Financing growth in innovative firms: allowing Entrepreneurs’ Relief on gains before dilution

March 2018
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**Subject of this consultation:** the changes announced at Autumn Budget 2017 to the conditions which must be met (‘qualifying conditions’) for Entrepreneurs’ Relief to be available on a disposal of shares in or securities of a company.

**Scope of this consultation:** the government will introduce legislation in Finance Bill 2018-19 to allow individuals who no longer hold a 5% interest in a company to claim Entrepreneurs’ Relief, where the reduction in their percentage shareholding is due to that company issuing shares to raise capital for the purposes of its trade. The new rules will apply to gains latent in shares and securities held at the time of fundraising events which take place on or after 6 April 2019. This consultation focuses on the mechanism which will achieve this extension of the relief.

**Who should read this:** the government welcomes comments from individuals, companies, advisors, representative bodies, and others who would be affected by the changes.

**Duration:** the consultation runs from 13 March 2018 to 15 May 2018.

**Lead official:** Beth Andrews – Business and International Tax Group, HMT; Rob Clay – Business, Assets and International Directorate, HMRC

**How to respond to or enquire about this consultation:** responses, requests for hard copies, and general queries about the content or scope of the consultation can be sent by email to PCR.ER.Consultation@HMTreasury.gsi.gov.uk, or by post to:

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E-mails will receive a confirmation of receipt. If you do not receive this, please contact HMT directly at Bethany.Andrews@HMTreasury.gsi.gov.uk

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury.

HM Treasury will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.
Additional ways to be involved: the government welcomes written responses and will consider meetings with external bodies during the consultation period. Please contact the lead officials if you are interested in meeting to discuss this paper.

After the consultation: the government will publish its response and draft legislation in summer 2018.

Getting to this stage: this is a new consultation, announced by the Chancellor at Autumn Budget 2017.

Previous engagement: this consultation was announced as part of the government’s response to the Patient Capital Review, in response to concerns raised by business groups.
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Executive summary

The government is determined to make the UK the best place for individuals to set up and grow a business. That is why in August 2017 the government launched its ‘Financing growth in innovative firms’ consultation\(^1\) to review the current environment for business growth in the UK, and with the help of individuals, business groups, and investors, identify what it can do to support the firms of the future. The current consultation seeks views on a change to the qualifying conditions of Entrepreneurs’ Relief (ER) that the government announced in response to the findings of this review.

ER was introduced to incentivise and reward entrepreneurs who, with significant initiative and risk, play a key role in building and growing a business. ER provides a 10% Capital Gains Tax (CGT) rate for gains on qualifying business assets, compared with the main higher rate of 20% (or 28% on residential property). This means that entrepreneurs can keep more of the rewards when their business is successful.

In some cases, an individual (such as a founder) may lose eligibility for ER when their company’s fundraising efforts result in their own shareholding becoming reduced (or ‘diluted’) below 5%. It was suggested in some responses to the review that this may act as a barrier to growth for some firms. For instance, in cases where an individual does not want or is not able to make further investment, they may choose to instead leave the company, or decline to seek funding which could help the business grow. Such an outcome conflicts with the intended purpose of ER, and the government therefore believes it is right to act now to remove this barrier in a fair and proportionate way.

This document outlines the new process by which individuals may remain entitled to ER on gains on shares in or securities of a company that relate to the time before the individual’s shareholding became diluted. The government proposes this is achieved through:

- a new facility that allows individuals to elect to be treated as having disposed of and reacquired their shares at the then-market value, and
- allowing individuals to defer the taxation of this gain until an actual disposal of the shares

\(^1\) https://www.gov.uk/government/consultations/financing-growth-in-innovative-firms (This consultation has now closed.)
Chapter 1

Introduction

1.1 Entrepreneurs’ Relief (ER) was introduced in 2008 and provides a 10% rate of Capital Gains Tax (CGT) for gains on qualifying disposals of business assets. This compares to the main rates of CGT, which are currently 10% or 20% depending on the taxpayer’s annual income, with gains made on residential property and in respect of carried interest received charged at 18% or 28%. The objective of ER is to promote enterprise by offering a reduced rate of tax to individuals who, with significant initiative and risk, have contributed to the creation and growth of a business.

1.2 Gains made on disposals of a business or part of a business, or of shares in or securities issued by a company (referred to in this consultation collectively as ‘Shares’) may be eligible for ER. The qualifying conditions for the relief depend on the type of asset involved. The conditions relevant for gains made on Shares are that:

- the claimant has held at least 5% of the company’s ordinary share capital
- the claimant has been able to exercise at least 5% of the voting rights in the company
- the claimant has been an employee of or office-holder in the company, or in one or more companies which are members of the trading group
- the company is a trading company, or the holding company of a trading group

1.3 These qualifying conditions must be met for the 12 months up until the point the Shares are disposed of.

1.4 Responses to the government’s ‘Financing growth in innovative firms’ consultation expressed concerns with the current 5% minimum shareholding requirement (highlighted above). Some considered that the requirement was causing individuals to exit their company early to retain the relief, as opposed to continuing to support and grow the business after fundraising. Respondents suggested solutions such as reducing the minimum percentage required, or removing the condition entirely.

1.5 At Autumn Budget 2017, the government announced that changes would be made to ER to ensure that entrepreneurs are not discouraged from seeking external investment to finance business growth in circumstances where their own shareholding becomes diluted.

1.6 This consultation sets out the government’s proposed changes in more detail, and invites views on how they will work in practice.
1.7 In developing this proposal, consideration has been given to the cost to the Exchequer of offering ER (forecast to be £2.7 billion in 2017-18\(^1\)), and quantitative research published by HMRC into customers’ awareness and experience of CGT and ER.\(^2\) The government recognises the importance of ER to its claimants, and wants to improve its targeting and the value for money it provides for the taxpayer.

1.8 Chapter 2 sets out the issue of dilution in more detail, chapter 3 outlines the main features of the new mechanism, and chapter 4 considers additional features that the government has considered as part of this proposal.


Chapter 2

Further explanation of current issue

2.1 The current issue emerges from one of the main options a company has for raising funds to finance its growth: issuing shares to new or existing shareholders. If an existing shareholder does not purchase any (or enough) new shares, then when a round of fundraising has been completed their stake in the company will have become reduced (or ‘diluted’). It follows that an individual who held over 5% of the company’s shares before a round of fundraising may fall below this threshold afterwards, even though they have not disposed of any shares.

2.2 As a result of this dilution, the shareholder would no longer be eligible for ER when they come to dispose of their Shares, unless they subsequently acquire more shares and retain the increased holding for a further 12 months.

2.3 This loss of entitlement to relief could be seen as a perverse consequence of the growth and success of the company. It has been argued that in some cases the risk of losing ER acts as a disincentive for seeking the appropriate finance that would allow the company to grow.

2.4 A shareholder in this position will therefore be required to pay the full rates of CGT on all gains which accrue when they come to dispose of their Shares. The government believes that a proportionate approach to this problem is to allow the individual to preserve their entitlement to relief on the increase in value of their investment up to the time when their eligibility is lost because of dilution.

2.5 As mentioned above, consideration has been given both to the cost of ER to the Exchequer, and to research recently published by HMRC on the effectiveness of the relief. Therefore, to ensure that this change remains targeted, but does not disproportionately increase the cost of the relief, ER will not be extended to any gains that follow the loss of eligibility.
Chapter 3
The government's proposal

Overview

3.1 The government proposes to address this issue by allowing individuals to elect to crystallise gains on their Shares immediately before their holding is diluted. The effect of making the election will be that the individual is treated as selling and immediately reacquiring their Shares at the then-market value. The individual can choose to defer the accrual of the gain on this elective disposal, so that ER may then apply to the deferred gain when the claimant comes to dispose of their Shares.

3.2 To make this new election, the individual must have satisfied the conditions for claiming ER at the time they were treated as having disposed of and reacquired their Shares.

3.3 To ensure this extension of the relief remains targeted, the dilution of the individual’s shareholding must be a consequence of an issue of shares made by the company for genuine commercial reasons.

Making an election to crystallise gains

3.4 The individual must make the election in their tax return for the year in which their shareholding is diluted. The normal self-assessment time limit for elections will apply to ensure that the taxpayer achieves certainty of tax treatment at an early stage, when important information (such as valuations) is more easily available. These time limits will also target the election at individuals who were considering their eligibility for ER at the time that the company was seeking to raise funds to finance its growth. The worked example below demonstrates the basic principles of this election in practice:

Worked example

3.5 Individual A subscribes £20,000 for 20,000 £1 ordinary shares in a new trading company of which she is a director. She thereby acquires 10% of the company’s ordinary share capital and 10% of the voting rights.

3.6 18 months later (in September 2023) the company raises working capital by issuing 1.8 million new £1 ordinary shares. Immediately before the new shares were issued, A’s shares were worth £3.50 each. She does not

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1 For clarity, the examples in this consultation document ignore the availability of the Annual Exempt Amount (AEA) and the possibility of other reliefs being due.
subscribe for new shares. Her holding is now 1% of the ordinary share capital and 1% of the voting rights.

3.7 If A had sold her shares immediately before the new shares were issued, she would have been able to claim ER on their gain of £50,000. Under the proposals, she will be able to elect in her 2023-24 tax return to be treated as having made that disposal and immediately reacquired the same shares at the same price. The return will reflect the gain (along with other relevant gains, losses, reliefs, income etc.) and A may claim ER.

3.8 Going forward, the acquisition cost of A’s shares is equal to their value at the deemed reacquisition. This is the cost which will be used in computing any subsequent gain or loss.

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**Question 1**

Will this elective disposal and reacquisition approach help to remove the potential barrier to growth of losing entitlement to ER?

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### Making a claim to defer the gain

3.9 The government appreciates that not all taxpayers will be able, or wish, to immediately pay the ‘dry’ tax charge arising from this election, as they may not have sufficient available funds with which to pay it. Therefore, the government is minded to allow the individual to make a claim to defer the accrual of the gain on the deemed disposal until the occasion of an actual disposal of Shares.\(^2\) This would mean that the gain would not be taxed until Shares were disposed of.

3.10 Where this claim is made, entitlement to ER on the deferred gain will be preserved so that ER can be claimed under the then-current rules at the time the gain is treated as accruing. Where the individual has chosen to pay the dry tax charge at the time of the first election, subsequent losses will not be able to be set against the gain on the deemed disposal of the Shares, and so will not give rise to an effective repayment of tax.\(^3\)

### Worked example

3.11 Individual A does not wish to pay tax on her gain in tax year 2023-24. She may claim for accrual of the gain to be deferred. The claim must be made in her 2023-24 tax return or by other permitted means up to 5 April 2028.

3.12 In June 2030 A resigns from the company and sells all her shares. By this time the shares are worth £11.00 each. A’s deferred gain of £50,000 is treated as accruing, and she may claim ER on that gain which will be treated as eligible for relief under the terms then applicable.

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\(^2\) There are several examples of deferral mechanisms on the Taxation of Chargeable Gains Act 1992, with possibly the most relevant being Part 5, Chapter 4 (ER where held-over gains become chargeable) which applies when ER interacts with the enterprise investment scheme deferral relief.

\(^3\) Except under the existing rules e.g. from the year of death.
3.13 A will also have another gain, accruing on the actual disposal. This will be
20,000*(£11.00 - £3.50) = £150,000. Assuming the present eligibility conditions continue to apply, ER will not be available on this gain because the company was not her personal company at the required times.

3.14 If, when she sells her shares in June 2030, A’s shares were instead worth only £3 each, a loss of £10,000 would accrue (20,000*(£3.00-£3.50): her shares are treated as having been acquired for £3.50 each under the deemed disposal and reacquisition). Subject to a claim, this loss would be available to set against her deferred gain of £50,000 which is also treated as accruing, or against other gains which accrue in the same tax year if that would be a more effective use of the loss.

**Question 2**
How frequently do you think these new facilities would be used?

**Question 3**
Do you envisage taxpayers electing for deemed disposal and reacquisition but not claiming deferral of their gain?

**Question 4**
Are there circumstances in which electing to be treated as having disposed of Shares, or allowing an individual to defer the gain would not remove the obstacle to refinancing?
Chapter 4
Further considerations

Interaction with trusts

4.1 In some circumstances, trustees of settlements may claim ER jointly with one or more qualifying beneficiaries of their settlements. Claims by trustees represent only a small percentage by number and value of the total claims to ER. The government does not propose extending this new elective disposal and reacquisition facility to trustees.

4.2 Principally, this is due to the complexity which would likely result from including them in this change. For instance, under the proposal outlined above, the trustees’ eligibility would be a function of the existence of one or more qualifying beneficiaries at the time of the dilution (amongst other factors). However, there may be more, fewer, or different qualifying beneficiaries at the time a deferred gain is treated as accruing and the claim to ER made. Allowing trustees to elect for deemed disposal and reacquisition (but not for deferral) is unlikely to be attractive, and may lead to a complex situation where only part of the crystallised gain is eligible for ER.

Question 5
Are trustees a significant constituency amongst investors who lose entitlement to ER on dilution?

Accrual of the deferred gain

4.3 Existing deferral mechanisms in the Taxation of Chargeable Gains Act 1992 operate by treating the deferred gain as accruing either on the occurrence of a specified event or after a specified period of time.

4.4 Where a gain has been deferred under this proposal, either the whole or a proportionate part of the gain will be treated as accruing when any of the rebased Shares (or assets which have come to represent the rebased Shares1) are disposed of.

Worked example (continued)

4.5 Before selling any shares, Individual A had a deferred gain of £50,000. If A had instead sold only 5,000 of their 20,000 shares then 5/20 of the deferred gain...
gain (£12,500) would be treated as accruing at the time of the disposal, along with a second gain of 5,000*(£7.50) = £37,500.

4.6 If the Shares which are subject to the deemed disposal and reacquisition are ‘pooled’ then a complication may arise if further shares enter the pool after dilution and before a disposal. This raises the question of whether accrual of a deferred gain should be linked to any disposal of shares from the pool, or to a subset of pooled shares or securities which represents the Shares held at the time of dilution. The government is minded to link accrual of the deferred gain to the first disposal (or disposals) of shares or securities equivalent in number to those held at the time of dilution.

Worked example (continued)

4.7 In an alternative scenario, Individual A acquires a further 5,000 £1 ordinary shares in 2027, bringing their total holding to 25,000 shares which are ‘pooled’ for CGT purposes. They sell 10,000 shares in 2029. The amount of deferred gain which is treated as accruing on this sale would be £25,000 (= £50,000*(10,000/20,000)) and not £20,000 (= £50,000*(10,000/25,000)).

Question 6
Do you foresee challenges around keeping track of deferred gains so as to ensure they are correctly notified to HMRC when they are treated as accruing?

Question 7
Do you agree that accrual of the deferred gain should be linked to a disposal of shares or securities equal in number to those in respect of which the gain was computed?

Interactions with associated disposals

4.8 ER may also be available on gains which accrue when a privately-owned asset is disposed of by an individual who has also made a material disposal of business assets such as shares. The asset disposed of in such an ‘associated disposal’ must have been used by the claimant’s partnership or company for the purposes of its trade. The government does not propose that the new elective disposal and reacquisition facility should apply to these privately-owned assets.

Question 8
Do companies which raise capital by means of issuing new shares commonly use assets owned privately by their shareholders? Will the effect of these proposals be significantly reduced by excluding private assets from their scope?
Determining the time of dilution

4.9 A critical factor will be the time at which the elective deemed disposal and reacquisition are treated as taking place. The government's proposal is that this time should be immediately before the issue of new shares by the company which results in one or both of the 5% shareholding and voting rights conditions ceasing to be met. Where a scheme or arrangement involves more than one issue of shares, the time will be immediately before the first issue which forms part of the scheme.

Question 9
Do you agree that this should be the time of the deemed disposal and reacquisition?

Conditions to prevent abuse

4.10 It will be a condition for election that the issue of shares by the company be part of a commercial scheme or arrangement which has as its main purpose, or one of its main purposes, the obtaining of capital as new consideration subscribed for the issue of new shares.

Question 10
Will this ‘commercial capital-raising’ condition allow elections in all legitimate circumstances? What other conditions might be necessary to prevent abuse?

Other considerations

4.11 The government does not propose new rules for partners disposing of their business, or for individuals who own shares acquired under the tax-advantaged employee share scheme Enterprise Management Incentive. It is not necessary to do so, as in neither case is there a minimum holding or investment condition corresponding to the 5% shareholding and voting rights conditions which apply to disposals of other shares and securities.

4.12 The government does not propose any wider provisions that would allow taxpayers to elect to be treated as making a disposal and reacquisition of assets in other circumstances.
Chapter 5
Assessment of impacts

Summary of impacts

<table>
<thead>
<tr>
<th>Economic impact</th>
<th>This measure is not expected to have a significant macro-economic impact.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impact on individuals, households and families</td>
<td>This measure is expected to have a positive impact on some individuals and households who own shares, as they will be charged a lower rate of tax on their capital gains than previously. One-off costs include familiarisation with new rules, and making an election and deferral claim at the time their shareholding is diluted. Ongoing costs include recording deferred gains, and maintaining records to ensure those gains are notified to HMRC when they are treated as accruing. The measure is not expected to impact on family formation, stability or breakdown. We will use the consultation to fully identify affected individuals and households, and the impacts on them.</td>
</tr>
<tr>
<td>Equalities impacts</td>
<td>It is not anticipated that there will be impacts on groups with protected characteristics.</td>
</tr>
<tr>
<td>Impact on businesses and Civil Society Organisations</td>
<td>This measure is expected to have a positive impact on a small number of (mostly small and medium-sized) companies raising money by issuing new shares. One-off costs include familiarisation with new rules when a company considers issuing new shares (the individual shareholder will make the election). It is not expected there will be any on-going costs (on the basis that it is the shareholder who will need to report accrual of the gain and claim relief). We will use this consultation to identify the number of companies affected and the impacts on them.</td>
</tr>
<tr>
<td>Impact on HMRC or other public sector delivery organisations</td>
<td>There will be no significant operational impact on HMRC.</td>
</tr>
</tbody>
</table>
**Other impacts**

Justice impact test: there is the potential for an impact on the Justice system in terms of a small increase in the number of appeals heard by the Tax Tribunal. A separate Justice Impact Assessment is being completed.

Other impacts have been considered and none have been identified.

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**Question 11**

Do you have any comments on the assessments of equality and other impacts in the summary of impacts table?
Chapter 6

Summary of consultation questions

1. Will this elective disposal and reacquisition approach help to remove the potential barrier to growth of losing entitlement to ER?

2. How frequently do you think these new facilities would be used?

3. Do you envisage taxpayers electing for deemed disposal and reacquisition but not claiming deferral of their gain?

4. Are there circumstances in which electing to be treated as having disposed of Shares, or allowing an individual to defer the gain would not remove the obstacle to refinancing?

5. Are trustees a significant constituency amongst investors who lose entitlement to ER on dilution?

6. Do you foresee challenges around keeping track of deferred gains so as to ensure they are correctly notified to HMRC when they are treated as accruing?

7. Do you agree that accrual of the deferred gain should be linked to a disposal of shares or securities equal in number to those in respect of which the crystallised gain was computed?

8. Do companies which raise capital by means of issuing new shares commonly use assets owned privately by their shareholders? Will the effect of these proposals be significantly reduced by excluding private assets from their scope?

9. Do you agree that this should be the time of the deemed disposal and reacquisition?

10. Will this ‘commercial capital-raising’ condition allow elections in all legitimate circumstances? What other conditions might be necessary in order to prevent abuse?

11. Do you have any comments on the assessments of equality and other impacts in the summary of impacts table?
HM Treasury contacts

This document can be downloaded from www.gov.uk

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