smaller UK companies – to support the growth of the UK economy and to incentivise investors to place money into companies with the potential for high returns. Within the market, there is a significant number of VCTs

currently available, most of which have a unique investment strategy, different diversifications (and dilutions) as well as different fund sizes.

Established VCTs have the benefit of past performance (some better than others) and the potential for regular dividend payments. For those established VCTs that have had favourable returns, the implication arises that this will continue, and they often raise further funds on the back of this assumption. However, could one argue that as a VCT grows, and its shares become more diluted, is the potential for high returns at risk of being diluted away? It may not be that simple, but perhaps older VCTs would be more suitable for those clients looking to supplement their regular income, while younger VCTs may be more appropriate for those seeking that higher risk/ higher return investment profile. Although investing in newer VCTs may not result in regular dividend payments for several years, many will look to target special dividends through earlier exits. A blend of different types of VCT would help diversify portfolio risk, while also offering the potential to deliver high returns to those investors interested in putting risk capital to work over several years.

Ahead of tax year-end, having a good awareness of the subtle, yet important, tax planning differences between VCTs and the EIS will certainly help ensure clients take full advantage of the available tax reliefs.

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