Should you invest in a VCT or other Esoteric Investments?

Smaller investors can receive tax-free dividends and a 30% income tax break – but beware the risks.

The tightening of the screw on tax perks and investment limits for pension saving is tempting high earners to add riskier Venture Capital Trusts (VCT) and Enterprise Investment Schemes (EIS) to their retirement planning.

Those who have already filled their pensions, through the Lifetime or Annual Allowance, can still obtain a healthy tax relief boost from VCTs, but they are not for the uninitiated.

Most people know tax should never be the main motivation for choosing an investment, but the generous breaks offered on both Venture Capital Trusts and Enterprise Investment Schemes – including 30% income tax relief – are, on paper, hard to resist.

The Taxman is not this generous for nothing.

The tax carrots are designed to attract money into Britain's riskiest fledgling businesses, which the Government says are a vital component of the Country's future economic prosperity. Both VCTs and EIS Schemes put investors' cash into high-growth entrepreneurial businesses, companies which have fewer than 250 employees, and are either unquoted or listed on the Alternative Investment Market (AIM).

The main difference between a VCT and EIS is that VCTs are invested in listed companies and are therefore more easily valued and tradable.

An EIS is a direct investment in one minnow company, although it is possible to spread the risk by investing in a fund which holds several schemes. Seed Enterprise Investment Schemes (SEIS) invest into start- up companies, with the higher risk, higher income tax relief of 50% is available.

"Essentially, those seeking tax-free dividends choose VCTs, whilst growth investors tend to pick EIS. But whilst the tax breaks are enticing, you need to be happy with the underlying investments".

Most VCTs launch new issues in the autumn, with a deadline of the end of the tax year, although they will close if they reach their target earlier. EIS funds work in a similar way, but there are stand-alone opportunities during the year.

Losses are available on EIS investments where income tax relief has been claimed, although a deduction is made for the 30% income tax relief.

Different types of Venture Capital Trusts

VCTs come in different forms. Most are "generalist" where the manager seeks out growth companies in a wide range of industries.

Other options include "Limited Life" VCTs which plan to wind up after the 5-year holding period for keeping the 30% relief. The managers of these tend to focus on preserving the value, rather than going for growth – meaning the maximum return is likely to be the 30% income tax perk.

There are also AIM Trusts, which direct money into shares quoted on the Alternative Investment Market. Returns tend to be more volatile, but the investments are easier to sell.

The below table compares the tax-efficient investment options:

COMPARING TAX-EFFICIENT INVESTMENT OPTIONS					
	ISA	**PENSION**	**VCT**	**EIS**	**SEIS**
ANNUAL CAP	£15,240	£40,000	£200,000	£1m	£100,000
LIFETIME CAP	X	£1.25m / £1m	X	X	X
INCOME TAX RELIEF	X	✓ *HMR	30%*	30%*	50%*
LOSS RELIEF	X	X	X	✓	✓
IHT RELIEF	X (✓ if AIM)	Depends	X	✓	✓
CGT FREE GROWTH	✓	✓	✓	✓	✓
CGT DEFERRAL	X	X	X	✓	✓
TAX-FREE INCOME	✓	X	✓	X	X
TAX-FREE LUMP SUM	✓	25%	✓	✓	✓

VCT / EIS and SEIS Schemes usually compliment more conventional saving and investment wrappers such as ISAs and personal pensions (for those wishing to take additional risk.

****   To gain freedom from income tax relief clawback, the investor must hold the shares for at least 3 years (EIS) or 5 years (VCT) from the later of the date of issue, or the date the qualifying trade begins.***

**** at Highest Marginal Rate.***