



HM Treasury



HM Revenue  
& Customs

# Allowing Entrepreneurs' Relief on gains made before dilution: consultation response

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July 2018





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# Chapter 1

## Introduction

- 1.1 The Chancellor announced at Autumn Budget 2017 the government's action plan to unlock over £20 billion worth of capital to support the growth of innovative firms as part of their response to the 'Patient Capital Review'. As part of this, and in response to representations from stakeholders, changes were announced to address a potential barrier to growth for firms caused by Entrepreneurs' Relief (ER).
- 1.2 Several responses to the government's consultation 'Financing growth in innovative firms'<sup>1</sup> argued that the minimum 5% shareholding requirement acts as a barrier to growth for firms where a company's financing efforts risk diluting a founder's personal shareholding below this threshold.
- 1.3 The government's proposed solution is to allow individuals to elect to be treated as having disposed of and reacquired their shares immediately prior to the dilution event, and to claim ER on the gain up until this point. The proposal also includes a second election that defers the gain, along with the opportunity to claim ER in its then-current form at the time of an actual disposal.
- 1.4 In developing this proposal, consideration was given to the current cost to the Exchequer of offering ER (forecast to be £2.7 billion in 2017-18<sup>2</sup>), and quantitative research published by HMRC into customers' awareness and experience of Capital Gains Tax (CGT) and ER<sup>3</sup>. 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.
- 1.5 To ensure that these changes address the identified barrier to growth, the government published a consultation on the details of its proposal on 13 March 2018<sup>4</sup>. The consultation closed on 15 May 2018.
- 1.6 A total of 21 written responses were received from representative bodies, professional service firms, and other interested individuals.
- 1.7 The majority of respondents were in favour of the government's plans to enable some entrepreneurs who have been diluted below 5% shareholding in their company to be able to retain entitlement to ER on a portion of their

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1 [www.gov.uk/government/consultations/financing-growth-in-innovative-firms](http://www.gov.uk/government/consultations/financing-growth-in-innovative-firms) (This consultation has now closed.)

2 [www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs](http://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs)

3 [www.gov.uk/government/publications/capital-gains-tax-entrepreneurs-relief-behaviours-and-motivations](http://www.gov.uk/government/publications/capital-gains-tax-entrepreneurs-relief-behaviours-and-motivations)

4 [www.gov.uk/government/consultations/allowing-entrepreneurs-relief-on-gains-made-before-dilution](http://www.gov.uk/government/consultations/allowing-entrepreneurs-relief-on-gains-made-before-dilution) (This consultation has now closed.)

gains. However, several noted that they were not aware of cases where a shareholder's personal tax circumstance has had a significant impact on the company's financing decisions. Of those who thought that possible loss of ER on dilution did impact on company decisions, some considered that the proposals did not go far enough, and that further flexibility would be needed to make sure entrepreneurs benefitted from the relief.

- 1.8 Chapter 2 sets out a summary of stakeholder responses, chapters 3 and 4 set out general comments in response to feedback from stakeholders and next steps, and Annex A lists the respondents to the consultation.

## Background

- 1.9 ER was introduced in 2008 and provides a 10% rate of 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 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.
- 1.10 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.
- 1.11 The government recognises that 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. The government is open-minded as to whether this risk does make an impact on business decisions in significant numbers of companies. On balance, the government has proposed that a proportionate approach to this concern would be to allow the affected 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.

# Chapter 2

## Summary of responses

### Q1 Will this elective disposal and reacquisition approach help to remove the potential barrier to growth of losing entitlement to ER?

- 2.1 Some respondents considered that the risk of a founding shareholder losing ER is unlikely to prevent a company from raising additional finance for its growth, though the loss of ER may be of considerable concern to the shareholder.
- 2.2 A quarter of responses believed that the proposal outlined in the consultation would successfully remove a possible barrier to growth.
- 2.3 Around half of respondents considered that it would go some way to removing a possible barrier, but argued that the effectiveness of the proposals may be reduced by various factors including cost and complexities relating to valuations at the time of dilution.
- 2.4 Other respondents believed that the proposed change would make no difference to how quickly a company grows.
- 2.5 Many respondents proposed alternative approaches, although these suggestions broadly fell outside the scope of the consultation to the extent that many represented a significant divergence from the proposed scheme. Further comments are provided in chapter 3.

### Government response

- 2.6 In view of this response, the government does not consider there to be a strong case that ER consistently acts as a barrier to growth for firms. However, it acknowledges the perceived unfairness, and that the relief enables additional funds to be retained by the claimant for the purposes of reinvestment.

### Q2 How frequently do you think these new facilities would be used?

- 2.7 Responses suggested that these facilities would be used fairly frequently where they are applicable, but that the overall number may be low.

### Q3 Do you envisage taxpayers electing for deemed disposal and reacquisition but not claiming deferral of their gain?

- 2.8 Feedback from respondents indicated that individuals would elect to defer their gain in most cases, unless for example they have allowable losses to offset against the gain.
- 2.9 Around a quarter of responses suggested that it would be more appropriate to have the option to defer the gain until an actual disposal of shares as the default, with individuals instead having to make a second election to pay the dry tax charge should they wish.

#### Government response

- 2.10 The government also anticipates that many claimants will choose to defer the gain, but considers that it is appropriate that the taxpayer should make a positive decision whether or not to defer any accrued gain at the time their shareholding is diluted below 5%. This ensures that the decision is recorded and should therefore assist with administration of the deferred gain. The government does not expect that this will have a material impact on the effectiveness of the changes.

### Q4 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?

- 2.11 Several responses argued that there would be circumstances in which the ability for the founder to 'bank' tax advantages on accrued capital gains would not remove a perceived obstacle to the company seeking refinancing.
- 2.12 Around half of respondents considered that the personal cost of obtaining a valuation of their shareholding may outweigh any benefit of securing the tax relief on the gain for the individual.
- 2.13 Eight respondents presented the case that minority shareholding discounts may have an adverse effect on the valuation of any accrued gain at the time of election. Respondents explained that where the individual's shareholding represents a relatively small influence in the company compared with other shareholders, the market value of their personal shareholding will be worth less than the equivalent percentage of the company's total market value. These discounts were argued to have a negative impact on the effectiveness of the changes, in cases where a discounted valuation of the individual's shareholding significantly lowers the tax benefit of making an election.
- 2.14 Eight responses referred to the proposals creating additional burdens on the taxpayer through added complexity, and suggested that the rules would benefit from simplification.

#### Government response

- 2.15 The government is grateful for these views about the costs of seeking a valuation, and has decided to take a balanced approach in its response by allowing entrepreneurs to use a non-discounted valuation of their shareholding based on the company's pro-rated value. This would mitigate

the effect of the market placing a discount on a minority shareholding, which could reduce the accrued gain at the time of election. As a result of this approach, the individual could 'bank' an advantaged tax position on a potentially higher amount of gain to justify the cost of obtaining a valuation.

#### **Q5 Are trustees a significant constituency amongst investors who lose entitlement to ER on dilution?**

- 2.16 There were no respondents who felt that trustees were a significant constituency amongst investors who lose entitlement to ER on dilution. Around three quarters of respondents either saw no issue with the exclusion of trustees from the proposals, or did not make any specific comments.
- 2.17 Five respondents believed that trustees should be included in these proposals. They noted the complexity that doing so would bring, but argued that drawing distinctions between different types of taxpayers was not appropriate and may also be complex.

#### **Government response**

- 2.18 The government acknowledges the views received. As the majority of respondents agreed with the proposed approach, and no major issues have been highlighted, the government has decided to make no changes to its current proposals in relation to trustees.

#### **Q6 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?**

- 2.19 Five respondents did not think that it would be unreasonably challenging for taxpayers to record and keep track of deferred gains.
- 2.20 Other responses raised concerns about tracking deferred gains through company share re-organisations, the possibility of taxpayers forgetting about deferred gains, and changes in advisory services.
- 2.21 Some responses suggested a record be kept on the individual's personal tax account, or other mechanisms to automatically record the election.

#### **Government response**

- 2.22 The government believes it is reasonable to expect taxpayers to keep records of any elections that they make such as these, and does not propose making any changes to the proposals in light of these views.

#### **Q7 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?**

- 2.23 The majority of respondents agreed that this proposal followed from the overarching approach.

- 2.24 Some raised concerns about the impact of share re-organisations on the overall number of shares that the individual holds. For example, share ‘splits’ resulting in an individual effectively owning a higher number of shares that are together worth the same value of the original shares. Some respondents raised concerns that a part disposal of this restructured shareholding may effectively create the unintended ‘dry tax charge’ the deferral mechanism was introduced to avoid.

#### Government response

- 2.25 The government has concluded that the approach, as set out in the draft legislation published alongside this document, addresses these concerns without needing any major changes. However, if stakeholders continue to hold concerns once they have had a chance to review the draft legislation, we will take these into account as appropriate.

#### Q8 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?

- 2.26 Most responses did not indicate that the effectiveness of the proposals would be reduced by excluding privately owned assets from their scope.
- 2.27 One response expressed concerns that the exclusion may disadvantage smaller companies, who may be more likely to use privately-owned assets.

#### Government response

- 2.28 The government is content with this aspect of the proposal and does not propose any changes.

#### Q9 Do you agree that this should be the time of the deemed disposal and reacquisition?

- 2.29 The majority of responses agreed that the time of the deemed disposal and reacquisition should take place just before the fundraising event, or series of fundraising events, that results in the claimant’s shareholding being diluted below 5%.
- 2.30 Some responses disagreed, and suggested that this did not allow enough time to make the election, or that the deemed disposal should take place after the commercial fundraising.

#### Government response

- 2.31 The government considers that the time periods outlined in the consultation document allow sufficient time for an individual to make an assessment of their position.

**Q10 Will this 'commercial capital-raising' condition allow elections in all legitimate circumstances? What other conditions might be necessary in order to prevent abuse?**

- 2.32 Many respondents agreed with the phrasing of the commercial capital-raising condition.
- 2.33 However, those that disagreed frequently argued that the proposals should be extended to other circumstances in which individuals may see their shareholding diluted below 5%. Examples given were the exercising of employee share options, and conversions of debt to equity.
- 2.34 Two respondents sought to extend the proposals to other instances where individuals may lose entitlement to the relief, such as where they cease to be an employee or office-holder.
- 2.35 One respondent felt that abuse could be targeted through simplification.

**Government response**

- 2.36 The policy objective of this proposal is to ensure that ER does not act as a barrier to growth for firms seeking additional external investment. On this basis, the government is minded not to extend the scope of the proposal to other dilution events that do not follow from commercial capital-raising events, or to other instances where an individual ceases to be eligible for ER.
- 2.37 The other comments have been considered, and the government is satisfied that the draft legislation being published alongside this document broadly addresses the technical concerns raised.

**Q11 Do you have any comments on the assessments of equality and other impacts in the summary of impacts table?**

- 2.38 Most respondents made no comments in response to this question.
- 2.39 Two respondents suggested that the cost of valuations could be included, and one response suggested that additional complexity may disadvantage those who do not receive tax advice.

**Government response**

- 2.40 These suggestions have been considered and incorporated into the assessment of impacts table where appropriate.

# Chapter 3

## General comments

### Alternative methods proposed

- 3.1 Many respondents proposed alternative methods to achieve the desired outcome, such as a time-apportionment of the gain or guaranteed eligibility once the conditions for relief have been met for a certain period.
- 3.2 In reviewing these suggested approaches, the government gave consideration to the cost to the Exchequer of ER, and recent research published by HMRC on the effectiveness of the relief, as it did during the development of the proposal outlined in the consultation. The government also gave consideration to whether different methods would be sufficiently targeted at addressing the possible barrier to growth.
- 3.3 The government considered the suggestion to time-apportion any gains between the period of time when the entrepreneur would have been eligible for ER, compared to the period after dilution below 5%. The government acknowledges that this could present a simplification - for example by not requiring individuals to obtain a valuation of their shareholding at the time of election – however, this approach would place substantial additional risk onto the Exchequer. The government notes that the impact on the cost of the ER would be dependent on the value of capital gains made after the entrepreneur is no longer eligible for ER due to the dilution of their shareholding.
- 3.4 Furthermore, the time-apportionment approach suggested by respondents excluded the requirement for an election to be made at the point of dilution, and therefore does not take in account whether the knowledge of ER at this point played a role in the company’s decision to seek additional financing.
- 3.5 As such, the government has decided not to adopt the proposed alternative methods, but is grateful to stakeholders for the time taken in their responses to the consultation to reflect on the nature of the relief and make recommendations.

### Treatment of deferred gains

- 3.6 Some responses also sought clarification on the treatment of the deferred gain. The proposal states that 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 individual disposes of their shares. This should be taken to mean that the rate applicable will be the then-prevailing ER rate, which may be higher or lower than the current rate. This reduces complexity, as reference will not

have to be made to the nature of ER at the time of election, and keeps the proposal in line with disposals made by individuals who have not made an election at any given time.

## Simplification

- 3.7 Many of the respondents advocated simplification of the tax system to ensure that ER is easy to use and understand. The government recognises that complexity can create additional uncertainty and compliance burdens for taxpayers, and will take these recommendations into account in any future policy developments.
- 3.8 The government continues to monitor its tax relief system, and all comments will be considered as part of the ongoing policy development process.

# Chapter 4

## Next steps

- 4.1 In summary, the government has decided to retain the main features of the proposal set out in its consultation, but make an adjustment to the valuation method that can be used by claimants.
- 4.2 Specifically, the government agrees that for the purposes of the election a valuation of the claimant's shareholding without applying minority shareholding discounts, and instead based on a proportion of the value of the whole company, will be acceptable.
- 4.3 Draft legislation has been published alongside this consultation response, to be included in the Finance Bill 2018-19. Stakeholders are invited to comment on this draft legislation as part of the new fiscal cycle.
- 4.4 If you do have any comments, these may be sent to the consultation inbox: [PCR.ER.consultation@HMTreasury.gov.uk](mailto:PCR.ER.consultation@HMTreasury.gov.uk).

# Annex A

## List of respondents

Association of Accounting Technicians (AAT)  
Association of Taxation Technicians (ATT)  
BioIndustry Association (BIA)  
Chartered Institute of Taxation (CIOT)  
Confederation of British Industry (CBI)  
Corporate Management Services Limited  
DAC Beachcroft LLP  
Deloitte LLP  
DWF LLP  
Grant Thornton UK LLP  
Institute of Chartered Accountants England and Wales (ICAEW)  
Institute of Chartered Accountants Scotland (ICAS)  
Kingston Smith LLP  
KPMG  
London Society of Chartered Accountants (LSCA)  
Pinsent Masons LLP  
PwC  
Quoted Companies Alliance (QCA)  
Scottish Lifesciences Association (SLA)  
Slevin Associates

*Names of individual respondents have been omitted from this list*

**HM Treasury contacts**

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