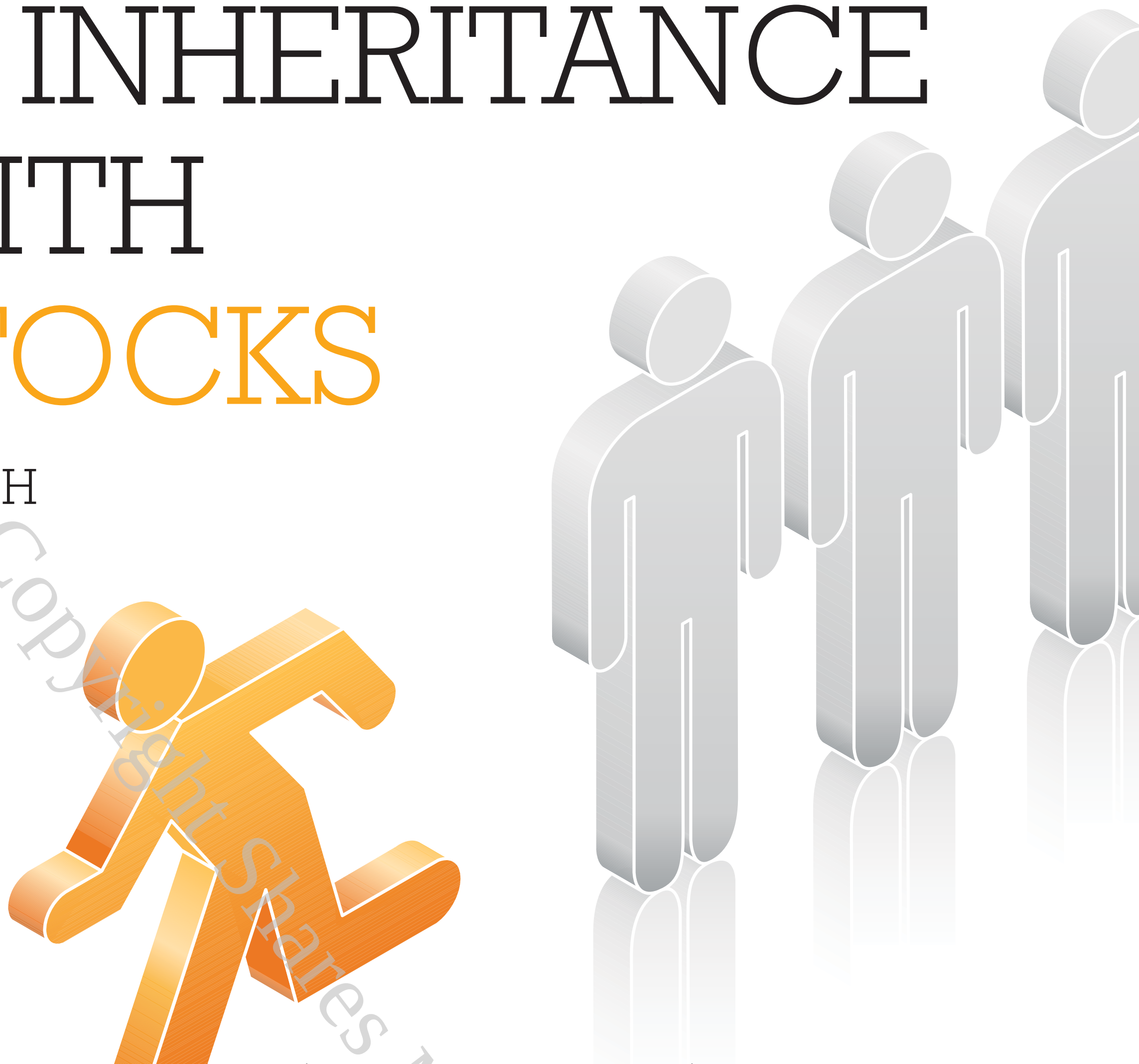
AVOID INHERITANCE TAX WITH AIM STOCKS

WE EXPLAIN WHICH STOCKS IN THE JUNIOR MARKET ARE ELIGIBLE FOR A TAX-EFFICIENT INVESTMENT SCHEME



DANIEL COATSWORTH

One of the key attractions of AIM stocks is their ability to help avoid paying inheritance tax (IHT). In a nutshell, if you invest money in AIM shares that meet certain criteria set by the taxman for at least two years, that money can be passed on to third parties, such as your husband or wife, upon your death without that windfall cash being taxed.

Our favourite stocks that presently qualify for IHT relief include veterinary specialist **CVS (CVS:AIM)**, air charter expert **Gama Aviation (GMAA:AIM)**, patent translation group **RWS (RWS:AIM)** and pubs operator **Young's (YNGA:AIM)**.

Sadly, this isn't a case of finding any AIM stock, parking your cash for a short time, and then having a lifetime golden wrapper around that money so that it will be exempt from IHT after you die. You need to read a bundle of terms and conditions before making an investment and make sure you keep accurate records once cash is invested – noting the date of the initial investment and any subsequent cash you put into the market – for pots of money intended to be gifted at death.

To qualify for the IHT relief, the AIM stocks needed to meet HMRC's Business Property Relief (BPR) qualification criteria. Sadly the taxman doesn't produce a list of eligible stocks – neither does the London Stock Exchange. Qualification is subjective and there's varying opinion among financial services providers as to which ones do and do not fit the bill.

This opaque situation has led to a proliferation of AIM/IHT portfolio services offered by stockbrokers and other financial institutions. You hand over cash and pay a fee for these companies to manage your money on a discretionary basis.

On one hand, paying a fee to a third party is never appealing when it doesn't take too much effort to find qualifying stocks yourself – and therefore make the investments on a DIY basis. But there is merit in letting someone constantly monitor the qualifying status of invested stocks, as a company can suddenly stop meeting the criteria if there's a one-off change to the source of its profits or its business model has evolved so core earnings are coming from a different source than

at the point at which you may have first invested.

Institutional investors also get a chance to put cash into placings – often priced at a discount to market price – so there's further advantageous reasons for using managed portfolio services.

THE SEARCH FOR STOCKS

'The big frustration for private investors is not having a list of companies that qualify for BPR. Legislation is retrospective, so there's no magic list, says Richard Power, head of Octopus Investments' smaller companies team. 'It depends on what a company's activities were on the date of a person's death. If a company does a sale or leaseback on their headquarters in the year someone dies, for example, their accounts will show an exceptional profit for this activity – for example this might be £10 million, in addition to £10 million profit for the normal business. Property profits don't qualify for BPR, so the individual holding the company's shares would only get half the value of their holding to qualify (for the tax relief).'

Power says there's quite a big list of companies in danger of not qualifying, including:

- Collective investment schemes.
- Property investments.
- Exploration assets held by resource companies – if they aren't physically extracting something this is deemed a property asset – therefore non-qualifying.
- Dual-listed stocks – eg **GW Pharmaceuticals (GWP:AIM)** – has Nasdaq listing.
- Joint venture income – eg **MP Evans (MPE:AIM)** has palm oil interests and a 50:50 farming venture.

David Battersby, investment manager at stockbroker Redmayne Bentley, says he follows a selection process to filter down the investment universe before putting clients' cash into the market for IHT-relief purposes. 'I look at the market cap, find out the free float – look at the largest shareholders and work out what's left for me to buy. I check with a market maker or dealer to verify I can buy and sell the stock easily, and then by this point our target has shrunk significantly.' Battersby then goes through each stock on the list to check they qualify with the HMRC BPR rules.

'Some investment managers write to companies regularly and ask if they qualify. The response is nearly always "yes, but it is not our fault if we don't qualify." Those letters are a waste of time. We are taking responsibility to manage someone's money. If we aren't sure the stocks qualify, we don't invest in them.'

The level of due diligence by portfolio managers can vary tremendously. For example, Octopus Investments says it gets accountant PWC to audit its AIM/IHT portfolio holdings every six months. Battersby at Redmayne says he's heard of other investment managers who take no decision whether a stock qualifies. 'They just employ a firm of lawyers to provide them with regular updates, potentially on a weekly basis.'

Battersby says the general rule is that qualifying companies need to be running a business that benefits the economy rather than simply making money through investments. 'It isn't just the UK economy that has to be the beneficiary. The European Union said it should apply EU-wide. But in true British tradition, the UK stuck two fingers up to the EU and said we'll make it worldwide.'

Octopus' Richard Power says he follows a set of guidelines when looking for suitable investments for his portfolio service. Companies need to be profitable, have a sound balance sheet, have long-serving management, high levels of earnings visibility and he prefers dividend payers.

This thorough approach has proved successful. In 2014, Octopus' AIM inheritance tax service (a portfolio of 26 stocks) delivered a 13% profit versus 16.5% negative total return from the FTSE AIM index. Since launch in January 2005, the portfolio has increased by 122.3% in value versus total return from the FTSE AIM index of -22.5%.

Holdings in the portfolio include identity management business **GB (GBG:AIM)** which helps corporates combat fraud and money laundering. There's also a long-held position in recruitment agency **Staffline (STAF:AIM)** which Power still believes offers 'great growth potential'.

Redmayne Bentley's AIM/IHT portfolio includes stamp collector **Stanley Gibbons (SGI:AIM)**, retailer **Majestic Wine (MJW:AIM),** Vimto drinks seller **Nichols (NICL:AIM)** and **Alliance Pharma (APH:AIM)**. 'I like stable, boring businesses,' says David Battersby. 'If you're investing money to be passed »

THE RULES

You need to invest in qualifying AIM companies for at least two years. The clock starts ticking from the point at which your money is invested in qualifying stocks. If you made a second (or more) deposit of funds, a new clock starts for that amount of money – so you'll need to keep accurate records as your investments would now need to be held over different time durations.

If you sell the stocks after the two year qualifying period ends, you then have three years to use that cash as you wish – but you must be reinvested in qualifying stocks by the time that three-year period ends. And it is also worth noting that you have to be invested at the point of death. It is worth speaking to a tax expert to get full clarification of the rules.

on to people, you want boring investments. This is not about putting money on the 2.30 at Kempton Racecourse.'

Chris Boxall at Fundamental Asset Management and Investors Champion reckons qualifying stocks for IHT relief include flooring products group **James Halstead (JHD:AIM)** and utilities services expert **Smart Metering Systems (SMS:AIM)**. Among those he believes don't qualify or may only partially qualify is **Falkland Islands Holdings (FKL:AIM)** – the conglomerate has fishing and transport services but non-trading operations including property and oil and gas investments which wouldn't qualify for the IHT programme. Also on the 'danger' list is **Abbey (ABBY:AIM)**, as Boxall explains: 'It is engaged in building and property development, plant hire and property rental business. The property investment element to the business suggests these shares will only be part qualifying.'

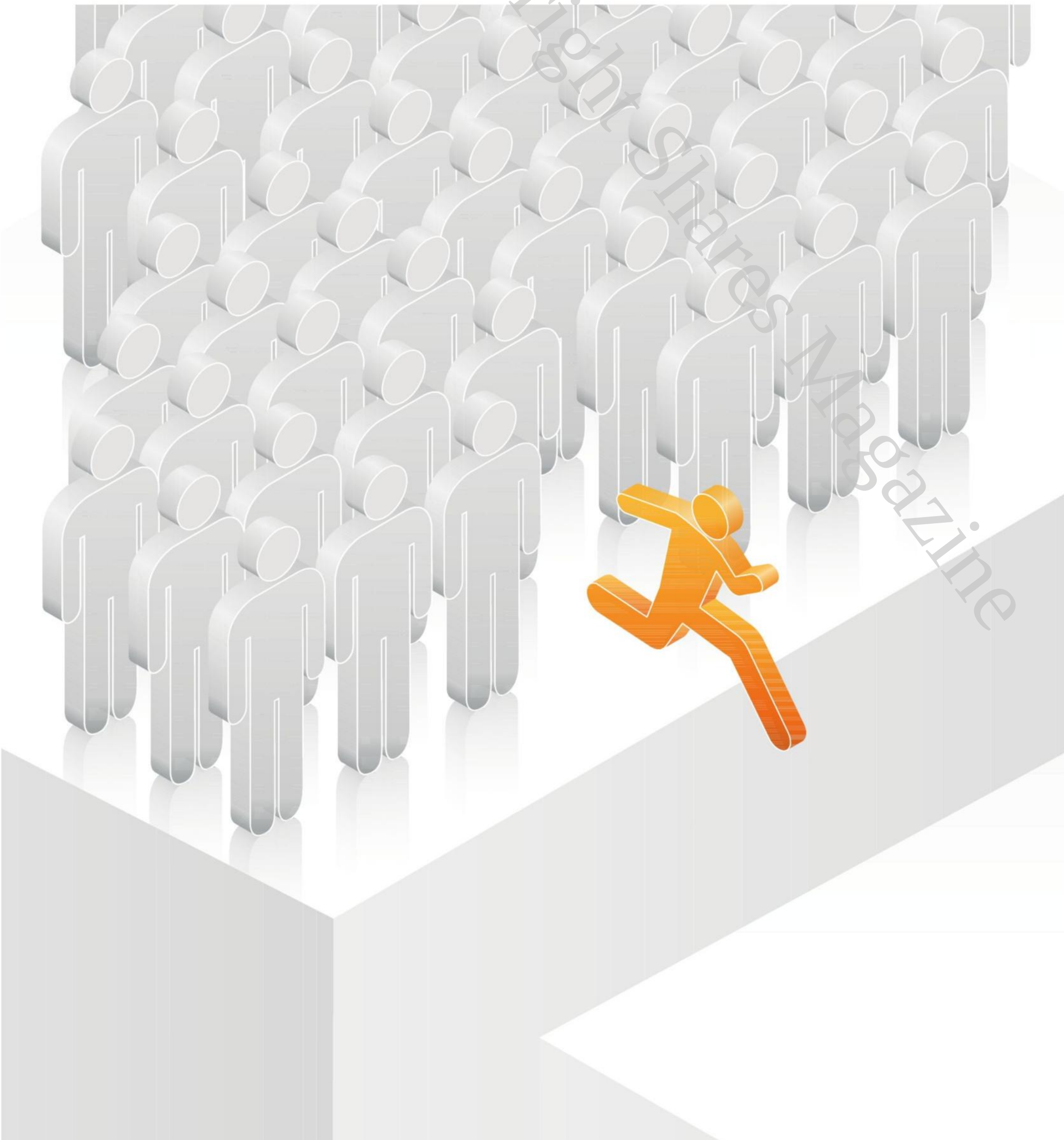
SELECTIVE APPROACH

Graham Neale has been running Killik's AIM/IHT portfolio since 2006 and says he has never used client money to invest in drug discovery, oil, gas or mining shares. The partner in the asset management firm reckons he can add more value by focusing on other sectors where companies are already profitable, generating cash, have a decent balance sheet and have management with a good track record.

OCTOPUS AIM IHT PORTFOLIO – TOP TEN HOLDINGS

COMPANY	SECTOR
Renew (RNWH:AIM)	Support Services
CVS (CVSG:AIM)	Healthcare
Staffline (STAF:AIM)	Support Services
Advanced Computer Software (ASW:AIM)	Software & Computer Services
SQS Software Quality Systems (SQS:AIM)	Software & Computer Services
RWS (RWS:AIM)	Support Services
Matchtech (MTEC:AIM)	Support Services
Restore (RST:AIM)	Support Services
ISG (ISG:AIM)	Support Services
Alternative Networks (AN.:AIM)	Telecommunication Services

Source: Octopus Investments (Data as of 31 Dec 2014)



The turnover in Killik's portfolio has been relatively low over the past three to four years; just a handful each year primarily due to takeovers. For example, it owns shares in **Advanced Computed Software (ASW:AIM)** which is in the process of being acquired by US private equity firm Vista Partners for £725 million. Further back in history, it was a forced seller of fast food specialist **Domino's Pizza (DOM)** when it moved from AIM to London's Main Market, as the latter doesn't qualify for the IHT relief.

The only exception to its 'no pharmaceutical' rule is a holding in **Abcam (ABC:AIM)**. The £903 million cap doesn't 'do' drug discovery, but rather has a library of antibodies to help pharmaceuticals make new drugs. Other current holdings include **Walker Greenbank (WGB:AIM)** which Neale likes for its popular brands and barriers to entry. 'It is very difficult for new companies to enter the wallpaper market. The sector hasn't seen new supply but demand is growing. Walker has been run by the current CEO for many, many years.' »

To help you better understand which stocks do and do not qualify, we've asked AIM/IHT specialist Chris Boxall to provide more detail. The investment manager helps to run Fundamental Asset Management's AIM portfolio service and co-founded Investor's Champion, an equities research business which has a search facility to screen for qualifying companies at http://aimsearch.investorschampion.com/. It reckons 778 out of 1,104 stocks on the AIM market (as of 31 Dec 2014) fully qualify for IHT relief. 'Of the 336 companies that do not "fully" qualify, 69 have dual listings and 171 are either investment companies or their principal activities do not qualify,' says Boxall. 'The balance either partially qualify or are structured in such a way that it is hard to determine unequivocally whether they qualify or not.'

WHAT TYPE OF BUSINESSES QUALIFY?

HMRC offers guidance of where relief cannot be claimed, as follows:

(a) business or company is engaged wholly or mainly in dealing in securities, stocks or shares, land or buildings, or in making or holding investments.

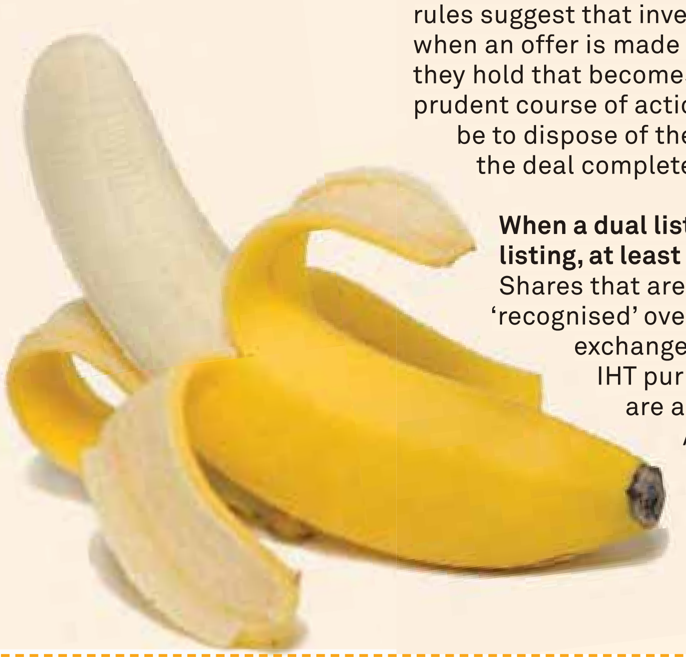
(b) business is not carried on for gain.

(c) business is subject to a contract for sale, unless that sale is to a company which will carry on the business, and the sale is made wholly or mainly in consideration of shares in the company buying the business.

(d) shares in the company are subject to a contract for sale or the company is being wound up, unless the sale or winding up is part of a reconstruction or amalgamation to enable the business of the company to be carried on.

With reference to (a), a stockbroker whose activities mainly involve dealing in shares wouldn't necessarily qualify but an investment manager, such as **Argo (ARGO:AIM)** which derives its income principally from managing investments (as opposed to trading), would seemingly qualify. However (a) also makes reference to the making or holding investments and Argo has substantial investments, being investments made in funds that it manages. It is therefore easy to argue that Argo would also be considered an investment company and therefore may only partially qualify for IHT purposes.

Criteria (c) covers the instance of a business subject to a contract for sale. The rules suggest that investors should be wary when an offer is made for an AIM company they hold that becomes unconditional. The prudent course of action would probably be to dispose of the holding well before the deal completes.



When a dual listing is not a dual listing, at least for HMRC purposes

Shares that are listed on a 'recognised' overseas stock exchange are quoted for IHT purposes, even if they are also traded on the AIM. However, HMRC also grants 'unquoted' status to certain overseas exchanges, therefore investors shouldn't necessarily dismiss an AIM stock just because it is listed on an overseas exchange.

Fyffes (FFY:AIM) is an importer and distributor of tropical produce. The group will be well known to many for its bananas and is a well-established business with revenue in 2013 of over €800 million. Its dual listing on the Irish Stock Exchange may put off many IHT investors, however, Fyffes shares are actually quoted on the Emerging Securities Market ('ESM') of the Irish Stock Exchange. The ESM does not meet the HMRC definition of 'listed' for the purpose of HMRC legislation, therefore, shares in Fyffes should still qualify for IHT planning purposes. Investor's Champion has unearthed 23 companies on AIM which have such qualifying 'dual quoted' status, the majority on the ESM.

Resource companies in general introduce another layer of complexity to the understanding of qualification as many are conceivably structured as investment companies. One such business is **Camco Clean Energy (CCE:AIM)** which refers to itself as a project developer but whose balance sheet reveals 'investments in associates and joint ventures' with a significant value, suggesting Camco would not fully qualify.

Look out for the property assets

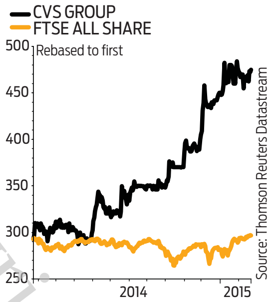
AIM companies that have significant property assets and only use these partially for their own use and, for example, rent out space to others might also be subject to the partial exemption rules. HMRC could class these as 'excepted' assets if they are not used wholly or mainly for the purposes of the business throughout the two year period that the investor holds the shares.

AIM-quoted packaging group **Robinson (RBN:AIM)** has a long history and has collected a number of property assets over the years, some of which are not currently used in the business. However, the group has always intended to sell its property portfolio and has never invested in it or developed it. In order to help prospective IHT investors in its shares Robinson has a helpful page on its website titled 'Tax & AIM' (www.robinsonpackaging.com/investors/tax-aim/) which explains why it believes it qualifies as 'properties held are residue from previous trading activities and there is an active plan to dispose of them'.

Housebuilders would generally qualify under the BPR rules, however, much like investment managers many AIM quoted housebuilders seem to enjoy being in the investment business as well.

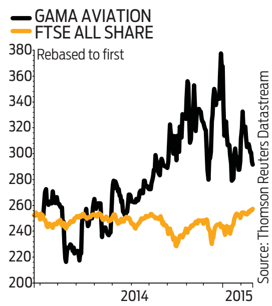
SHARES' TOP AIM/IHT PICKS

CVS (CVSG:AIM) 467.25P



THE SECOND-LARGEST veterinary services business in the UK has 272 vet practices across the country. We'd argue CVS has attractive defensive qualities as pet owners will always shell out the cash for any treatment as pets are generally considered as family members. The pet insurance market continues to expand and consumer confidence is also growing – adding up to an attractive backdrop for the small cap business as spending increases on pet healthcare. CVS has bought 20 new vet practices annually since 2007 and intends to keep consolidating the industry. It is expanding in the large animal market, so expect horses and farm animals to play a bigger role for revenue generation – handy as they account for nearly half the £2.9 billion UK vet services markets, says Berenberg. The bank forecasts £17 million pre-tax profit for 2015, rising to £19 million in 2016. The dividend isn't overly generous on a prospective 0.6% yield, but 7.7% compound annual growth rate in EBITDA forecast for the next three years is attractive.

GAMA AVIATION (GMAA:AIM) 300.67P



NEWLY MERGED WITH Hangar8, the aviation business operates private aircraft in the UK, Europe, the US, Far East and Middle East. It is one of Graham Neale at Killik's top stocks in his AIM/IHT portfolio. He's been an investor for some time and topped up when Hangar8 raised new money to 'extinguish' net debt and provide working capital for its tie-up with Gama. 'The company is consolidating an immature market.' Neale says he was impressed with Hangar8's management and liked the fact that Hangar8 didn't own any planes, so there's no asset depreciation issues to battle. 'Gama does have some planes on its balance sheet because of the merger – but it is getting rid of them,' he reveals. 'So you now have a cost cutting story and a good old fashioned revenue growth story.' Neale reckons a lot of investors will sit on the sidelines until the enlarged Gama business has shown it can continue the success enjoyed just as Hangar8 – delivering the goods could result in a new upwards rally in the share price. Cantor Fitzgerald notes Gama's aircraft management contract with US members' group Wheels Up (which provides affordable flying) 'has very good growth prospects'. Analyst Robin Byde adds: 'This is due to strong growth in new members and a rapid expansion of its King Air 350i turboprop fleet. Wheels Up is also looking at expanding in Europe.'

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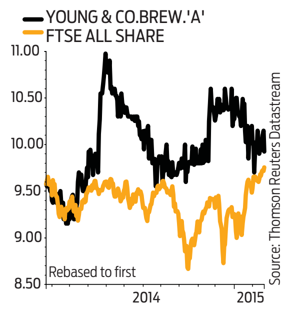
YOUNG'S & CO (YNGA:AIM) £10.04



IF YOU'RE GOING to hold shares for at least two years to qualify for the inheritance tax savings, you really need to pick solid, sustainable businesses. Young's certainly fits the bill with a long track record of growing earnings. The key to its success is down to several points. Firstly, location – a bias towards the vibrant South East area including prime spots in London where there's not one but three customer types: locals, commuters and tourists. Second, its pub estate is well-invested. That sounds like 'corporate speak' but it is very important. If you want people to be repeat visitors to pubs, they have to like the look and feel of the place. Young's pubs are generally very smart and offer a good range of high-quality food and drink. It is unashamedly premium-priced and that helps differentiate the company from most other listed pub stocks.

In the financial year to March 2015, net debt is forecast to be £107 million. That compares with £546 million net fixed assets, being property and equipment. Such balance sheet strength provides flexibility to keep making acquisitions. Panmure Gordon forecasts an 8.5% rise in pre-tax profit in the current financial year to £28 million, nudging up to £29.8 million in 2016.

RWS (RWS) 166.34P

THE DEBT-FREE PATENT translation specialist has an enviable track record when it comes to earnings per share, revenue, profit and dividend growth. It is the world's largest translator of patents. In a technology-driven market, there's an increasing need for companies to protect their intellectual property (IP) on a global basis, hence why we believe its earnings trajectory remains firmly upwards. Don't obsess over recent unfavourable foreign exchange rates which are affecting so many companies including RWS as this should only be a temporary issue. The other fear has been the unitary patent in the European Union whose timescale for adoption is being brought forward a year to 2015, running in parallel with the existing system. RWS believes large corporates will shun the new system until it has proven capable of protecting valuable IP. RWS also owns market comparison site Inovia which helps a corporate to find patent attorney firms in foreign countries where IP protection is required. RWS has a monopoly on any translation work on deals sourced through the system. A 5:1 share split was done in February to improve RWS's share liquidity. The shares aren't cheap on a prospective PE ratio of 20.8 for the financial year to September 2015 – but you're paying a premium for a top quality business. Numis forecasts £22.3 million pre-tax profit this year, rising to £23.4 million in 2016. You get a 3% dividend yield as a sweetener.