Financial Times - Never invest just to avoid tax

March 30, 2013

Better to put money into something you really want to own.

The tax year ends this coming week and if your mail is anything like mine, you are being inundated with offers of investments which qualify for tax relief provided you invest on or before April 5.

Some of these offers make sense. They are the ones in which tax relief is available for investment through a so-called “wrapper” such as an individual savings account(Isa) or a self invested personal pension (Sipp). You don’t pay any tax on capital gains realised or dividends received in your Isa, or on any funds withdrawn from it, and you can also get tax relief on contributions into Sipp. You can put sensible investments into Isas – stocks, cash, mutual funds, and an even wider range of assets in Sipps, including commercial property.

Do you really want to invest in unquoted companies with less than £15m of gross assets, which is what is required to qualify for an EIS or a VCT? And should anyone invest in movies? Last year, Disney, which is not exactly inexperienced in the movie business, lost more than $200m on the movie John Carter.The problem comes when you invest mainly to obtain the tax relief, rather than because of a genuine desire to invest in the underlying assets. With enterprise investment schemes, film finance schemes and venture capital trusts, I suspect that the main object of most investors is to avoid or defer tax rather than to access the highly restricted and specialised investments which these schemes involve.

We are often blinded by the ability to avoid tax. Not only does this lead us to invest in assets which we would not normally consider, it means we tend not to look as closely at the fees which are charged. From a selection of EISs and VCTs I found initial fees which ranged from 2 per cent to 7.5 per cent of the amount invested, charges of 2-3 per cent each year and performance fees, typically at 20 per cent on any gains, albeit over a hurdle rate. A product with such a rich fee structure generates a lot of sales effort, as you may also have spotted from your mailbox.

This combination of tiny, illiquid companies and high fees produces an inevitable result. Out of 131 VCTs, only 17 have a net asset value higher than the subscription price. Worse than that, the only way you can realise your investment in a VCT is to sell the shares. That is usually done not at net asset value but at the share price which typically trails the NAV by some margin. Only five of the 131 had a share price above their issue price, partly because purchases in the secondary market don’t attract tax relief.

To be fair, a lot of VCTs distribute dividends, as they are also exempt from tax, but if I look at the only VCT which I have ever invested in, the cumulative total of dividends plus NAV barely gets me back above the price at which I subscribed for the shares seven years ago. A prospectus inviting new subscriptions this tax season shows the total return since subscription excluding subscription costs as 8 per cent. That’s not 8 per cent per year, it’s 8 per cent in total.

You might object that I was unlucky or chose badly. But the VCT in question features in the middle of the 131 VCTs in NAV terms, and scored 86 out of a possible 100 in Tax Efficient Review in February.

Managers of tax-based investments seem to want investors to focus on returns after tax relief. So if you got 30 per cent income tax relief on your VCT subscription they will try to get you to focus on the return from the 70p each £1 invested cost you after tax relief (even though the tax relief is actually applied to your tax code through self-assessment, not added to your investment as basic-rate pension tax relief is).

The flaw in this argument is that the 30p was supplied by the taxman, not by the manager, who had 100p to invest, before the not-inconsiderable fees, of course.

Rather than investing in assets you would not normally want to own through these complex, illiquid and expensive vehicles, purely to avoid tax, it is usually better to invest in things you really want to own and pay the tax due on any profits you make.

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This is the third in a five-part series on the fundamentals of investing

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