Venture Capital Trust Association
Summer 2025 Policy Paper

Introduction

Venture Capital Trusts (VCTs) are an established part of the UK funding ecosystem, providing a vital source of patient capital to innovative, high-growth small businesses. Young, high-tech companies need finance to help them expand, and VCTs enable them to access the support and funding they need to grow, enter new markets, and drive employment across the UK.

Since their establishment, VCTs have grown and become a UK success story. Venture Capital Trust Association (VCTA) members now manage more than £5.6bn, over 90% of a £6.2bn industry, invested across sectors as diverse as digital technology, medicine development, life sciences, deep tech, specialist manufacturing and retail.

The VCTA was pleased to note the recognition of the scheme's successes from both the previous and the current government, in addition to the Treasury Select Committee, and we welcomed the cross-party consensus that the VCT scheme and Enterprise Investment Scheme (EIS) should be extended beyond their April 2025 'sunset clause', as they now have been.

Now, looking ahead to the future of the scheme, there are several policy changes that HM Treasury can make to ensure VCTs are able to realise their full potential in supporting some of the UK's most innovative, fast-growing startups and SMEs to scale up.

We have outlined several of these below.

In summary:

1. **Investment limits:** Raising the lifetime, annual and other scheme investment limits to stop the power of VCTs being eroded by inflation.

2. **Age limits:** Amending the age limit within the VCT rules to better enable the scheme to support regional businesses and under-represented founders.

3. **Supporting AIM:**

    i. Allowing VCTs to reprice their holdings for the purpose of the 80% test based on the higher of cost or latest market price, rather than being required to revalue on down rounds.

    ii. Recognising that, for companies listed on AIM, the extent of the market failure that the VCT scheme seeks to address can become more acute when public markets are under pressure, it is proposed that VCTs are allowed to make non-qualifying investments (through primary issuance or secondary market share purchases) on AIM of existing qualifying companies held within that VCT's qualifying portfolio.

4. **Bringing the rules up to date:**

    i. Reforming the reinvestment of proceeds rule – at a cost benefit to the Exchequer

    ii. Abolishing the 70% qualifying income test

    iii. Solving the subsidiary trap

    iv. Replacing the 'Undertaking in Difficulty' test with the going concern test.

1. **Raising the lifetime, annual and other scheme limits to stop the power of VCTs being eroded by inflation.**

Across the political spectrum there is agreement that the UK's life sciences sector has huge growth potential, and we have the opportunity to cement our position as a leader in the life sciences space. There are similar ambitions for sectors such as AI and deep tech. VCTs are ideally positioned to help these innovative companies, which need investment to grow and undertake cutting edge research, over the course of their life cycle.

However, for VCT funding to have the impact the scheme was designed to deliver in these high-tech sectors, the lifetime and annual limits of the scheme, and also other limits including the gross assets test, need to be raised to reflect current economic circumstances.

Currently, the lifetime limits for VCT investee companies are £12m (£20m for Knowledge Intensive Companies) and the annual limits are £5m (£12m for Knowledge Intensive Companies).

The lifetime and annual limits have remained static despite rapidly rising inflation and therefore have not kept pace with the investment needs of innovative, fast growth companies – especially those in sectors like life sciences, which tend to require greater capital over time.

To adapt the lifetime limits to better suit our economic environment, the VCTA believes that these limits should be increased to £30m (£40m for Knowledge Intensive Companies) and annual limits should be increased to £15m (£25m for Knowledge Intensive Companies), with a commitment to review these levels every three years, with a report published to Parliament.

Based on current inflation forecasts, **if VCT limits are not raised <u>at least</u> in line with inflation, the scheme's investment power will soon be eroded to only half of what it was in 2016**. There is room to channel further investment to the life sciences and tech sectors in particular, as businesses in this space have significant upfront costs at the lengthy research and development stages before they begin turning a profit.

As a general rule, we believe it is right that all monetary value limits on the VCT scheme – for example, the gross assets test – are reviewed every three years alongside the levels of the lifetime and annual limits and are accordingly increased in the event that inflation has eroded the scheme's investment power. Increasing the limits as above anticipates forecast inflation over the coming years and would enable the scheme to go further to back the next generation of innovative British startups and scaleups.

Regarding the gross assets test in particular, we would recommend increasing the £15m gross assets limit to £30m to give businesses more room to manoeuvre and resolve the issue of manufacturing businesses in the UK's regions being put at a particular disadvantage compared to their tech industry counterparts in London and the south east of England, given they frequently, for example, need to own or rent large factory or warehouse space that risks pushing them over the limit.

We would further recommend that the gross assets test is carried out only at the pre investment stage, not following investment. This would better support VCT backed businesses, especially those based in the UK's regions and nations, to grow.

There is also a technical accounting change that could easily support high-growth manufacturing businesses. We suggest adopting a "frozen GAAP" approach to accounting for gross assets as it was pre-IFS16 – this was an arbitrary technical accounting change in the UK which means that all property rent and asset lease costs over the life of a lease now have to be capitalized as an Right of Use intangible asset; together with a corresponding liability for the payments. This increase in gross assets dramatically reduces any headroom to the gross assets test without any change to the underlying business. Changing this rule to a frozen GAAP basis would be **cost neutral** for the government.

Equally, as the high tech and R&D focused scale up companies capitalise their R&D and intellectual property costs, the accounting further increases gross assets on the balance sheet and may unduly restrict access to the VCT scheme.

Finally, we would recommend that the post investment Gross Asset Test be removed, to simplify the scheme and to enable VCTs to crowd in large investment rounds at the point where they hand over the baton to non-tax incentivised investors investing larger amounts into the breakout companies. The point of the Gross Assets Test is to assess a business's suitability for investment – applying a test after investment therefore does not make sense and hinders the UK's ability to scale up its successful start-ups.

2. Amending the age limit within the VCT rules to better enable the scheme to support regional businesses and under-represented founders.

At present, we believe that several age-related limits within the VCT scheme prevent investments in companies which meet the aims of the scheme.

The rules should be amended – within the EU state aid framework – so that VCT investment is targeted more effectively. This would ensure that companies which meet the policy objectives are not prevented from raising VCT funding by technical constraints not included in the EU state aid rules.

The two amendments to the age limit test which would make the most positive impact on the operation of the VCT scheme are outlined below.

2.1. Firstly, at present the UK VCT rules on the age limit for qualifying companies are stricter than EU regulations.

The EU applies the age limit test (7 or 10 years, depending on the type of business) to the 'first commercial sale' that a company makes in a certain market. By contrast, UK legislation requires consideration of both the date of the first commercial sale of the business activity, and the age of the legal entity when this sale was made.

This means that many companies which clearly meet the policy objective of the EU guidelines on State Aid risk finance are being prevented from receiving VCT funding because of this additional test applied by UK rules.

This presents frequent difficulties when a business has entirely ceased an old trade and started a new one. The commercial reality is that this new trade represents a new business, with all the risk that it involves, but the way the UK rules are currently applied does not recognise this.

The age limit test should therefore be **applied to the age of the specific trade rather than the company**. Bringing the test in line with the EU regulations in this way would increase the number of businesses which meet the policy objectives of the VCT scheme, thereby unlocking greater investment into potentially high-growth UK businesses who lack access to finance.

We also note that Labour's December 2022 Start Up, Scale Up policy report recommended removing the age limit due to it adversely affecting regions outside of London, where businesses tend to take longer to develop to the point where they are ready to receive VCT funding. Research undertaken by the VCTA in 2022 found that while there is significant variation between regions, there is a high differential on age of business when considering Greater London (5.1 years) vs. Rest of UK (7.02 years). It is therefore more challenging for a business based outside of London to qualify under the VCT age restrictions, because it takes those companies longer to get to the stage where they are ready to seek out VCT funding to enable them to continue to grow.

Indeed, this is also one of the reasons why the last government changed the SEIS age limit from two years to three years. This issue also disproportionately impacts female founders and entrepreneurs, who are more likely than their male counterparts to take time out from growing their business due to parental leave or caring responsibilities.

A further way to simplify the age limit and deliver an additional boost to businesses in the UK's regions and nations would be to equalise the age limit between Knowledge Intensive companies and other investee companies, making both ten years, and doubling the revenue point at which the clock starts on this test, from £200k to £400k. This would again adjust for inflationary pressures and better enable manufacturing businesses in post-industrial areas of the country to access and benefit from the scheme.

Finally, we would recommend action to address the anomaly that the fastest growing companies can lose their status as Knowledge Intensive via a technicality where the rate of R&D spend has to be completely in sync with growth. Companies that spend money on R&D upfront can pass the test, but if they then grow rapidly, can fail the test if growth outstrips R&D. We would recommend that the Knowledge Intensive Test is carried out at the point of first investment and then, provided a company does not change its trade, is not carried out again.

Delivering the change

Delivering this change would require an amendment to legislation. The age condition is provided for by both section 280C and 294A of the Income Tax Act 2007. Both sections were inserted into the 2007 Act by the Finance (No. 2) Act 2015. This measure is cost-neutral and would serve to lessen the disadvantage to companies based outside of London and the South East of England.

2.2.Secondly, complications arise when a potential investee business – which would meet the age limit test outlined above – is part of a corporate group.

If one of the other companies in the corporate group is too old, the potential investee company cannot receive VCT investment. This is the case even if the company which is too old is no longer part of the corporate group.

This is sensible as an anti-tax avoidance measure (for example preventing a situation where an old company is incorporated into a new one to avoid the age limit test), but it has unintended consequences that prevent companies which would genuinely be eligible from receiving VCT investment.

The origin of this problem is the reference in the UK's legislation to "imported trades." This is not included in the EU's guidelines.

To correct this and considering our above recommendation that the age limit apply to the age of the trade rather than the company, we are suggesting that a 'materiality test' should be applied to the *trade* in the group which is too old. If this older trade represents less than 20% of the activities of the group at the point of investment, the investment should be allowed to go ahead. This measure is cost neutral to the government and would unlock greater investment into potentially high-growth UK businesses who lack access to finance.

Delivering the change

Delivering this change would require a change to UK legislation. The definition of carried trades from subsidiary companies is provided for by both section 280C and 294A of the Income Tax Act 2007. Both sections were inserted into the 2007 Act by the Finance (No. 2) Act 2015.

3. **Supporting AIM:** Following the recent VCTA roundtable with AIM VCT funds, members recommend two policy solutions specifically aimed at the AIM market. We will provide further details in a specific note shortly.

i. **Allow VCTs to reprice their holdings for the purpose of the 80% test based on the higher of cost or latest market price, rather than being required to revalue on down rounds**.

ii. **Recognising that, for companies listed on AIM, the extent of the market failure that the VCT scheme seeks to address can become more acute when public markets are under pressure, it is proposed that VCTs are allowed to make non-qualifying investments (through primary issuance or secondary market share purchases) on AIM of existing qualifying companies held within that VCT's qualifying portfolio.**

- Allowing VCTs to support existing portfolio investments in this way will improve their access to capital (primary issuance) and reduce the cost of capital (secondary purchase). These changes would mitigate new modes of market failure that arise, most typically at times of elevated volatility, as non-state aided investors retrench. Starved of capital, these otherwise healthy small companies pull back from non-essential investment with long term impacts on growth and innovation. In extremis, in times of elevated market volatility, the market failure can place their solvency at risk.

4. Bringing the rules up to date

4.1 Reforming the reinvestment of proceeds rule – at a cost benefit to the Exchequer.

VCTs will, over time, sell the shares in businesses they have invested in once their money has helped the business to grow and develop. The proceeds from these sales are treated differently from those from fundraisings, having to be re-invested within 12 months. This reduces the proportion of investments that meet the requirement for VCTs to have at least 80% of their assets (with certain exceptions) invested in "qualifying" investments. From the Exchequer's perspective every pound that is invested from recycled proceeds has no cost; every pound via fundraising attracts income tax relief.

We suggest that the time period allowed for redeploying the proceeds of investment disposals be extended from 12 months to 36 months, to bring it in line with the time limit for investing newly raised funds. We are suggesting this change because, if a VCT sells a large stake in a business – or sells several stakes in quick succession to comply with the qualifying holding test, the VCT may well be required to distribute rather than recycle some or all of the proceeds.

By treating realised proceeds in the same way as funds raised from investors and extending the period of investment affords the VCT a greater opportunity to recycle the funds, which is of benefit to the Treasury. It may be impossible to re-invest the proceeds within 12 months given the limited amount that can be invested into any one company. In these scenarios, in order to comply with the 'qualifying holdings requirement' the VCT may be forced to pay a dividend to investors.

This effectively results in scenarios where HM Treasury pays out tax credit where it does not need to, as it means VCTs rely on raising money afresh in scenarios when there would otherwise be opportunities to 'recycle' the capital from selling stakes in businesses they had invested in, which comes with no cost to the Exchequer.

According to industry data, between April 2023 and March 2024, more than £70 million was paid out as special dividends by VCT fund managers, accounting for over 16% of total dividends in that period. It is likely that this number would have been much lower were it not for the reinvestment of proceeds rule.

Delivering the necessary change to prevent future similar scenarios and save the Exchequer money would require a small amendment to UK legislation – the time period for disposals is provided for by subsection (2)(a) of section 280A of the Income Tax Act 2007.

4.2 Abolishing the 70% qualifying income test.

The 70% qualifying income test is no longer fit for purpose. Early-stage, high growth businesses do not generally generate profits and with VCT qualifying investments now predominantly comprising equity, these underlying investments do not generate income, which is why the test is out of date. The qualifying holdings test at 80% already exists as an effective assurance that the funds are deployed into investments meeting the policy goals.

Moreover, the return on bank deposits now means that it is a struggle to meet this test in some cases. This outdated rule has the unintended consequence of driving odd behaviour – for example, if you had an amount of cash to be invested held in a bank account and earning 5% interest, this could fail the 70% qualifying income test. The only way to get around this would be moving to a zero-interest account or investing in money markets. We suggest that this test is abolished.

However, if this is not possible, we would recommend expanding what can be treated as 'qualifying income' – for example, including Gilts held by VCTs.

This was overlooked in the very short time that officials had to amend the 2015 Finance Bill to meet EU requirements. There is no reason VCTs should not be allowed to hold Gilts, as they are liquid. This measure is cost-neutral and would require a UK legislative change.

4.3 Solving the subsidiary trap.

Where a portfolio company becomes a subsidiary of a corporate acquirer then the VCT's own investment is no longer deemed to be qualifying. There is a scenario whereby a portfolio company, in continuing to raise funding to support its plans, ends up in a situation where a single investor holds more than 50% of the shares and the VCT fund is disadvantaged through circumstances beyond its control.

To resolve this issue, we would recommend that the same VCTs be enabled to follow on their investments in the same companies (perhaps up to a set amount) where a corporate acquirer owns more than 50% of the shares. We would also recommend a 'safe haven' of continued qualifying holding. To avoid any activity that would run counter to the spirit of this rule, we would recommend that only investments which have qualified for at least (e.g.) three years are eligible to access these follow on and 'safe haven' provisions. The UK has the power to legislate for this, and we anticipate that this measure would be cost neutral for HM Treasury.

4.4 Replace the 'Undertaking in Difficulty' test with the going concern test.

We do not believe it is appropriate to use the age of a business as a factor for whether a company is an Undertaking in Difficulty (UID). Under VCT legislation, companies must invest all funding within 24 months, but if a business outside of its initial investing period were to have incurred losses of more than 50% of its funding, it would fall foul of the Financial Health Requirement.

Many VCT investee companies are developing technology, and it is natural therefore that they incur significant losses. This does not mean that they are failing or that the business is not valuable. This view of the requirement is highly inconsistent and should be remedied by replacing the current UID test with a more appropriate method of assessing whether a company is in difficulty.

The current approach taken by HMRC is also highly subjective and can lead to inconsistent approaches depending on the inspector. As a result, we believe that the current position is creating more work for HMRC because more advance assurance applications are being made due to the uncertainty, taking up additional HMRC time and resources.

As an alternative approach, we recommend using the long-held and widely accepted principle of going concern, as a better barometer and test. An ongoing going concern basis is agreed annually by the directors of a company when they prepare annual accounts, or earlier if a company has cash flow issues. In addition to signing off a set of accounts, if a company is audited, then the auditors will also consider whether a company is a going concern in their audit opinion. However, many VCT investee companies will not have audit as they are below the legal thresholds, so annual accounts and a business plan that includes growth over time would likely be the main methods of carrying out a 'going concern test.'

Making this change is cost neutral to HM Treasury and would likely over time be a cost benefit because of increased growth, VCT-backed businesses taking on more employees, and therefore driving up revenue from PAYE.

For further information on these policy suggestions, please contact the VCTA secretariat at vcta@secnewgate.co.uk

Addendum: Case Studies

Egress

Egress is a high-tech startup which received investment from VCTA member Albion Capital. Founded in 2007, Egress has built a reputation as one of the leading players in the cyber security space. It is the only cloud email security platform to use an adaptive security model, leveraging AI to continuously assess human risk and provide enhanced email protection.

Albion's longstanding relationship with Egress started in 2014 with a Series A £2.2 million funding when the company was a team of twelve. Over the course of a decade the business has built a presence across seven locations, grown to a team of over 300 people globally, and is trusted by the world's biggest brands. At exit last year, the business was delivering almost £50m of ARR and growing 30% per annum while being profitable. Its enterprise value has multiplied 35 times since Albion first invested.

However, while Egress is a significant VCT success story, following their exit Albion was forced to pay out a £25.1 million special dividend to investors, which it was calculated as necessary to avoid falling foul of the HMRC 'qualifying holdings requirement'.

Chess Dynamics

Chess Dynamics ("Chess") is a defence technology company which designs and manufactures surveillance and fire control solutions for land and maritime armed forces. It is a key subcontractor to the UK defence prime contractors. Founded in 1999, Chess has been a trusted supplier of advanced defence technologies for over 20 years.

The ProVen VCTs (part of VCTA member Beringea) first invested in Chess Dynamics's parent company, Chess Technologies, in 2008, when Chess's annual revenue was c. £2m. At the time, Chess Technologies had another subsidiary, Chess Systems, which was a small general precision engineering business founded in 1993. As Chess Systems was unrelated to the core defence business, it was put into insolvent liquidation and dissolved in 2012.

Over the years following the initial investment, the ProVen VCTs made several follow-on investments to support Chess's continued growth. However, when the age limit rule for qualifying investments was introduced in November 2015, Chess did not meet this requirement because it had once been part of the same group as the older Chess Systems, even though Chess Systems no longer existed. The ProVen VCTs were therefore unable to make any further investments into Chess.

When the business needed additional investment in 2016 to fund ongoing projects, the inability of the ProVen VCTs to invest meant that there was a high probability of the business failing. Fortunately, the company was able to raise the capital needed from an existing angel investor.

Chess was sold to UK defence group Cohort plc in 2018 and continues to play a key role in the UK defence industry. The holding period of 10 years is an excellent illustration of the way in which VCTs can support advanced manufacturing businesses in the UK with patient capital. However, because of the dysfunctional age-test, the business nearly failed, resulting in the loss of highly valuable technology and many skilled engineering jobs.

Oxsensis

Oxsensis is a startup company founded in 2003 which has developed the world's highest temperature sensors which can be used in gas turbines, for example in power stations. They are capable of measuring heat and pressure in the harshest conditions where temperatures can reach over 1000°C: the equivalent of molten lava and hundreds of degrees hotter than traditional sensors can stand. With more accurate readings comes the possibility of running turbines at higher combustion temperatures, thereby increasing efficiency, lowering operating costs, and reducing carbon emissions.

Albion and other VCT funds were unable to follow on their investments in Oxsensis after 2022, when a German co-investor acquired more than 50% of shares in the company. The subsequent acquisition of Oxsensis by the German co-investor as a result of VCT funds being unable to follow on meant that, after a 20-year journey and more than £35 million in investment, UK shareholders received almost nothing, and the company is no longer UK owned.