SAUNDERSON HOUSE

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A guide to Tax-Efficient Investing for High Earners

High earners and wealthy individuals can be subject to high income tax and capital gains tax liabilities. However, there are a number of government-backed investment initiatives which enable individuals to save tax efficiently but are often overlooked.

The UK government has made a number of tax reforms in recent years to increase tax revenue and reduce the fiscal deficit. Most notable among these are changes to pension legislation, with people earning more than £150,000 a year (including their employer pension contribution) seeing their pension annual allowance drop to £10,000 per year and, unless they hold one of the forms of Lifetime Allowance Protection, their lifetime allowance fall to £1m. Individual Savings Accounts (ISAs) remain an attractive investment vehicle, although with annual contributions restricted to £20,000 they only provide a limited tax shelter. Buy-to-let investing has been a successful strategy for some, providing a steady level of income in retirement and, in many areas, strong capital growth too. However, increases in stamp duty on buy-to-let properties (and second homes) and restrictions to landlords' mortgage interest relief now make this less appealing. Finally, with asset prices having risen sharply since the 'nil rate band' was fixed at £325,000 in April 2009 (where it will remain until at least 2020/21), family members and beneficiaries are increasingly left with inheritance tax bills to pay.

This changing landscape is encouraging investors to consider other tax-efficient investment schemes, namely Venture Capital Trusts (VCTs), Enterprise Investment Schemes (EISs) and Business Property Relief (BPR). In this guide we look at each of these schemes in detail, showing how they help investors to mitigate or avoid future tax liabilities, recoup tax already paid and receive tax-free income and gains, depending on the product.

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An overview of the tax reliefs is shown in Fig. 1. It is worth noting that these options will not suit everyone and they are not substitutes to more conventional tax shelters such as pensions, ISAs, CGT allowances and gifting. However, they can be effective when used appropriately and, for high earners and wealthy individuals, should be included in wider financial planning discussions.

Figure 1: Overview of Tax Reliefs

	Maximum investment	Income tax relief	CGT relief / deferral	Tax-free dividends	Tax-free growth	Inheritance Tax (IHT) free	Loss relief
VCT	£200,000	30%	No	Yes	Yes	No	No
EIS	£2,000,000*	30% + carry back	Deferral	No	Yes	2 years	Yes
BPR	Unlimited	No	No	If in ISA	If in ISA	2 years	No

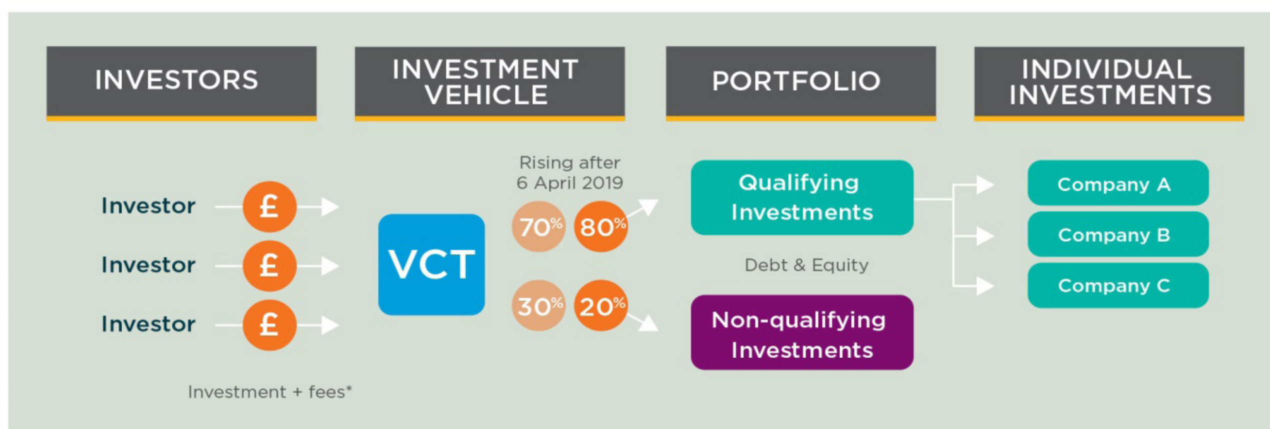
**£2m for investments in "knowledge-intensive" companies, otherwise £1m*

Source: HMRC

Venture Capital Trusts (VCTs)

VCTs were introduced in 1995 to encourage investment into small UK companies. They are closed-ended investment companies listed on the London Stock Exchange. They pool investors' money and employ a professional manager to make investments in unquoted companies or companies whose shares are traded on the Alternative Investment Market (AIM) and PLUS Markets. These companies must carry out a qualifying trade and, at the point of investment, be less than seven years old (with certain exceptions), have fewer than 250 employees (or less than 500 for a 'knowledge-intensive' company) and have no more than £15m in assets. To retain government approval as a VCT, it must invest a minimum 70% of its assets in qualifying holdings, rising to 80% for accounting periods beginning on or after 6 April 2019. The balance can remain in non-qualifying investments.

Figure 2: Overview of VCTs



*The Investment will be subject to initial fees and annual management charges, while performance fees are common

VCTs may raise money for new share pools or existing ones. Established VCTs will typically raise money for an existing share pool, providing access to a portfolio of maturing investments which has the benefit of immediate diversification and, in most instances, dividends (since holdings are closer to being realised and a number will be generating income from interest on loans and dividends).

As of 5 April 2018, at least 30% of all new funds raised must be invested in qualifying holdings within 12 months of the accounting period in which the VCT issues shares, with the remaining funds invested by the end of year three.

VCT tax benefits

There are three main tax benefits available on investments of up to £200,000 per tax year:

- **Income tax relief at 30%** on the purchase of newly issued VCT shares (received upfront), allowing investors to reduce their income tax liability in that tax year.
- **Tax-free dividends**, providing the potential for a regular stream of tax-free income.
- **Tax-free capital gains,** meaning investors have no tax to pay on gains when shares are sold.

VCTs are therefore among the most tax-efficient investment vehicles available and can be a useful option for investors looking to complement their pension plans or other long-term investments, such as ISAs. It is worth adding that investing in small UK businesses offers the potential for significant long-term growth if the companies in the VCT are successful. They may also bring extra diversification to an investor's portfolio.

Risks and drawbacks of investing in a VCT

VCTs have a higher risk profile than an investment in larger companies. Businesses in the early stages of their development have a higher failure rate than more established businesses and can change value more quickly and more significantly than larger companies. Investors therefore have greater risk of losing their capital and dividends can be reduced or suspended altogether.

Although VCTs are listed on the London Stock Exchange and in theory can be bought and sold at any time, as only newly issued shares qualify for income tax relief, the secondary market is illiquid. This means that even if a buyer can be found, many VCT shares trade at substantial discounts to their respective net asset values (NAVs). Further, as the price of shares bought on the secondary market is determined by supply and demand, should these not align (as is often the case), the difference between the buying and selling price (the spread) may be wide. Disposing of a VCT holding in the secondary market may therefore only be possible at a price significantly below the NAV of the shares. A large number of VCT managers do, however, offer share buy-back schemes, which they typically undertake at a 5%-15% discount to NAV.

It is important to note that income tax relief is clawed back if the shares are not held for at least five years. Investors should be prepared to invest for at least this long and we would advise longer. It is worth adding that how much an individual benefits from the tax reliefs will depend on their particular circumstances and HMRC may change the rules at any time.

Finally, investors should note that the ongoing charges associated with VCTs are typically higher than those for mainstream collective investments and it is common for them to have a performance fee.

Who might consider buying VCT shares?

We believe VCTs are most suitable for individuals with a balanced or adventurous attitude to risk, with surplus cash available to invest for the long-term and a large income tax liability. Pension and ISA allowances should already be made full use of, as well as any tax-free growth available using dividends allowance and annual capital gains tax exemptions.

VCT case study

David is a high earner and comfortable taking a higher level of investment risk. He makes full pension and ISA contributions, and is looking at other tax-efficient ways to supplement his income in retirement. He plans to work for another five years and will have considerable surplus income over that period. After meeting with his financial adviser, David agrees to invest £50,000 per year for the next five years into a range of Generalist and AIM VCTs.

Below we assume that the VCTs have an average target dividend yield of 5%, which is achieved every year in perpetuity, and there is no movement in capital values.

When David enters his first year of retirement, he has a VCT portfolio of £250,000 at a net cost of £175,000 (after 30% income tax relief). He has received £37,500 in tax-free dividends (5% on the sum invested over five years) and stands to receive a further £12,500 in tax-free dividends each year thereafter. The tax-equivalent yield of £12,500 in dividends to an additional rate taxpayer on a net investment of £175,000 is 13.0%. David must remain invested for five years into retirement to keep all of the tax breaks provided (the income tax for each contribution invested for less than five years would otherwise be repayable), although this is part of a long-term holding and he does not need access to the capital. The VCT holdings could be sold if required, although David understands that this would be at a discount to NAV.

For a well-managed Generalist or AIM VCT, we would consider a 5% dividend yield together with some uplift in capital value to be achievable over the long term. However, dividends may be higher or lower in any single year depending on market conditions and the level of realisations, while portfolio values are also likely to fluctuate.

Enterprise Investment Scheme (EIS)

The EIS was introduced in 1994 as the successor to the Business Expansion Scheme. It is designed to help small UK trading companies raise finance by offering a range of tax incentives to investors who purchase new shares in those companies.

> "As a result of the tax treatment and shorter minimum holding period, EISs can be used more tactically than VCTs from a financial planning perspective".

The two most common structures of an EIS investment are:

EIS Companies, epresenting a direct investment in the eligible shares of a single EIS qualifying company. This may include a company set up by an EIS manager or adviser that qualifies for EIS tax relief. Fundraisings for EIS Companies are launched throughout the year and are open for a limited period of roughly three months, closing sooner if fully subscribed. Investment horizons vary from just over three years to longer holding periods.

EIS Managed Portfolios, a discretionary portfolio invested in shares of a number of EIS qualifying companies, typically 6-10, selected by a fund manager. EIS Managed Portfolios are generally available for investment all year round, with an investor's subscription allocated to a spread of deals typically over a 12-18 month period. The manager generally targets an investment horizon of 4-10 years, with money returned to investors periodically as the underlying holdings are exited.

EIS Tax Benefits

The tax treatment of EISs is generally more advantageous than that of VCTs, with both receiving **30% income tax relief** on the amount invested and tax-free capital gains, but EIS investors are able to:

- **carry relief back** to the tax year prior to when the shares are issued;
- **defer capital gains taxes** incurred elsewhere;
- claim **'loss relief'** on any realised losses (on each underlying investee company); and;
- qualify for **inheritance tax relief** on the investment provided the shares have been held for two years and are still held at the time of death.

Moreover, the minimum holding period in order to keep the tax breaks is shorter, at three years.

As a result of the tax treatment and shorter minimum holding period, EISs have been used more tactically than VCTs from a financial planning perspective. This is most relevant for lower risk, often asset-backed strategies, which aim to return capital to investors shortly after the minimum qualifying timeframe has passed. However, with the introduction of a 'capital at risk' condition to the EIS rules in the 2018 Finance Act, these lower risk strategies are no longer viable.

In comparison, the appeal of higher risk, high growth strategies is the potential for strong upside should the investee company prove highly successful, although holding periods are likely to be materially longer.

Risks and Drawbacks of Investing in a EIS

While we can segment EIS investments into lower and higher risk brackets when compared against each other, it is important to be aware that all EIS investments, by their nature, are high risk. They must adhere to the same restrictive qualifying investment criteria as VCTs, but are more concentrated and have little or no liquidity. Investors in the lower risk strategies should not consider their capital to be entirely secure and those in the higher risk strategies should expect to see some failures. That said, the ability to claim loss relief on any realised losses means that the maximum downside of an EIS investment is 38.5% for an additional rate taxpayer.

Income tax relief is clawed back if the shares are not held for at least three years. Furthermore, as EISs are not listed, there is no secondary market through which an investor can sell their shares. This means that the only exit route is through sale of the underlying investments. Investors should therefore pay close attention to the exit strategy of the EIS investment as a guide to the expected holding period, bearing in mind that the exit may be dictated by, or at least closely tied to, economic and market conditions.

Investors should be mindful that, for the purposes of claiming tax relief, the relevant date is when the EIS shares are issued and not the date when the investment is made. For EIS Managed Portfolios, claiming tax relief will therefore be lumpy, as the shares are only issued after each underlying investment is made. However, investors can take advantage of 'carry back' relief, so that shares issued over two successive tax years are treated as being received in the same period.

More importantly, investors should be aware that only the amount invested in EIS shares receives tax relief. This is not an issue for EIS Companies, where the whole subscription is in EIS shares. However, for EIS Managed Portfolios where the manager sets aside initial and annual management fees, typically only 90-95% of the subscription is invested in EIS shares and therefore receives tax relief.

As with VCTs, how much an individual benefits from the tax reliefs will depend on their particular circumstances and HMRC may change the rules at any time. The ongoing charges associated with EISs are typically higher than those for mainstream collective investments and it is also common for them to have a performance fee.

Who might consider buying EIS shares?

We believe EISs are most suitable for individuals with a balanced or adventurous attitude to risk, with surplus cash available to invest for the long- term and a large income tax liability. Pension and ISA allowances should already be made full use of, as well as any tax-free growth available using dividend allowances and annual capital gains tax exemptions.

EIS case study - EIS Managed Portfolio

Meena is 40 and works in the City. She earns £400,000 per year and has an adventurous risk profile. She would like to invest in a higher risk strategy with the potential for high reward. She does not require income and is comfortable 'locking up' her capital for a number of years. Meena agrees to invest £100,000 into an EIS Managed Portfolio.

Over the next 18 months, the EIS manager invests £95,000, after fees, into six qualifying companies. Meena receives EIS 5 certificates in respect of these holdings on which she claims £28,500 income tax relief. The net cost of her investment is £71,500. Over the next seven years, two of her investments are sold at a multiple of 2 x cost, one at 1.5 x cost, one halves in value and two are complete failures. The proceeds from these are £95,000, which is equal to the amount the EIS manager invested into the companies. However, after claiming loss relief (£11,400) and when accounting for the income tax relief received (£28,500), Meena's total return is £134,900 on £100,000 invested. The percentage return on the net investment is 48%.

Company	1	2	3	4	5	6	Fees	Total
Amount Invested	**£15,833**	**£15,833**	**£15,833**	**£15,833**	**£15,833**	**£15,833**	£5,000	£100,000
Income Tax Relief	**£4,750**	**£4,750**	**£4,750**	**£4,750**	**£4,750**	**£4,750**	**n/a**	£28,500
Proceeds of Sale	£31,666	£31,667	£23,750	£7,917	nil	nil	n/a	£95,000
Loss Relief at 45%	nil	nil	nil	£1,425	£4,988	£4,987	n/a	£11,400
Total Return								**£134,900**

Business Property Relief (BPR)

BPR was introduced in the 1976 Finance Act and permits individuals full relief from inheritance tax on transfers of 'relevant business property'. This includes a business, an interest in a business, unlisted shares and most shares quoted on the Alternative Investment Market (AIM).

In order to qualify for BPR on death, qualifying assets must have been held for at least two of the previous five years and still held at the time of death. BPR is also available on gifts of business property provided that the property is owned by the recipient throughout the period between the gift and the death of the transferor, or the earlier death of the recipient.

Aside from IHT exemption, the appeal of BPR schemes as an estate planning solution includes:

- **Efficiency:** the value of the investment should be fully exempt from IHT after only two years. Other methods can take up to seven years.
- **Control**: the investor retains the beneficial ownership of the investment and access to funds. Other methods can require the individual to give up control of their assets.
- **Simplicity**: there are no complex legal structures, client underwriting or medical surveys. There is also no maximum age limit.

The rules stipulating what qualifies for BPR are less restrictive than those in place for VCTs or EIS; for example, shares do not need to be newly issued and there are no gross asset restrictions. Certain conditions do apply, however, to prevent the relief being obtained where the business of the company in question is mainly comprised of dealing in securities, stocks or shares, land or buildings, or in making or holding investments. It should be noted that BPR relief is assessed by HMRC on a case-by-case basis at the time of death of the investor and, as such, is not guaranteed.

"The rules stipulating what qualifies for BPR are less restrictive than those in place for VCTs or EIS".

There are two main types of BPR scheme in the marketplace: one invests in the shares of an unlisted BPR-qualifying company and the other invests in a portfolio of AIM-listed stocks. The unlisted company is usually operated/advised by an investment manager and has a relatively conservative business model designed to preserve capital whilst delivering modest growth. Typical trading activities include secured lending, asset leasing, media financing (e.g. to television and film production companies) and renewable energy production. The AIM portfolio solution is managed by a professional investment manager on a discretionary basis and is designed to generate strong investment returns but taking a higher level of risk.

Since 2013, when the Government changed the rules to allow AIM-listed shares to be held in an ISA, it has been possible to transfer existing investments in an ISA into BPR-qualifying AIM investments, thereby sheltering an individual's ISA assets from inheritance tax. Of course, the AIM portfolio is likely to be higher risk than the portfolio of stocks listed on the Main Market. However, with 40% inheritance tax potentially due on the standard stocks and shares ISA portfolio (subject to the individual's wealth exceeding the inheritance tax-free allowance), the AIM ISA portfolio effectively has a big performance cushion to compensate for this risk.

When assessing a BPR scheme, liquidity should be a key consideration. This is particularly important for schemes focused on unlisted companies, as the individual will either need to sell the shares back to the company (which is the most common method) or to another investor in order to exit.

Estate Planning case study 1 - unlisted BPR-qualifying company

Graham is 78 and wants to minimise the inheritance tax bill his children will face whilst retaining control of his investment should he need it to cover long-term care if his health deteriorates. He has a large family home in his name, considerable assets in his pension and a taxable share portfolio of £800,000. After speaking with his financial adviser, he decides to sell his taxable share portfolio and invest in an unlisted BPR-qualifying company ("the Company").

The Company targets a return of 3% per annum, although has a 2% initial charge and a 1% dealing fee levied on purchase and sale of the shares.

Graham passes away five years later, over which period the Company's shares have risen by 3% per annum. His children sell his holding and receive proceeds of £890,600. This full amount is free of inheritance tax.*

**£800,000 x 0.97 = £776,000 (investment less initial fee and dealing fee for purchase)*

£776,000 x (1.03x1.03x1.03x1.03x1.03) = £899,597 (five years of growth at 3% per annum)

£899,597 x 0.99 = £890,600 (less dealing fee for sale)

Had Graham continued to hold his taxable share portfolio until death and, assuming the same investment return, his children would have received proceeds of £556,452 after inheritance tax.*

**£800,000 x (1.03x1.03x1.03x1.03x1.03) = £927,419 (five years of growth at 3%)*

£927,419 x 0.6 = £556,452 (less inheritance tax at 40%)

Graham's taxable share portfolio would have had to grow by 13% per annum over the five years to have generated the same proceeds as the BPR solution.

Estate Planning case study 2 - AIM Inheritance Tax ISA portfolio

Susan is 74 years old. Her home and savings are valued at considerably above the current inheritance tax-free allowance of £325,000. Included in these savings she has ISA investments worth £100,000. After meeting with her financial adviser and confirming that she's comfortable with the risks, Susan transfers her ISAs into an AIM Inheritance Tax ISA.

Susan passes away some years later. Stock markets have been volatile over this period and her AIM portfolio has lost 15% in value. Her ISAs are therefore worth £85,000 on death, although with no inheritance tax liability on this (since the investments are BPR qualifying), the full amount is passed on to her beneficiaries. The investments she previously held have performed better and are up 10%. Had she remained invested in these then her ISAs would be worth £110,000. However, her beneficiaries would have 40% inheritance tax to pay on this, meaning that only £66,000 would have been passed on.

Conclusion

In recent years it has become more difficult for high earners and wealthy people to shelter their income and capital from the taxman. The tax-efficient investment schemes discussed in this paper outline different ways in which investors can mitigate or avoid future tax liabilities, recoup tax already paid and receive tax-free income and gains, depending on the product.

It is important to recognise that the schemes are not suitable for all individuals and investors must understand and be comfortable with the level of investment risk inherent in the products. However, their high risk nature should not automatically be viewed as a negative, with the track records of some managers showing strong investment returns even without tax reliefs factored in.

VCTs, the EIS and BPR are well established schemes and we anticipate growth in these areas as investors look for additional financial planning options given restrictions to more conventional tax shelters. However, it should be noted that HMRC has changed the rules governing the schemes in the past and may do so again in the future.

> "It is important to recognise that the schemes are not suitable for all individuals and investors must understand and be comfortable with the level of investment risk inherent in the products."

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