



EIS vs VCT

HOW ARE THEY DIFFERENT?

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30 MINUTES UNSTRUCTURED CPD



www.deepbridgecapital.com

Contents



THE UK

The United Kingdom is home to some of the most tax-advantaged investment schemes anywhere in the world.

These initiatives are designed to encourage private investors to provide venture capital funding to early-stage companies. The most common of these are the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs), with latest Treasury statistics showing £2.3bn invested via EIS during the 2021/22 tax year and £1.1bn via VCTs across the same period*.

LEARNING OBJECTIVES

By the end of this document, you should be able to:

- 1 DESCRIBE THE KEY DIFFERENCES BETWEEN EIS AND VCT.**
- 2 IDENTIFY WHERE ONE PRODUCT MAY BE SUITABLE FOR RECOMMENDATION OVER THE OTHER.**
- 3 EXPLAIN HOW BOTH PRODUCTS MAY BE USED IN CONJUNCTION TO SOLVE TAX PLANNING PROBLEMS.**

RISKS AND IMPORTANT INFORMATION

Investments in unquoted companies carry high risks and investors could lose all funds invested. Investors should not invest if capital is required in the near term. No established market exists for the trading of shares in private companies, making it difficult to sell shares. The value of tax reliefs depends on personal circumstances and may be subject to change in the future. The availability of tax reliefs depends on the Company invested in maintaining its qualifying status. Past performance is not a guide to the future performance of an investment, and investors are encouraged to take independent legal, tax and financial advice before considering an investment.

*Enterprise Investment Scheme, Seed Enterprise Investment Scheme and Social Investment Tax Relief statistics: May 2023 - GOV.UK (www.gov.uk)

With over two decades of experience working in and around financial services, Andrew Aldridge, Director at EISA and Partner & Chief Marketing Officer at Deepbridge comments:



“The Enterprise Investment Scheme and Venture Capital Trusts allow investors the privilege of being able to include venture capital within their investment portfolio, whilst benefiting from the incentive of generous tax reliefs.

The UK continues to be an entrepreneurial nation, developing great innovations and exciting growth-focused companies which are reliant on the early-stage funding provided by EIS and VCTs. These enterprise-enabling schemes play a key role in empowering the entrepreneurs, innovators and visionaries which are developing the technologies and companies of the future.

Being critical tax planning tools, offering investors access to growth-focused venture capital and supporting economic growth are just some of the reasons why all financial advisers should be regularly considering EIS and VCTs as part of their clients investment portfolio.”

WHAT ARE EIS AND VCTs?

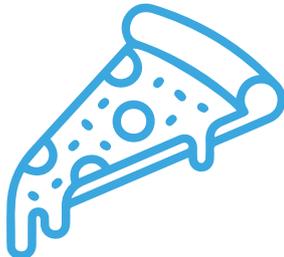
The Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) are UK Government initiatives offering tax reliefs to investors as an incentive to provide investment to early-stage, unquoted and growth-focused companies. The UK Government’s objective is to allow access to funding for companies providing employment and innovation to boost the UK economy.

To explain the two different types of funding, Deepbridge describe an EIS structure as a ‘Pizza’ and a VCT structure as a ‘Soup’.

EIS: THE INVESTMENT PIZZA

EIS investors own shares in each of the companies that make up their EIS portfolio. The fund structure of an EIS typically involves a fund manager, like Deepbridge, creating and managing a portfolio of qualifying companies. Once the investor funds are deployed and share certificates have been raised, investors own direct shares in each company that make up the fund (at the time of investment). So, if the EIS fund is the pizza, each slice is an individual company that investors own a portion of, allowing direct exposure to potential returns.

The amount of slices (companies) available is dependent on the size of the investment, the fund manager and how hungry the investor is for Venture Capital investing and diversification!



VCT: THE INVESTMENT SOUP

VCT investors subscribe for shares in the VCT itself, like they would with more mainstream funds such as an Open-Ended Investment Company (OEIC). This is because a VCT is an investment company listed on the London Stock Exchange (i.e. a single entity) that buys shares in unlisted early-stage companies. The money from all investors is pooled and a portion of the cash is then invested into selected companies. The remainder is either taken as profit for the VCT or held as cash for liquidity purposes. In this way, a VCT is like a soup, with investors funds pooled together to access investments indirectly.

VCTs typically invest in around 20 businesses in different industries and stages of progression. The diversification of the businesses is depending on their size and stage, acting like ingredients that make up the VCT soup.



Important to note: For the purposes of both EIS and VCT shares on the London Stock Exchanges’ Alternative Investment Market are treated as unlisted and may qualify for EIS and VCT reliefs, subject to meeting prescribed criteria.

SUMMARY TABLE

	EIS	VCT
STRUCTURE	DIRECT	POOLED
INCOME TAX RELIEF	30% (30% carry back)	30%
MINIMUM TERM	3 YEARS	5 YEARS
MAXIMUM INVESTMENT	£2m P.T.Y*	£200k P.T.Y
DIVIDEND	N/A (EIS returns are on exits)	TAX EXEMPT
GROWTH	TAX EXEMPT	TAX EXEMPT
CAPITAL GAINS TAX DEFERRAL	YES: NO MAXIMUM	N/A
IHT EXEMPTION (BR)	AFTER 2 YEARS	N/A
SHARE LOSS RELIEF	YES	NO

*Subject to qualification as knowledge intensive companies.

SIMILARITIES



THE OBJECTIVE

The Government are clear with the objective of EIS and VCTs; to fund early-stage companies with growth potential. In return for the generous tax reliefs provided to investors by the Government, the companies EIS and VCT support may provide jobs, pay tax, and boost the UK economy.

To receive either EIS or VCT funding, investee companies must abide by certain qualification rules laid out by HMRC. One of these includes the risk to capital condition*, which ensures the schemes are focused on investment in early-stage companies that have the intention to grow and develop in the longer term.

**VCM8530 - Venture Capital Schemes: risk-to-capital condition: an overview of the risk-to-capital condition - HMRC internal manual - GOV.UK (www.gov.uk)*



COMPANY AGE/STAGE OF DEVELOPMENT

In accordance with EIS and VCT qualification rules, they can fund businesses up to 7 years old, with up to 250 employees*. As requirements are consistent across the products, they can invest in the same businesses. This dispels the myth in the market that VCTs invest in later stage, and therefore lower risk companies. The company age and stage of development should be considered according to each fund.

**More lenient rules lenient rules are allowed for companies that qualify as Knowledge Intensive, see 'Qualifying Rules' section for more information.*



RESOURCE

Typically, both EIS and VCT funds are managed by regulated Investment Managers. This is likely to allow investors the reassurance of investing alongside experienced professionals who might take a proactive role in driving growth within portfolio companies. For most investors, it is important to adopt a portfolio approach as Investment Managers use their experience of other early-stage companies to help them grow, recruit, access further funding and much more. Investment Managers are responsible for ensuring the VCT and EIS remains qualifying according to HMRC guidelines. Should companies no longer meet the qualification criteria set, investors may be subject to repaying tax reliefs claimed.



TAX RELIEF

- ✓ Both VCT and EIS offer 30% upfront income tax relief on the amount invested, in the current tax year.
- ✓ Both VCT and EIS offer capital gains tax (CGT) free growth, meaning no CGT is payable on exit.

THE DIFFERENCES



EXITS AND LIQUIDITY

EIS

Exits in an EIS are made on a company-by-company basis, as investors own shares in each business that form together the EIS fund.

Exit strategies for EIS companies are similar to those of a private company, typically by trade sale of shares, management buy-out, listing on a recognised exchange or liquidation. HMRC set out in the Income Tax Act that no pre-arranged exits are permitted in an EIS, and shares must be held for a minimum of three years before the exit point (for tax reliefs to apply).*

Although an exit is not the primary driver in raising EIS investment, fund managers typically value companies on an exit assumption (whether applied to EBITDA on 5 year projections or another method). As and when exits occur, the value of the shares (including the original investment amount and potential growth) can be paid out directly into an investor's bank account as a lump sum.

Over the lifetime of a portfolio, this may be considered as an additional, tax free income source. Although investors have the potential of direct exposure to tax free growth, the process and timescales of an exit may be complex and lengthy.

*Income Tax Act 2007 (legislation.gov.uk)

VCT

VCT investors' shares may be sold after the 5 year minimum term is completed, although VCTs may only permit the sale of holdings at certain times in the year.

At this point, investors may wish to reinvest into another VCT, but are not permitted to buy and sell shares within the same VCT, within a 6 month period.*

At the point of sale, it is common for shares to be sold at a discounted valuation of their Net Asset Value ("NAV"). The NAV represents the total value of the VCTs assets minus its liabilities. Assets are the value of its investments, along with cash and receivables, and any liabilities such as management fees and expenses will also be subtracted from the NAV. Therefore, published returns may not always be what the investor sees on exit.

Exits are either achieved by share buybacks from the fund manager themselves (typically at a discount as above) or via secondary trading. Trading of VCTs is permitted, but it may not always be easy to sell these holdings. This can be because shares traded on a secondary market may have lower liquidity compared to more widely traded securities and it may be hard to find buyers, especially if there is low demand. Discounts are also a factor in secondary trading and will be higher if demand is low.

*CG13350 - Bed and breakfasting: general - HMRC internal manual - GOV.UK (www.gov.uk)

Consider this

Some fund managers may use both their VCT and EIS structures to fund the same portfolio companies, so a consideration of portfolio diversification is potentially important. This may be increased if different fund managers are used, as many fund managers offering both VCT and EIS will use both funding sources for the same investee companies.



RETURNS

EIS

EIS Investors will not benefit from tax free dividends, as the objective of the EIS is to grow the businesses to sell for profit at the point of exit, but capital growth is capital gains tax free.

EIS investors benefit from all up side returns, with growth achieved on a company-by-company basis returned to the investor, subject to any performance fee charged by the fund manager.

VCT

VCTs potentially offer tax free dividends and tax free capital growth to investors throughout the investment, so the overall investment may make a return, on top of the 30% income tax relief, subject to any performance fee charged by the fund manager.

Growth achieved by companies within the fund will be pooled and shared across all investors by way of dividends, fund growth or reinvestment into other assets.



ADDITIONAL EIS TAX RELIEF(S)

[DOWNLOAD PDF](#)

THE FOLLOWING TAX RELIEFS ARE AVAILABLE ONLY THROUGH AN EIS INVESTMENT:

THE CARRY BACK FACILITY

EIS is the only tax-efficient scheme that offers investors retrospective tax relief. One key example of this is with the income tax carry back facility, allowing investors to claim back income tax paid not only in the current tax year but also the previous one. Tax relief can be split across the two years in any balance or claimed solely in either year. With EIS, up to 30% of the amount invested can be claimed, and with Seed EIS, up to 50% can be claimed. For advisers, this type of tax planning is particularly pertinent at tax-year end, after their client(s) have submitted their previous year's tax return on January 31, they then often have a short window to get cash deployed before tax-year end in order to offset income tax against the previous tax year.

CAPITAL GAINS DEFERRAL

EIS investors can also use the scheme to defer CGT liabilities for gains achieved within the previous three years or the upcoming 12 months. This can be particularly powerful across a portfolio of EIS assets with CGT potentially being written off via annual allowances as the EIS portfolio achieves exits over several tax years.

INHERITANCE TAX RELIEF

EIS investors can benefit from 100% inheritance tax exemption through the availability of business relief, after an EIS-qualifying investment has been held for at least two years.

SHARE LOSS RELIEF

As EIS investors own direct shares in businesses, HMRC acknowledges that the risk of companies failing largely sits with the investor. As a consideration of this, HMRC allow EIS investors to claim share loss relief if the value of EIS shares drop to zero, or if the shares are sold for less than the original amount invested. This is the case even if an investor holds a portfolio of EIS companies that, overall, has delivered a positive return. Loss relief can be claimed against either their income tax or capital gains tax bill. In conjunction with any income tax relief claimed, this could provide total tax relief of up to 61.5% for a 45% taxpayer.



FEES

EIS FEES

The fees associated with an EIS investment can vary depending on the specific EIS fund and the fund manager. However, there are several common fees that investors may encounter:

- 1. Management Fee:** This fee is charged by the EIS fund manager for managing the investment portfolio. It is typically calculated as a percentage of the total assets under management and is charged annually.
- 2. Performance Fee:** Some EIS funds may charge a performance fee, also known as carried interest. This fee is usually a percentage of the profits generated by the fund above a certain threshold. It is designed to align the interests of the fund manager with the investors by incentivising them to achieve positive investment returns.
- 3. Administration Fee:** An administration fee may be charged to cover the administrative costs associated with managing the EIS fund. This fee can vary and may be charged annually or on a per investment basis.
- 4. Placement Fee:** In some cases, EIS funds may charge a placement fee, also known as an initial charge or subscription fee. This fee is typically a percentage of the amount invested and is charged upfront when an investor joins the fund.
- 5. Investee company charges:** Whether borrowing money or raising venture capital, there is almost always a cost of capital to companies raising. This could be described as a due diligence fee, a fundraising fee, a cost-of-legals fee or an ongoing management or board seat fee. Whether such fees represent value for money will depend on the investment style and support provided by the respective manager, and may be difficult to judge.

VCT FEES

The fees applied in a VCT can vary depending on the specific VCT and its fund manager. However, there are some typical fees that investors may encounter. These fees may include:

- 1. Management Fee:** This fee is charged by the fund manager for managing the VCT's investments. It is usually calculated as a percentage of the total assets under management and is typically charged annually.
- 2. Performance Fee:** Some VCTs may charge a performance fee, also known as carried interest. This fee is typically a percentage of the VCT's profits above a certain threshold. It is designed to align the interests of the fund manager with the investors by incentivising them to generate positive returns.
- 3. Initial Charge:** An initial charge may be applied when investors initially invest in the VCT. This charge is deducted from the amount invested and is typically a percentage of the investment.
- 4. Annual Administration Fee:** This fee covers the administrative costs associated with running the VCT, such as legal and accounting expenses. It is usually calculated as a percentage of the NAV and is charged annually.
- 5. Other Expenses:** VCTs may also incur other expenses, such as custodian fees, audit fees, and marketing expenses. These expenses are typically borne by the VCT and may indirectly impact the returns to investors.
- 6. Investee company charges:** Whether borrowing money or raising venture capital, there is almost always a cost of capital to companies raising. This could be described as a due diligence fee, a fundraising fee, a cost-of-legals fee or an ongoing management or board seat fee. Whether such fees represent value for money will depend on the investment style and support provided by the respective manager, and may be difficult to judge.

It is important to carefully review the documents and prospectus of a VCT or EIS fund, in order to understand the specific fees and charges that apply. Please note that not all fees charged to investee companies will necessarily be disclosed. These fees can impact the overall return on investment, so it's advisable to consider them alongside other factors when evaluating an opportunity.

Consider this

We recommend understanding what the fees are as well as how they are applied. There are three ways fees can be applied:

- a.** Charged to the investor pre-deployment.
- b.** Charged to the investee company post-deployment.
- c.** Charged to both investors and investee companies (points a and b).

The fee structure applied impacts the tax reliefs available if charged pre-deployment, but it could be equally as important to understand what fees are charged to investee companies. Providers are not required to disclose fees to the investee company post-deployment unless prompted, and this may be difficult to access.



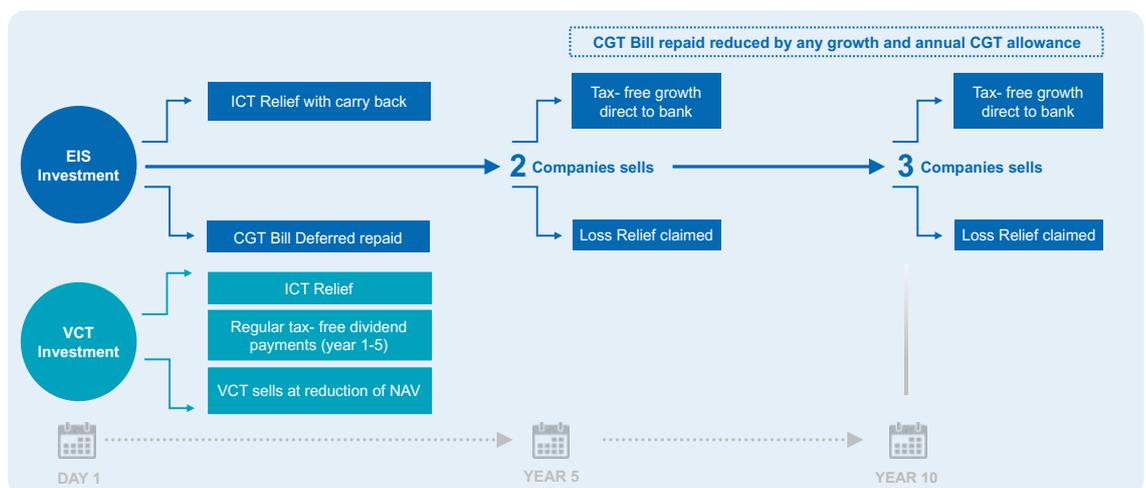
INVESTING IN EIS AND VCTs TOGETHER

As a result of the differences between EIS and VCTs, that have been laid out in this document, many advisers recommend that clients invest in both products, at the same time. The benefits of adopting this approach are:

- ✓ Potential of regular income streams over a number of years.
- ✓ Diversification across the companies that sit within the VCT fund and EIS portfolios.
- ✓ Increased exposure to Venture Capital (early-stage businesses) which may provide diversification against existing traditional portfolios, such as listed stocks and bonds. For more information on how Venture Capital provides diversification, see an independent report written by [Hardman & Co](#) which argues that Venture Capital is its own asset class.
- ✓ Access to a multitude of complementary tax reliefs.
- ✓ Retaining access to growth with EIS investment, whilst benefiting from the potentially shorter time horizon in a VCT.

‘THE COMPLIMENTARY DUO’ – A FICTIONAL CASE STUDY

To help demonstrate how this would work, we would like to introduce you to Manesh, who is an additional rate taxpayer and has recently made a large gain on the sale of a property. He wants to eradicate his entire Income Tax bill in the current and previous tax year. So, he invests into both a VCT and EIS today allowing him to claim 30% upfront Income Tax relief through his VCT against the current year’s income tax bill and his EIS investment, which he can carry back to offset Income Tax against the previous year’s income tax bill. Through his EIS, he defers his CGT bill from the sale of his property, allowing him to delay paying the bill until the companies on his EIS portfolio exit (reducing the bill with potential growth on investment).

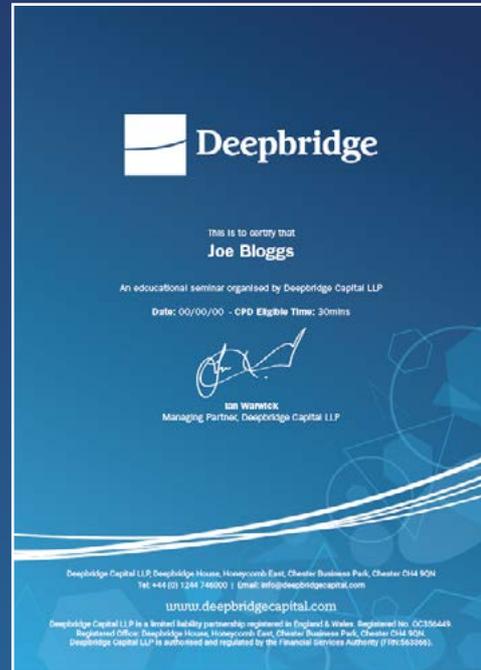


Please note: VCT investors need to be comfortable with the risk profile associated with this type of investment.

PLANNING SCENARIO EXPLAINED:

- For the first 5 years of the investment, Manesh receives regular tax free dividends from his VCT investment which he uses as an additional income stream.
- On year 5, he sells his VCT portfolio at a 95% reduction of NAV. At this point, he may choose to reinvest the money into another VCT to restart the cycle of dividends and claim 30% upfront tax relief again.
- From year 5-10, the companies in Manesh’s EIS portfolio start to sell, allowing him to potentially receive tax free growth on his original investment amount. He may be entitled to use his annual capital gains allowance to reduce the overall CGT bill owed.
- For any companies in the EIS portfolio which have been sold at a loss, Manesh may be able to claim loss relief to reduce his overall capital exposure. If he does not wish to pay the CGT bill back at all, he may reinvest in another EIS portfolio to keep deferring this.
- If Manesh holds his EIS investment for two years, then at the point of death, it is free from IHT.
- Should he pass away whilst holding the investment, the CGT bill is also no longer payable.

On completion, please email:
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