

'Inadvertent breaches' of the investment tests

AIC guidance for Venture Capital Trusts

Background

To maintain VCT status (after its initial qualifying period) a company must at all times continue to have at least 70% by value of its total investments in 'qualifying holdings' and at least 30% by value of 'qualifying holdings' must be in 'eligible shares' as defined by section 842AA and Schedule 28B of the Income and Corporation Taxes Act 1988 ('the investment tests').

When a VCT realises an investment, particularly a substantial one, this can create problems with regard to its compliance with the investment tests. If the VCT were to place the proceeds on an interest-bearing deposit account, this money would constitute an investment (but not a qualifying holding) and therefore reduce the proportion of the VCT's investments in qualifying holdings. Where substantial disposals are concerned, particularly at a multiple of the original cost, this could potentially take the company below the relevant thresholds, thereby threatening the company's status as a VCT.

If the investment tests are breached this will normally result in the company losing VCT status with all the consequences that would entail. This could include shareholders being required to pay back the up front tax relief they received on investment.

However, where it can be shown that the breach of the conditions was outside the company's control (an 'inadvertent breach'), it may nonetheless be able to retain its VCT status.

HMRC published guidance on 'inadvertent breaches' in August 2006. The AIC, together with other interested parties, has been in discussions to clarify in more detail how these provisions might operate.

This paper sets out the conclusions of those discussions and has been reviewed by HMRC. The paper deals with the breach of the investment tests, but not of the other requirements of s842AA(2) of the Income and Corporation Taxes Act 1988.

Use of Non-Interest Bearing Accounts

Some VCTs have managed a potential, temporary, breach by placing cash proceeds of realisations into Non-Interest Bearing Accounts ("NIBAs") on a short-term basis pending further investment in qualifying holdings, and, or, distributions of profits from those realisations being made. This is because a NIBA, because it does not produce any income, does not constitute an investment. Therefore, realising an investment and putting the proceeds into a NIBA does not reduce the proportion of a company's investments in qualifying holdings to the same extent.

However, tax legislation has now been amended so that NIBAs (and other money in the company's possession as well as other sums owed to the company) will constitute an investment from 6 April 2007. The Government introduced this legislation because of concerns that the use of NIBAs compromises the overall policy intention of VCTs, that is channelling funds into fledgling companies.

As a result of this change, compliance with the investment tests may become more difficult than in the past, and therefore it is possible that more VCTs will be placed in a position where realisations may threaten VCT status. It is therefore even more important for all VCT Boards and managers to understand the (limited) extent to which they may be able to rely on the 'inadvertent breach' guidance, so that any corrective action required may be taken as soon as possible.

General principles

Section 842AA Income and Corporation and Taxes Act 1988 has no specific provisions to allow any of the tests to be suspended to manage commercial realisations and allow the fund to bring itself back into compliance.

HMRC's ability to be flexible over compliance with the test is therefore extremely limited (and rests only on a ministerial statement made in relation to the legislation). It can only suspend the investment tests in circumstances where the VCT has breached it inadvertently. It has no powers to maintain status where the breach is not inadvertent.

HMRC will take a view on whether a breach is inadvertent on a case-by-case basis. It will agree not to withdraw approval where:

- The breach is inadvertent;
- The breach is notified to HMRC as soon as it is identified; and
- The position is corrected without delay.

As a general rule, if the VCT has any means of ensuring that its level of qualifying holdings remains over the 70% threshold, the breach will not be considered inadvertent and the investment tests will not be suspended. Also, if the test is breached in error this is unlikely to be considered inadvertent, even if the breach is relatively minor and corrective action is taken in good time. In these cases, the Board should expect that the VCT will lose all of its tax advantages.

The nature of an inadvertent breach

Whether or not a breach is inadvertent will be assessed on the facts on a case-by-case basis. Some relevant factors are set out below:

Forced sales: Where a breach of the investment tests arises because the sale of an asset is forced, this may be considered inadvertent. This raises questions over what would comprise the forced sale of an investee company.

If a VCT is entitled but fails to exercise a power of veto over the sale (whether through a vote or other means) the sale will not be considered forced.

N.B. not owning a majority of the shares in the company does not automatically mean that there were no circumstances under which control over the sale could not have been exercised alone or in concert, as VCTs will normally negotiate provisions to protect their position as minority shareholders through an investment agreement with other shareholders

HMRC will consider a sale forced where the VCT has no legal power to prevent other shareholders from transferring their shares and the consequences of other shareholders transferring their shares is that control of the investee company will pass to one or more third parties with whom (or with the majority of whom) the VCT has not been able to enter into an investment agreement. In these circumstances if the VCT joins the sale to such third parties HMRC will regard the sale as forced.

Scale of the breach: Even where the realisation is the result of a forced sale, this might not be sufficient to allow HMRC to consider the breach inadvertent. If a forced sale results in the tests being breached by a small margin (perhaps a few percent), and the fund had only been a little way over the thresholds before the transaction, HMRC is likely to require an explanation as to why, for example, other investments had not been made prior to that transaction to ensure that the test were not compromised. This would particularly be the case if the breach was the result of a series of sales – even where they were forced – over a period where the cumulative returns resulted in a breach. (Of course, if any of those individual sales were not forced it is less likely that the breach would be considered inadvertent.)

Where a forced sale results in the percentage of qualifying investments reducing by a large margin (likely to be the case where the original investment has increased in value many times) an appeal under the inadvertent breach guidelines is more likely to be sympathetically received. A VCT's arguments will be strengthened if it was well over the 70% threshold before the proceeds of the sale were received. Nevertheless, if a VCT was invested at, say, 85%, and a single realisation took it just below the 70% level, HMRC would still need to be convinced that an overall investment level even higher than that already achieved was not possible.

N.B. A commercial decision by the VCT not to be substantially above the investment test thresholds – perhaps to retain capital to provide follow-on investment – is likely to make it more difficult for HMRC to treat the breach as inadvertent, unless the level of investment would be immaterial to the test being breached (that is, where a forced sale would have resulted in, for example, the 70% threshold being breached even if the VCT had been 100% invested in qualifying holdings).

Change in status of the asset: It is possible that, without a sale, a holding could change its activities in a way which would mean it is no longer a qualifying holding. This might occur, for example, if it changed its activities to

become substantially involved in property development or other non-qualifying activities. It may be that this could provide grounds for an inadvertent breach, but only if the VCT were unable either to prevent the investment becoming non-qualifying or if it had no possibility of divestment before the company became non-qualifying. The VCT would be expected to take remedial action with regard to the investment tests from the point at which it became aware of the change of activities.

Insolvency of investee company: A breach may be considered inadvertent if it arises from the insolvency of a qualifying asset. Again, the facts of the case will be critical for a breach to be considered inadvertent. What was the overall level of qualifying holdings? Could other investments have been made, or dividends paid out, to reduce the level of non-qualifying assets?

Process issues

The approach taken by the VCT and its manager when it becomes aware of a possible breach of the test will be critical to HMRC being able to treat the breach as inadvertent. A VCT should contact HMRC as soon as it is aware of a potential breach. The VCT should not wait until the breach has occurred but should make contact as soon as any risk of a breach is identified. Contacting HMRC before a breach occurs does not, however, guarantee that HMRC can treat the breach as inadvertent.

HMRC will also need credible proof to substantiate the fact that the breach was inadvertent. This should cover:

- The history of the sale of the qualifying holding; and
- Other actions taken (seeking to identify/complete other investment possibilities or pay a dividend) to try and ensure the test is not breached.

Records of negotiations, due diligence, investment opportunities, phone calls and meetings may all be relevant in successfully applying to HMRC for a breach to be considered inadvertent. The material provided should be sufficient to provide a standard of proof which satisfies HMRC that the breach was both inadvertent *and* no reasonable action could have been taken to maintain compliance with the test.

N.B. It is important to recognise that it is not for HMRC to demonstrate that a breach was not inadvertent in order to remove or withhold VCT status. HMRC is unable to grant VCT status unless it is shown to its satisfaction that the necessary conditions have been met. The onus is therefore on the VCT Board and its manager to demonstrate that the breach was, in fact, inadvertent.

Remedy

Where HMRC has agreed that a breach is inadvertent, the actual remedy will be negotiated on a case-by-case basis. Customarily this will involve HMRC

agreeing to suspend the appropriate tests for a period of time and a plan of action for compliance with the test by the end of that period. This suspension is intended to allow the VCT to move back into compliance as quickly as possible, either by paying a dividend or reinvesting.

HMRC guidance

This note should be read in conjunction with HMRC's VCT manual, which sets out its specific guidance on inadvertent breaches. This comprises five separate notes:

- Inadvertent breach of approval conditions: circumstances in which a breach can occur
- Inadvertent breach of approval conditions: circumstances in which approval will not be withdrawn
- Inadvertent breach of approval conditions: meaning of 'inadvertent'
- Inadvertent breach of approval conditions: notification of breach
- Inadvertent breach of approval conditions: correction without delay

They can all be accessed through the following internet link:

<http://www.hmrc.gov.uk/manuals/vcmmanual/VCM60000.htm>

Conclusion

The AIC believes that there is also a case for amending tax law so that VCTs have greater flexibility to manage commercial realisations. It is therefore liaising with VCT Boards, the BVCA and VCT managers to discuss how additional flexibility could be achieved whilst preserving the policy intentions lying behind the tax regime applicable to VCTs.

However, until any such changes are announced, Boards and managers of VCTs should continue to ensure the investment tests are met on the basis of the existing law.

Disclaimer

This note is intended as general guidance only. Please consult your professional advisors if you have any doubt over how the issues raised in this note affect you or any VCT with which you are involved.

December 2006

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