Office of
Tax Simplification

Business Lifecycle Report:

Simplifying the taxation of key events in the life of a business

April 2018

Contents

Foreword

The Office of Tax Simplification (OTS) has reported in the past on many aspects of the tax system as it applies to businesses, recent publications having included the reviews of the corporation tax computation and VAT.

In order to take a more holistic view of the tax charges, reliefs and administrative issues that impact on growing businesses, this paper considers key events in the lifecycle of a business, defined as Start-up and incorporation, Financing for growth, Succession (passing on a business), and Disposal or cessation of a business.

The focus is on businesses owned by individuals and families and on events that affect business owners. Once again, a primary concern is to improve the "user experience" through simplification both of the tax system itself and the way in which it is administered.

The paper considers the extent to which the various reliefs and incentives achieve their objectives and whether they could operate more simply. The interaction of the reliefs is also considered as it is sometimes the system as a whole which gives rise to complexity as much as the impact of a particular relief or feature. The paper also considers administrative aspects as much as the design of the reliefs, as the day to day experience of those who own or manage businesses is key to the effectiveness of the tax system.

This paper is an initial review of the tax issues which impact at various points in the business life cycle. A number of areas have been identified where simplification is clearly possible and desirable and there are other areas where further work would be worthwhile.

We welcome views on the issues raised in this paper and look forward to considering some of the areas touched on in more depth.

Angela Knight CBE

Paul Morton

Executive Summary

Summary Conclusions

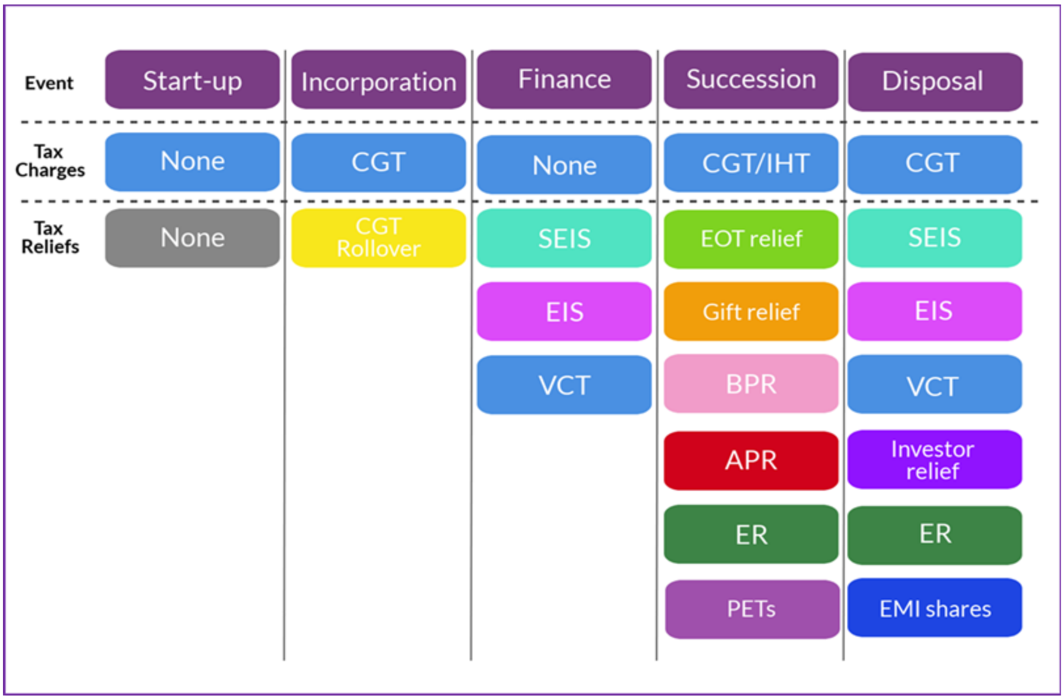
The OTS considers that the complex patchwork of tax charges and reliefs which apply at various points in the business lifecycle needs an overhaul to reduce complexity, make reliefs more accessible and to encourage UK businesses to fulfil their potential.

In this paper the OTS addresses the tax charges and reliefs that occur at particular stages in a business's life, particularly those arising as a result of changes in its ownership, for example through the issue of new shares in return for finance. The paper focuses on businesses owned by individuals and families, rather than businesses that are widely owned via a stock exchange listing or by private equity houses or foreign corporations.

The stages or "key life events" in the business lifecycle are identified and the tax charges and tax reliefs that may apply to each of them are reviewed.

Chart 1 provides an outline illustration of the tax charges and reliefs for each of the key life events. All the acronyms are explained after the chart.

Chart 1: Tax charges and reliefs for each life event



Source: OTS

At start-up, the founders of businesses generally receive no assistance from a tax perspective, but as the business moves through its lifecycle, more reliefs and options become available. Core features of the reliefs are set out in Annex A. In essence:

- CGT (capital gains tax) rollover enables an unincorporated business to be transferred to a company in exchange for shares being issued to the business owners, without any chargeable capital gains arising at that time.
- SEIS (Seed Enterprise Investment Scheme) helps companies raise money when starting to trade. It does this by offering tax reliefs to investors who subscribe for new shares in the company. Companies can receive a maximum of £150,000 through SEIS investments: investors qualify for 50% income tax relief on the initial investment, exemption of 50% of capital gains reinvested into SEIS shares, and full CGT relief on disposals, if relevant conditions are met.
- EIS (Enterprise Investment Scheme) helps companies raise money to grow by offering tax reliefs to investors who subscribe for new shares in the company. Under EIS, companies can raise up to £5m each year, with a maximum of £12m in the company's lifetime (£20 million for knowledge-intensive companies). The company must generally receive the investment within seven years of the first commercial sale. If these and other conditions are met, investors receive 30% income tax relief on the initial investment, deferral of gains reinvested into EIS shares and full capital gains relief on disposals.
- VCTs (Venture Capital Trusts) are managed funds that are listed on the London Stock Exchange and are often part of larger investment groups. Investors subscribe for shares in a VCT, which then in turn invests in qualifying trading companies, providing them with finance to help them develop and grow. Investors receive 30% income tax relief on the initial investment and do not pay tax on dividends or capital gains made by the VCTs or on disposal of the VCT shares, if the qualifying conditions are met.
- An EOT (Employee Ownership Trust) is a trust designed to enable employee ownership of shares in the companies they work for. Shareholders of a trading company qualify for full relief from capital gains tax on disposals of ordinary shares to EOTs, and the employees of the company are exempt from income tax on certain bonus payments made by a company controlled (through more than a 50% shareholding) by an EOT. The EOT is also exempt from inheritance tax (IHT) charges on trusts providing certain conditions are met.
- Gift relief enables a capital gain on a gift of business assets to be held over – so that the tax liability is deferred - until the individual receiving the gift disposes of it. At the time of disposal, tax will be payable on the deferred gains. Gift relief also applies to shares in any unlisted trading company, or shares in a listed trading company in which the individual holds at least 25% of the shares (or 5% by the individual where their family hold more than 50%),
- BPR (Business Property Relief) and APR (Agricultural Property Relief) give up to 100% relief from inheritance tax on business and agricultural assets respectively, whether passed on during the owner's lifetime or on their death.

- ER (Entrepreneurs' Relief) means that owners of businesses pay tax at 10% on all capital gains up to a lifetime limit of £10 million, when they sell qualifying business assets (such as shares in the business).

- IR (Investors' Relief) is a recently-introduced relief, complementary to ER, which provides for a 10% rate of capital gains up to a lifetime limit of £10 million, to apply to an individual's disposal of shares subscribed for in a qualifying trading company (not generally available to employees and company officers).

- PETs (Potentially exempt transfers) are gifts that are not generally counted towards the value of an estate for inheritance tax purposes if they are given more than seven years before death: a sliding scale of relief applies to the IHT on gifts given less than seven years before death.

- EMIs (Enterprise Management Incentives): companies with assets of £30m or less may be able to offer EMIs, which apply to grants of options over shares with a market value up to £250,000 per employee. Employees do not pay income tax or National Insurance Contributions if they exercise the option to buy the shares for at least that market value. Capital gains tax on a subsequent sale of the shares by the employee is relieved under ER, so the rate of tax is 10%.[1]

The OTS has identified a number of areas where simplification or streamlining should be considered. These are set out in detail in Chapters 2 to 5 as **Observations**, and also listed together in Annex C for ease of reference. They do not necessarily constitute a comprehensive list - other issues may emerge in the course of further work.

Headline observations

The most important of these Observations are summarised below, under the headings of the Chapters of this report.

Start-up and incorporation

a) For the small incorporated business, the administrative burden of having to register separately with Companies House and with HM Revenue and Customs (HMRC) could be reduced by introducing seamless "one-stop shop" registration and filing facilities, as previously recommended by the OTS Small Company report.

   The OTS understands that a joint registration process using the gov.uk web incorporation service is currently being developed. The OTS proposes that to reduce the administrative burden HMRC should:

   - streamline the joint accounts filing process, and
   - extend the one-stop shop to all incorporations, including those using third party software.

b) While various tax reliefs are available for those who invest in businesses though the EIS, SEIS and VCT schemes, there are no reliefs for founders or

[1] Shortly before publication of this paper, the OTS learned that EMI is no longer available for options made after 6 April 2018. This is because State Aid approval, which is necessary for the scheme, lapsed. The State Aid notification process is ongoing and the government is working to have the scheme reapproved quickly. https://www.gov.uk/government/publications/employment-related-securities-bulletin/employment-related-securities-bulletin-no-27-april-2018

their close relatives. However, whether simplification involving a more uniform application of reliefs would be worthwhile or feasible is unclear, and would perhaps turn on the effectiveness of a relief where many family members might invest anyway, as well as the State Aid rules.

Financing

c) The requirement for a shareholder to hold a minimum 5% of a company's share capital to qualify for ER can act as disincentive for some founder shareholders to bring in external venture capital. They might choose not to accept equity investment to avoid losing the minimum 5% shareholding per individual. Allowing some flexibility in this area would remove a tax barrier to investment in and growth of businesses. The Government launched a consultation at Spring Statement 2018, which aims to end this potential disincentive to seeking investment: the OTS welcomes this consultation.[2]

d) The three main tax-favoured venture capital schemes - SEIS, EIS and VCT - have common features but also a number of differences which mean they attract different types of investors who invest for different reasons. Whether those reasons are consistent with the capital needs and future business aims of the companies concerned is unclear. This may mean the reliefs are not targeted most effectively. For example, there are contrasting views as to whether SEIS investment limits are too low or too high, and the role and place of VCTs is not well understood by businesses looking for venture capital. The OTS has also heard that smaller businesses are often wholly unaware of the schemes.

e) The absence of an entry relief for companies making venture capital investment is inconsistent with the other forms of venture capital investment referred to above. It might be worth exploring what effect this inconsistency might be having in distorting and reducing the availability of venture capital from the corporate sector.

f) There is a case for improving the administrative processes around authorising SEIS and EIS companies, and granting tax relief for investors. The OTS is aware that legislative changes about the nature of companies in which investments can be made is expected to streamline the processes, which is to be welcomed. However, digitisation and relaxation of legislative inflexibilities could also contribute to faster turn-arounds, which in turn would better enable companies to attract venture capital.

g) Complexities built into the SEIS/EIS legislation often catch out unwary companies, either at the time of application or after SEIS/EIS status has been granted. This can cause good businesses to lose necessary venture capital, or result in relief being denied or withdrawn some time after the investors have made their investments. Some of the rules may be necessary to properly target the reliefs, but a review of these complexities to remove unnecessary ones, or to build in de minimis thresholds (for small companies) would be useful.

---

2 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/688492/entrepreneurs_relief_consultation_web.pdf

Succession

h) When a business is disposed of by way of a gift, relief from CGT is potentially available under Entrepreneurs' Relief or CGT gift relief: they offer the option of paying 10% now, or potentially paying at the full rate at a later point. These two reliefs are mutually exclusive, but determining which is better to claim depends on the future plans of the recipient of the gift, which will often be uncertain. Some simplification of the interaction of the reliefs would help to make the choice clearer and simpler for all parties including HMRC.

i) CGT reliefs (ER, gift relief) are available in respect of transfers of shares in trading companies where the non-trading element of the business is not more than 20% of the whole. In contrast, IHT BPR is available on transfers of a business, or shares in a business, where the non-trading element of the business (whether incorporated or not) is less than 50%. As well as the confusing effect that results from two different rules, this can lead to businesses adopting commercially unnecessary and complex structures to preserve their qualification for the reliefs.

Disposal

j) The cost of tax relief on claims to ER is greater than that of any of the other reliefs considered in this report. While those other reliefs appear to be designed to encourage investment in young and growing businesses, or to preserve existing business from break-up in the event of succession, ER does not seem to achieve either of those objectives. Its place in the range of reliefs, and its purpose, warrant a closer look.

k) Tax reliefs on sale are generally available in respect of consideration received at the point of sale, including any value attributed to contingent consideration. The reliefs are not available in respect of additional contingent consideration received and accounted for at some later point. This difference of treatment will influence business owners to sell for cash when a sale with the consideration being tied to future business performance might have been a better structure to encourage business growth. Simplifying the treatments by bringing them into line would remove a business distortion.

l) The "double taxation" both of the sale proceeds of a business by a company as well as the subsequent capital distributions when the company is wound up is disadvantageous for the seller, compared to the single tax charge on the proceeds of sale of a company itself. In contrast, the purchaser of the business enjoys more favourable tax treatment and reduces their risks by buying assets from a company rather than buying the company. A conflict of interest is therefore created between vendors and purchasers, which must make successful business transactions more difficult to achieve. Aligning the tax treatments would help to reduce such difficulties.

Conclusion

The various reliefs have developed over many years under successive governments to encourage entrepreneurial activity.

The availability of these reliefs at the different stages of a business's life has evidently played a part in creating a business climate that encourages entrepreneurial behaviour in the UK. However, as can be seen from the Observations above, when one looks across the tax charges and reliefs applicable to the business lifecycle as a whole, the picture becomes complex and confusing to many.

It is apparent that that some of the reliefs are not known or understood by the very businesses they are designed to assist. Complexity and different potential outcomes deter people from learning how reliefs do (or may) apply to their business. This complexity can have the effect that reliefs are either perceived to be unavailable or do not always provide support when businesses most need them. In consequence, not all businesses receive the support through the tax system that would enable them to flourish.

This is a time when the need to encourage innovation, support growing businesses, the economy and employment in the UK, is a vital priority. It has never been so important that the business tax system is fit for this purpose and supports these aims.

The OTS suggests there is a pressing need to undertake a detailed review of the tax system as it operates on key events in the business lifecycle, to help the UK economy to maximise its opportunities and to make the system clear and simple for companies to understand and use. This might be supplemented by additional work focusing on tax complexity as it impacts business growth, including learning from the OTS reviews of VAT and small company taxation.

Chapter 1

The business lifecycle and tax - an overview

The UK business environment

1.1 The UK is already recognised as one of the best countries in the world in which to do business.[1] Successive UK governments have supported entrepreneurial activity through taxation and other policies, and the present government's policy objective is to improve living standards and economic development by increasing productivity and growth across the whole country.[2]

1.2 Government can support businesses by providing tax reliefs to encourage innovation and investment, such as the Research & Development reliefs that are available for small, innovative businesses, and by ensuring that tax is not a hindrance at critical stages of business development, for example by acting as a disincentive to potential reinvestment in innovation, or by hampering successful transition through the business lifecycle.

1.3 A recent study by the European Commission's Directorate-General for Taxation judged that three of the current UK reliefs - Seed Enterprise Investment Scheme, Enterprise Investment Scheme and the Venture Capital Trust scheme - were in the top 6 tax incentive schemes (in terms of effectiveness) out of 46 such schemes in 28 European Union countries.[3] Effectiveness in this context is measured against 16 desirable design features, including technical rules, targeting to relevant business types and categories, and transparent, even-handed application of the reliefs.

1.4 UK businesses raised more than £7.1 billion in venture capital in 2016.[4] In addition, the UK is home to half of the top 10 fastest growing companies in Europe, is the number one European destination for inward investment, and is ranked fifth in the Global Innovation Index.[5] Investment is particularly important for the most innovative firms, which have high potential for growth and high productivity potential. The availability of a range of tax reliefs might contribute to this high level of enterprise in the UK.

---

1 World Bank Doing Business reports 2017 and 2018

2 https://beisgovuk.citizenspace.com/strategy/industrial-strategy/supporting_documents/buildingourindustrialstrategygreenpaper.pdf

3 European Commission "Effectiveness of tax incentives for venture capital and business angels" September 2017
https://ec.europa.eu/taxation_customs/sites/taxation/files/final_report_2017_taxud_venture-capital_business-angels.pdf

4 https://www.bvca.co.uk/Portals/0/Documents/Research/Industry%20Activity/BVCA-RIA-2016.pdf?ver=2017-07-13-111054-127&timestamp=1499940663502

5 https://www.insead.edu/news/global-innovation-index-2017

1.5 However, the UK faces challenges in growing businesses to scale. In November 2016, the Prime Minister announced a review of barriers affecting access to long-term finance by growing firms. The review was led by HM Treasury and supported by an industry panel. It found that the healthy start-up climate was supported by tax reliefs for investment: however, gaps were identified in later stage funding for growth. The review sought ways to increase the availability of patient capital in the UK: 'patient capital' in this context means "long-term investment in innovative firms led by ambitious entrepreneurs who want to build large-scale businesses".

1.6 Following the review, the government announced a significant package of funding for innovative firms at the Autumn 2017 Budget, together with a number of changes to tax reliefs, discussed below, designed to target them more effectively at innovative business activity.[6] At Spring Statement 2018, the government launched a consultation on a potential extension to the EIS regime: a fund with enhanced tax reliefs that would support investment in the most knowledge-intensive business.[7]

1.7 However, the availability and sustainability of patient capital is only one of a wider range of issues faced by a business during its life. The OTS considers that there is value in looking at the tax implications of the range of reliefs and charges that can arise during the business lifecycle to see the wider picture of tax as it affects businesses at different stages of development. This is why this initial review was undertaken, and further work is considered desirable.

The business lifecycle

1.8 The lifecycle of a business spans the period from when it starts to operate, through its growth to a level of maturity and culminating with the point at which it passes out of the hands of the owners, either by succession during the owner's lifetime or on their death, sale of the business, or cessation of trade. Disposal of a going concern does not, of course, mark the end of the business, but may be said to start a new lifecycle.

1.9 There are various events in the business lifecycle that have some sort of tax impact. Some of these tax impacts affect the business itself, while others affect the owners of the business. Chart 1.A below shows how these various events fit together and illustrates when a tax impact might happen.

---

6 https://www.gov.uk/government/publications/patient-capital-review

7 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/689229/PU2158_Financing_growth_in_innovative_firms_web.PDF

Chart 1.A: Business lifecycle of events

Source: OTS

1.10 This paper is primarily concerned with the events that have a tax impact on the owners, described as the "key life events". These can be identified as:

a) Start-up

b) Incorporation (where undertaken)

c) Financing for growth

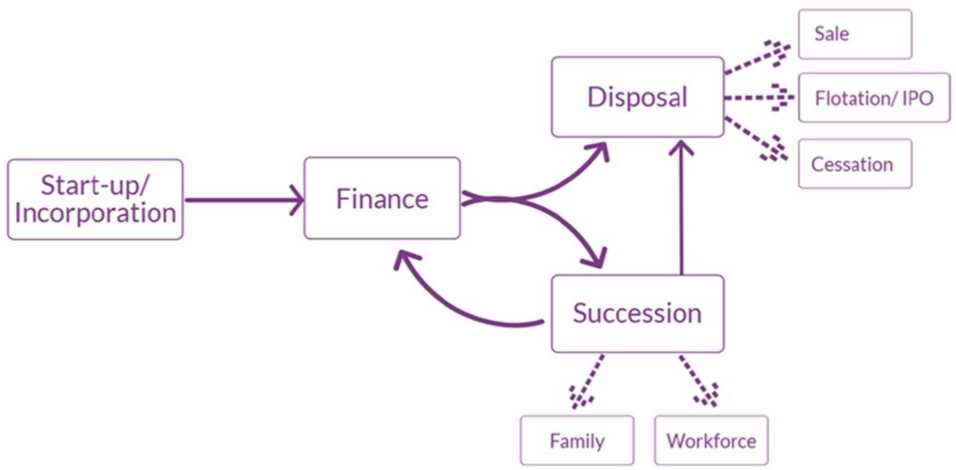
d) Succession, either to a connected party where a business is passed from one generation to the next, or to the existing workforce

e) Disposal by way of sale to any other new owner, or flotation on a stock market, or the cessation of business with or without the disposal of assets

1.11 A range of other key events that may occur as a business grows are also noted in Chart 1.A. Taking on a first employee or registering for VAT bring additional tax and other burdens that can have a significant impact on growth. The OTS recently looked at options to simplify VAT, and its report on the taxation of small companies looked at tax simplification from that perspective. This paper complements those reviews by taking a holistic overview of key life events as they impact on business owners and noting areas where there is scope for simplification. The OTS proposes to continue consideration of opportunities to simplify taxation for growing businesses.

1.12 Chart 1.B illustrates the key life events explored in this paper and the different paths a business can take during its life.

Chart 1.B: Chart to show key life events of a business



Source: OTS

The impact of tax changes and reliefs

1.13 At each key event of the business's life, the tax system makes an impact - either to impose a charge on, or to allow a relief to- the owners of the business.[8] In this paper, the OTS considers the tax charges and reliefs that impact at each key life event for a business that runs its natural course to ultimate sale, succession, or a solvent winding-up after the cessation of business activity. The paper does not focus on the tax impact of a business that ends prematurely because of business failure.

1.14 The tax charges and reliefs, the circumstances to which they apply, and how these affect the various key life events, are considered in detail in the following chapters. Chart 1.C overleaf gives an overview of these charges and reliefs.

8 The term 'owners' in this context includes sole traders, partners in a firm, and holders of shares in a company that owns and carries on the business.

Chart 1.C: Chart showing main changes and reliefs

Event	Start-up	Incorporation	Finance	Succession	Disposal
Tax Charges	None	Capital Gains Tax (CGT)	None	CGT/Inheritance Tax (IHT)	CGT
Tax Reliefs	None	Relief on the incorporation of an existing business in exchange for shares, so that this can normally be done without CGT.	Income tax reliefs on investments by non-founding investors, provided through the Seed Enterprise Investment Scheme (SEIS), Enterprise Investment Scheme (EIS) and the Venture Capital Trust (VCT) scheme, which reduce investors' tax liabilities by 50%, 30% and 30% respectively of the amount invested.	On the gift of a qualifying business, capital gains can be deferred until a subsequent disposal if the donor and recipient jointly request this. Gains on gifts into a trust can also be deferred at the donor's request. Alternatively the owner can claim Entrepreneurs' Relief (ER), which reduces the rate of CGT to 10% on lifetime gains up to £10m.	The owner of a trading business can claim ER which reduces the rate of CGT to 10% on lifetime qualifying gains up to £10 million. ER is also available on disposals of shares or securities in a trading company or the holding company of a trading group, subject to conditions being met.
			SEIS and EIS investors can reinvest existing chargeable gains into the SEIS/EIS shares. Taxation of that gain is then eliminated to the extent of 50% (SEIS) or deferred (EIS) until the subsequent disposal of the shares.	Business Property Relief (BPR) and Agricultural Property Relief (APR) provide that qualifying businesses that are not substantially investment businesses, and qualifying interests in agricultural enterprises, enjoy up to 100% IHT relief.	A CGT rate of 10% is also available under the recently introduced Investor's Relief for investment in newly issued shares of a trading company which are then held for the three-year qualifying period.
				No capital gain on death as the deceased is treated as not disposing of assets. Legatees treated as acquiring the assets at full market value for capital gains tax purposes, thus achieving a tax-free uplift in the deductible cost used for computing gains or losses on a subsequent disposal.	SEIS, EIS and VCT investors enjoy unlimited tax-free gains on qualifying disposals.
					Relief from capital gains tax is also available on the disposal of a qualifying shareholding in a business to a qualifying Employee Ownership Trust.

Source: OTS

Chapter 2

Start-up and incorporation

> **Illustrative case study: MJ Business Systems**
>
> Mike and Jenny are employees of a multi-national IT company. They decide to set up their own business to develop accounting packages for small business clients. They begin trading in partnership, operating from a spare room in Jenny's house. They each invest £5,000 of their own money to buy equipment and office furniture. The partnership can claim 100% capital allowances on this expenditure. No other tax relief is available to Mike and Jenny for the money they have each invested in the business.

Start-up

2.1 An individual seeking to start a new business can set up either as a sole trader or in partnership with others, or in an incorporated form (generally a limited company with the founders/owners holding all the shares).

2.2 The owners of a new business will not generally face any tax charges or get any tax relief for money or assets they use to start the business.[1]

Observation

2.3 The absence of any immediate tax relief for the capital contributed by the start-up owner contrasts sharply with the plethora of tax reliefs that are available to subsequent investors. These reliefs are considered in detail below in Chapter 3 (Financing for growth).

Incorporation

> **Illustrative case study: MJ Business Systems continued**
>
> Mike and Jenny soon realise that to protect their personal assets (mainly their respective family homes) they need the protection of limited liability. In addition, trading as a limited company will give them more commercial credibility in the wider market place of larger national businesses they now wish to target. So they decide to incorporate their business by transferring it to a newly-formed company, MJ Business Systems Ltd, in which Mike and Jenny are the only, and equal, shareholders.

[1] Other than in the somewhat unusual circumstances where four or more unconnected individuals create a company and invest in it through the SEIS or EIS schemes, referred to separately in Chapter 3 (Financing for growth)

Their accountant advises them how to do this and a local solicitor draws up the business asset transfer agreement and sets up the company for them, in such a way that no tax is payable on the transfer. Professional fees amount to £2500 plus VAT.

These costs are not tax relievable either in the company or personally for Mike and Jenny. They both continue to work full-time in the business, now as directors of the company.

2.4 An incorporation involves passing the assets and liabilities to a limited company. The consideration given by the company will generally consist of an issue of new shares in the company, and can also include cash and an issue of debt. The transfer of assets by the individual to the company, which is a separate legal person, constitutes a disposal of assets at market value by the individual for capital gains tax purposes, so capital gains tax can potentially arise. A capital gains tax relief is however available for the incorporation of an existing business, which enables incorporations to be undertaken tax-free.

2.5 Where the consideration paid by the company is wholly in the form of shares, all capital gains arising to the individual on business assets passing to the company are deferred, with the deferred capital gains reducing the base cost of the issued shares. This means that on any future sale of those shares, the gain on the sale of the shares will be increased by the amount of the deferred gains. Where the consideration paid by the company for the assets transferred to it is partly in a form other than shares (cash or loans), the amount of the deferred gains is restricted to the fraction that the value of the issued shares bears to the value of the total consideration paid, with the balance being chargeable to capital gains tax.

Observation

2.6 The capital gains relief on incorporating a company is generally well-known and understood by professional advisers, but it is less well understood by business people. Business owners often do not understand the restrictions on the relief if the company gives anything other than shares (for example cash or loans) for the assets. For these reasons, and to enable a company to be formed without additional tax cost, professional help is generally sought and significant fees incurred, often by businesses that can least afford such costs at the early stages of development.

Choice of legal form (sole trader, partnership or limited company)

2.7 The rate of tax levied on the profits of a business depends on its legal form, so this will be one consideration in deciding which form to adopt.

2.8 The rate of corporation tax payable by a limited company, currently 19%, is lower than the combined rates of income tax and NIC on self-employed profits. Until changes were introduced from 6 April 2016, no income tax was payable on dividends within the basic rate band, which might have influenced sole traders and partnerships to incorporate for tax-saving reasons. However, commercial factors are important too, and the recent tax changes to dividends - which are now liable to income tax for individuals within the basic rate band, subject to the dividend allowance (£2000 from 6 April 2018) - makes tax a less important factor in deciding whether or not to incorporate.

2.9 When the OTS looked at this in its small company review,[2] drawing on an independent IPSOS MORI study and its own survey, the conclusion was that the availability of limited liability (while by no means the only factor) was a primary consideration in deciding to operate through a company. Enhanced credibility, customer requirements and a formalised structure were other relevant factors.

Administration on starting the business

2.10 No review of the tax aspects of the business life cycle would be complete without some discussion of the practical steps that the owner of a new business needs to take to register for and comply with various tax obligations. Generally, individuals do not seem to find registration particularly difficult and clear guidance is available online[3] although some will undoubtedly ask an accountant to do it for them.

2.11 Whatever business form is chosen, the starting point for obtaining information about what the business needs to do to comply with tax rules is likely to be www.gov.uk, which sets out a step by step approach.[4]

2.12 A sole trader will need to register for Self-Assessment and, if taxable turnover will exceed the VAT registration threshold (currently £85,000), the business must register for VAT. Businesses can also register voluntarily for VAT at turnover levels below that threshold. The business will need to keep business records. It might have to register with HMRC for the Construction Industry Scheme, if working in the construction industry.

2.13 An early event in the life of many a small business is when it takes on its first employee, and is therefore required to deal with the complexities of employment law as well as tax obligations as an employer. Those tax obligations require the employer to deduct income tax and National Insurance Contributions (NIC) from the employee's wages, and pay this to HMRC together with employers' NIC. There is an HMRC on-line facility which guides an employer through the process of opening and operating a Pay As You Earn (PAYE) scheme to enable these things to be done.

2.14 Those setting up a business in incorporated form, or incorporating an existing business, will have to register for Corporation Tax as well, and operate a PAYE scheme in respect of directors' remuneration, whether or not it has other employees. The company must also be registered at Companies House.

2.15 The time limits for registering for taxes are different depending on whether a new business is carried on by a company or not. When a business is owned

---

2 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/504850/small_company_taxation_review_final_03032016.pdf

3 https://www.gov.uk/set-up-sole-trader, for example.

4 https://www.gov.uk/set-up-business

directly by an individual or individuals they must register for income tax by 5 October in the second tax year of trading. An incorporated business must register for corporation tax within 3 months of starting to trade.

Observation

2.16 The anticipated one-stop shop for registering a limited company, as proposed in the OTS small company report, has not (yet) fully materialised. The OTS understands that a joint registration process using the gov.uk web incorporation service is currently being developed. Following the end of the accounting period, the company's annual return and accounts can be submitted to both Companies House and HMRC from the same portal (although it is necessary to input many of the figures twice). Streamlining the joint accounts submission and extending the one-stop shop to the registration process for all incorporations, including those using third party software, would reduce the administrative burden.

Chapter 3

Financing for growth

Illustrative case study: MJ Business Systems Ltd, continued

Mike and Jenny see an opportunity to develop more sophisticated software to supply to large national retailers. To do this, MJ Business Systems Ltd will need to employ several software developers and support staff who will require additional office accommodation. Mike and Jenny put together a revised business plan, which suggests the company needs a capital injection of £200,000 to finance the additional expenditure envisaged on wages, rent and other premises costs.

Jenny's father, Henry, offers to provide the capital by subscribing for shares under the Enterprise Investment Scheme (EIS), which would enable him to claim 30% income tax relief on his investment, and to defer a large capital gain that he has just realised on the sale of an investment property. However, the company's accountant, when asked to apply for EIS status, points out that Henry will fail the EIS "substantial interest" test. This is because Jenny and he are associates, and so Jenny's 50% shareholding will be attributed to Henry, taking him over the 30% maximum permitted. As he will not receive tax relief on his investment, Henry reluctantly decides to invest his money in an EIS company elsewhere.

Mike and Jenny next turn to the company's bank. However, the bank is not willing to lend because of a combination of a short and, to date, unprofitable trading history, and there being no projected profits for the next few years. The same picture emerges from conversations with other commercial lenders, other than those prepared to lend at unacceptably high interest rates.

Mike and Jenny decide to resurrect the EIS approach, recognising that they will have to give up a large proportion of shares in the company to external investors. Those of their close relatives who are also their associates will not be able to enjoy tax relief on any investments unless Mike and Jenny each dilute their shareholdings to such levels that, in each case, they and their associates would be below 30% shareholding. After many months of discussions with EIS fund managers, the company succeeds in raising £225,000 of investment and issues new share capital equal to 60% of the total, whereby Mike and Jenny lose control of the company.

The money raised meets the immediate needs of the business and pays the professional fees incurred in advising on and processing the EIS application.

Unfortunately, the delay in raising the money means that the company has missed several opportunities to tender for new work, and has not been able to establish itself on the list of preferred suppliers at one of its largest prospective clients.

Sources of funding

3.1 Many businesses, either when starting up or seeking to expand, will need capital to fund their growth. If a business is to have access to all available sources and make the right choices at different stages of its development, it is likely to need to take professional advice, which will be increasingly specialised as the complexity of the business and the financing issues increase. Of course, it is possible for a business to attract investment from more than one source - for example it might start with a bank loan, then raise some SEIS investment, followed by a round of EIS financing. At each stage, the different impacts of these reliefs on the business and on the owners will need careful consideration.

3.2 The options and tax implications of each source of finance are considered below.

Bank loan

3.3 A bank loan is perhaps the most obvious initial choice for financing a business. From a tax perspective, the interest paid on the loan is a business expense, which is deductible for income tax or corporation tax purposes.

3.4 However, innovative early stage businesses must cope with significant uncertainty in everything from potential market share to viability of technology and untested business models. Conventional debt finance from banks might not be suitable to manage this type of investment risk, nor might it be affordable, as revenue streams to meet interest and capital payment schedules will be limited or non-existent for some time.

3.5 In cases where a business either cannot or does not wish to take on bank debt, or where banks do not wish to lend, the business will need to consider other options.

Family and friends

3.6 Many entrepreneurs receive initial financing from family and friends. No tax relief is available for informal cash injections from this source outside of the approved venture capital schemes considered below – indeed many of those reliefs would not be available to an investor who is, by reason of being a family member, an associate of the entrepreneur.

3.7 It is a matter for further consideration whether giving relief to family members, who might invest anyway, would be effective in stimulating additional investment, or whether the risk of giving relief for investment that might happen without government intervention would outweigh the benefit. In addition, there are questions of State Aid which would need to be addressed. (State Aid rules aim to prevent governments supporting local industries in a way that would damage competition in the wider market.

Carefully targeted support in cases where there is demonstrable market failure should satisfy the tests.)

3.8 Where financing is provided by way of gifts, as opposed to loans or share subscriptions, there will be no IHT on the value of the gift if the giver lives for seven years after making the gift.

Business Angels

3.9 These are individuals who make serial investments in new or young businesses that are perceived to offer good opportunities for growth. Outside of the approved venture capital schemes, tax relief has generally not been available for the initial investment by a business angel.

3.10 However, the recently introduced Investors Relief for new equity investment in trading companies provides for a reduced 10% rate of capital gains tax on lifetime gains up to £10 million on the sale of qualifying shares (which must be held for not less than 3 years). This relief might prove to be an inducement for investors and thus a potential additional source of equity funding.

Crowdfunding

3.11 Crowdfunding has emerged in recent years as a relatively informal way to raise finance. In simple terms, crowdfunding involves a number of people each pledging typically small amounts of money. Because the individual contributions are generally small, some crowdfunding platforms and investors may be less strict in their requirements than financial institutions such as banks. So this can be a less formal and thus more accessible choice of funding for entrepreneurs who might struggle to secure bank lending.

3.12 SEIS and EIS tax-advantaged venture capital schemes (see below) can be utilised where crowdfunding is used to raise venture capital, though the small size of each individual investment can make the administration unduly onerous. Rewards and incentives (such as discounts on goods sold by the investee company) may be offered to investors in some of the less formal crowdfunding arrangements: these will generally prejudice the availability of SEIS or EIS reliefs. Investor relief, discussed above, might also be available for investments made though crowdfunding.

Private Equity

3.13 Equity finance as a medium-term investment intended to remain in place over several years is an important source of finance for growing businesses and there is evidence that it has grown significantly in recent years: for example, investments in UK companies by members of the British Venture Capital Association grew from £4.7 to £7.1bn between 2014 and 2016.[1]

3.14 The term private equity embraces venture capital (VC) funds and private equity (PE) houses.

[1] Table 2a: https://www.bvca.co.uk/Portals/0/Documents/Research/Industry%20Activity/BVCA-RIA-2016.pdf?ver=2017-07-13-111054-127&timestamp=1499940663502

3.15 Venture capital funds will typically provide new capital to early stage businesses by way of equity subscription. As such they play an important role very early in the business life cycle in getting new businesses off the ground.

3.16 The sizes of equity stake taken by VC investors vary, but minority stakes are much more common than controlling ones.

3.17 In contrast, PE or buyout funds will normally invest in businesses at more mature points in their life cycles. The PE fund will typically buy the shares of the existing shareholders rather than subscribe for new shares. This is considered in more detail in Chapter 5 (Disposal or cessation of a business).

3.18 No tax relief is generally available to the VC investor unless the investment is made by way of the EIS or VCT schemes discussed below.

Tax-favoured venture capital schemes

3.19 Successive governments have introduced reliefs to help small and medium-sized companies attract the investment they need to grow. These reliefs are now frequently marketed to prospective investors as packaged investment schemes. They offer tax relief for those who invest in qualifying trading companies for specified minimum periods of time. So they encourage medium-term investment into higher-risk trading companies that might otherwise struggle to raise capital through conventional bank finance.

3.20 The three tax-favoured schemes that are relevant to privately-owned businesses are EIS, SEIS and VCTs. There is also a Social Investment Tax Relief (SITR) scheme. SITR is not considered in this paper because it is designed to encourage investment in enterprises that deliver social or public benefits rather than purely commercial activities.

3.21 The three tax-favoured schemes provide the following reliefs to the individual investor

a) income tax relief at 30% (EIS), 50% (SEIS) and 30% (VCT) of the amount invested

b) relief from capital gains tax by way either of partial exemption (SEIS) or deferral (EIS) of capital gains realised on other assets

c) relief from capital gains tax on gains on disposal of the shares invested in all three schemes

3.22 SEIS and EIS investments can either be made directly into the company, or through an SEIS or EIS fund (the OTS has been told that about half of all such investments are by individuals, and half by funds) which will invest in a number of qualifying companies. VCTs are listed companies that raise money from investors and use that money to invest in qualifying trading companies.

3.23 Each scheme requires the company in which the investment is made to be a trading company (subject to exclusion of certain proscribed trades and other conditions). In each case, that investment must be held for a minimum period (3 years for SEIS and EIS, 5 years for VCTs) for the income tax reliefs to be preserved. SEIS and EIS shares must also be held for those minimum periods to obtain capital gains reliefs on sale.

3.24 The availability of inheritance tax relief for business property (commonly referred to as Business Property Relief (BPR)) for SEIS and EIS investments may also play a part in encouraging such investment. BPR is available on the value of shares/securities in a qualifying business which have been held for at least 2 years: it is considered later in this paper in Chapter 4 (Succession (passing on a business)).

Corporate venturing

3.25 There are no longer specific tax reliefs[2] available for companies making a venture capital investment by way of equity. The cost of any investment is deductible only in computing a capital gain on the subsequent sale of the shares, when the Substantial Shareholder Exemption (SSE) can apply to exempt the capital gain from tax, subject to relevant conditions being met.

3.26 The absence of any up-front relief along the lines of EIS income tax relief for individual investors means that there is no initial tax incentive for companies to invest in fledgling businesses. The OTS has heard, possibly as a consequence, that this potential source of funds is virtually non-existent, outside the realm of large family businesses investing in start-ups of family members.

Choice of fund-raising strategy

3.27 If bank lending is not readily available, and family and friends are unable to provide financing, companies will look at other sources. Crowdfunding is relatively new, and informal, whereas the other sources have been around for longer and are perhaps better understood.

3.28 The availability of the tax reliefs attaching to SEIS, EIS and VCTs has brought an increased number of investors into the market who are undoubtedly a potential source of venture capital for companies.

3.29 The OTS has heard that EIS and SEIS are popular, with a good level of awareness among businesses and advisers. A total of c£2.3bn was raised through these two schemes during the 2015/16 tax year.[3]

3.30 SEIS is aimed at the small start-up and is used by fledgling businesses to attract initial, or seed, investment. EIS is used either to set up larger companies or for second round financing. Sometimes SEIS is a sole funding source: sometimes SEIS and EIS are undertaken together to raise finance. SEIS gives the initial investors more tax relief (50% rather than 30% under EIS), so rewarding at a higher rate the first to commit, which then acts as a pump-prime for the larger EIS-qualifying investments.

3.31 The VCT scheme as a source of equity funding was mentioned less frequently to the OTS during its work on this paper and appears to be less popular and raise less money than EIS, and only a little more than SEIS, which is aimed at and restricted to very small start-ups. While VCTs in recent years have increased the amounts raised each year, reaching £570m in 2016/17, these

---

[2] Corporate Venturing Scheme relief was removed 1 April 2010

[3] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/611525/Combined_tables_to_complexity and_volume_of_reliefs_available _publish.pdf

are relatively small sums in comparison to the £2.3bn raised by EIS and SEIS. Only 75 VCTs are currently operating and the number is reducing as the industry consolidates, with few new entrants: 38 of the current 75 were actively raising funds in 2016-17.[4]

3.32 The types of company that a VCT can invest in are defined similarly to those companies that can participate in EIS [see Annex A for more information on these rules]. However, the OTS has heard that the companies typically invested in by VCTs have been more mature and larger than companies attracting EIS investment. This may change in the light of the new rules announced at Budget 2017, with VCTs looking to focus more on innovative early-stage companies.

Observations

3.33 In the course of its work, the OTS has identified a number of structural, administrative and technical complexity issues concerning the various tax reliefs that, if resolved, might improve the environment for investors and investee companies, as follows:

Structural

SEIS limits

3.34 The rules for SEIS (both for investors and investee companies) have been modelled on the EIS rules, but because SEIS schemes are limited to much smaller amounts of money, the administrative burden is disproportionately greater. As a result, SEIS is seen in some quarters as too administratively burdensome to be effective. There was agreement among advisers of all sizes that the advisory fees involved in putting an SEIS scheme in place were significant compared to the level of investment allowed. Fees are high because of the complexity of the legislation and the need for specialist input.

3.35 Where SEIS is used as a stand-alone scheme, the SEIS limit of £150,000 per investee company is considered by some advisers to be too small to enable most businesses to get off the ground with only that level of funding. On the other hand, the OTS has also heard that there are some investors (typically business angels) who think the limit is too high in that it creates artificially high share valuations which then act as an impediment to second round (for example EIS) funding. There is also a perception among some investors and advisers that SEIS has created an unnecessarily competitive market, particularly in high-tech start-ups, driving up demand for, and thus salaries of, qualified technicians.

The VCT market

3.36 Several reasons have been suggested for the relatively small amounts invested annually in VCTs, as compared to SEIS/EIS investments, including

a) the business model for VCTs involves the realisation of investments and recycling of the sale proceeds into new investments, so that the

4 https://www.gov.uk/government/statistics/venture-capital-trusts-number-of-trusts-and-amount-of-funds-raised-october-2017

same initial investment into the VCT can be used several times, whereas EIS investments, on realisation, are returned to the investors

b) VCTs are seen as an income product aimed at investors who are looking for dividend income, rather than those seeking an exit and a capital gain

c) VCTs do not attract IHT relief, which is available under EIS and SEIS

d) VCTs require a longer holding period (5 years compared to 3 for EIS) to maintain income tax relief

e) VCT subscriptions cannot be used to defer/roll-over a capital gain on another asset

f) investors in VCTs expect to receive dividends at about 5% of the amount invested. Those dividends are funded by the companies in which the VCT invests. Their cost of capital is therefore higher than for EIS investments, where there is generally no dividend expectation. This higher cost will discourage some companies from seeking VCT investment rather than EIS investment.

3.37 Changes introduced in recent years and others announced in the 2017 Autumn Budget will have the effect of requiring VCTs to focus on investing in companies whose objectives do not include capital preservation such that they are not at risk of failure. To that extent, those companies will be aligned with companies seeking SEIS and EIS investments. Because investors in VCTs expect a dividend flow, it might be expected that the companies invested in by VCTs will continue to be larger and more established than the newer SEIS or EIS company. However, there is some anecdotal evidence that the recent and proposed changes are driving VCTs to compete with direct EIS investment opportunities.

3.38 Nevertheless, the absence of entry roll-over relief and the longer holding period required for income tax relief will continue to make VCTs less attractive to some potential investors. In general, the role of VCTs is not as well recognised within the business community seeking finance as SEIS and EIS. Further clarification of and focus on the role of VCTs would be welcomed.

Corporate Venturing

3.39 The absence of any entry relief appears to have virtually shut down this potential source of venture capital. Such a relief did exist between 2000 and 2010, but was not renewed thereafter. OTS has heard from HMRC that the take-up was modest (compared, say, to EIS) at only £103 million of investment over 10 years, and that there was some abuse through the use of special purpose investment vehicles and investments being made into larger entities than had been envisaged when the relief was introduced.

3.40 It is possible that the recent relaxation of the SSE rules, whereby the investing company no longer needs to be a trading company or a member of a trading group, might encourage more activity. If some further encouragement could be given by a well-targeted entry relief, the existing cash reserves of the corporate sector could be a valuable additional source of venture capital.

Non-executive and/or part-time directors

3.41 Individual investors, some of whom are referred to as "business angels", who invest in small or early stage start-ups are frequently also willing to invest some of their time and expertise in the company's business, bringing potentially valuable experience to bear in helping the company to grow.

3.42 In return for providing their time and expertise, the investors might be rewarded with dividends, salary and sometimes share options or shares. In receiving some of these rewards they might put at risk the EIS relief they and other investors would be entitled to in respect of their initial subscription for shares in the company, if the rewards were not seen as "necessary and reasonable".[5]

3.43 The possible loss of tax reliefs can discourage individuals from contributing their time in this way.

Administration

Delays in receiving documentation

3.44 Although HMRC approve straightforward cases quickly, initial investors in SEIS, EIS and VCT schemes often have to wait a long time to receive the documentation needed to claim the relief on their tax returns. There are a number of stages in the process of obtaining this documentation, and the OTS considers that this area would benefit from an in-depth review with a view to identifying options to streamline the process. As a result of the lengthy process, individuals' tax returns sometimes have to be submitted before the documentation has been received to meet filling deadlines. This means that the tax relief cannot be claimed at that point. Investors may have to amend their tax returns later and submit additional forms to claim the relief once they receive the relevant documentation.

Advance assurance process

3.45 Advisers raised concerns about the advance assurance process.[6] This allows a company to receive conditional agreement from HMRC that it qualifies for EIS (or SEIS). It is common practice to apply for advance assurance: the consequences of a mistake are significant, and investors like to see HMRC approval. Applying for advance assurance also helps speed up the process of filing forms on behalf of investors at a later stage (as HMRC will already have information on the company on file).

3.46 While a few advisers felt that the current process worked well, the majority complained of long delays. HMRC has told the OTS that 80% of cases are dealt with within fifteen working days: advisers said some applicants might not hear from HMRC for five weeks or more, and then often got a response asking basic questions that could have been raised sooner, or asking for the identity of investors before they have in fact been found. These delays have a

5 ITA 2007 s168(2) (f)

6 https://www.gov.uk/government/publications/enterprise-investment-scheme-advance-assurance-application-eisseisaa

commercial impact: protracted delays in confirming whether a business activity might in principle qualify for relief have led some business ventures to fail.

3.47 HMRC launched a consultation on options to improve the service in December 2016 and published the government response in December 2017.[7] The consultation noted that HMRC doubled the resource allocated to this process since 2011-12 in an attempt to improve performance, but demand in that period trebled. HMRC explored a range of options to better manage the process. The response explains that HMRC will continue to offer this service, but will not offer it to any speculative investment or any application "where it is reasonable to conclude that the proposed investment is part of a capital preservation arrangement".

3.48 Further improvements to guidance are planned, including a checklist of information HMRC will need to receive before being able to approve an application. HMRC's internal guidance on the subject (which is published online and can be viewed by the public) was updated on 6 March 2018 to reflect the revised process and the new information that is needed[8] although at the time of writing this paper the core public-facing guidance had not been updated.[9] The OTS welcomes the recent improvements to the process, and hopes to work with HMRC to make further improvements to both process and guidance.

3.49 Applications raising novel or complex points will of course take time to assess, but there is a good argument to speed up the advance assurance process in those cases as well as the straightforward ones. A number of possible options to reduce the time taken to get clearances were identified during OTS meetings:

a) HMRC could ask companies to provide more information as part of the initial application. A key difference between those advisers who felt the process worked well and those who didn't was that the advisers who provided relevant additional material at the time of making the application received quicker and more satisfactory responses. HMRC's updated internal guidance clearly sets out the information that is required[10]: once links to public-facing guidance are updated this should help smooth the process.

b) Consider automating the advance assurance process, so that assurance on straightforward applications could be obtained instantly subject to satisfactory completion of an online form. Additional safeguards could be built into the process, to identify cases where human intervention is needed.

---

7 Consultation: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/574564/Tax-advantaged_venture_capital_schemes_-_streamlining_the_advance_assurance_service.pdf Response: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/663935/Tax-advantaged_venture_capital_schemes-streamlining_advance_assurance_service-Gov_response.pdf

8 https://www.gov.uk/hmrc-internal-manuals/venture-capital-schemes-manual/vcm35040

9 https://www.gov.uk/guidance/venture-capital-schemes-apply-for-advance-assurance

10 https://www.gov.uk/hmrc-internal-manuals/venture-capital-schemes-manual/vcm35040

c) Change the administrative framework to allow companies to make changes to comply with the rules after the compliance statement has been submitted, where the company and its investors have not benefitted from any transgression of the rules. (A significant number of rejections now arise where company articles of association or preference share agreements are out of line with the rules, or where they inadvertently submit the wrong form. In such cases, they are not able to revise or amend their processes or the form once submitted.)

Investor record-keeping

3.50 The records that an investor needs to maintain are quite extensive, particularly if both income tax and capital gains tax deferral relief is claimed in respect of a portfolio of investments. Ideally, it might be helpful for both taxpayers and HMRC if a shared, permanent, workspace could be established in the personal tax account.

Technical Complexity

General

3.51 Apart from the small number of advisers specialising in this area and the large accountancy firms with well-resourced specialist departments, it was apparent from discussions that the volume and complexity of the various reliefs meant that it is challenging for professional advisers and companies seeking venture capital investment to understand them comprehensively.

3.52 The differences between the reliefs, and thus the choices available to investors and companies, inevitably leads to complexity and uncertainty. More concerns were raised in the area of growth funding than any other of the business lifecycle events.

Maintaining compliance with the rules

3.53 The OTS has heard that companies frequently fall foul of the rules either before or after initial approval has been granted because they don’t understand all the complex legislative requirements, or they take commercial actions that can cause them to lose their EIS/SEIS status. This makes it very difficult for them to raise further funding. Furthermore, tracking the company’s decisions and actions in the required manner so that entitlement to reliefs can be re-established at the point of share disposal is burdensome for small businesses and their shareholders.

3.54 The OTS understands from HMRC that some such aspects could be alleviated with legislative changes to allow positive HMRC intervention to support applications. The OTS would support an exploration of what could be done in this area.

Example 1

In preparation for an initial public offering (IPO) of its shares on a public exchange for the first time, a company was required to consolidate multiple classes of shares currently in issue to just one class of shares. The issued shares included EIS shares.

In this particular case, HMRC's view was that consolidation of the share classes would result in the EIS shares losing their preferential tax (specifically CGT) status as the transaction would be treated as a disposal, even though the new class of shares to be received by the EIS investors would not confer any preferential rights. In this instance, the gain realised by the EIS investors on their shareholding was subject to CGT, which otherwise would have been exempt if the shares retained their EIS tax status.

Qualifying period

3.55 SEIS and EIS Investors are required to hold the qualifying shares for at least three years to maintain their income tax relief. If the shares are disposed of earlier, the income tax relief already claimed will be withdrawn: any latent capital gain on the EIS shares will not be exempt and will be treated as accruing at the time of the disposal.

3.56 While a minimum holding period provides a disincentive for investors to withdraw their investment and allows the company some stability, in some cases this can prompt behaviour from investors that gets in the way of commercial decisions. This can be of particular concern in industries like high technology, where three years can be a long time to wait before an exit or sale is undertaken. There are cases where venture capital shareholders have blocked commercial decisions because of the personal tax cost that would result. This potentially makes it more difficult for the business's owners to take sound commercial decisions.

3.57 One way to overcome this would be to allow certain events (for example, acquisition by a third-party company within three years of issuing EIS shares, consolidations and share reorganisations) to be treated as not prejudicing the available tax reliefs. This would, of course, need to be accompanied by anti-avoidance rules to prevent abuse. Another option could be that the loss of reliefs could be tapered over time rather than subject to the cliff edge at the three-year point.

Example 2

A high-tech company was approached by a US firm for acquisition within two years of founding. The deal was initially blocked by a venture capital shareholder, an EIS fund with substantial voting rights. The reason was that the EIS fund investors would lose the income tax relief they had received because they would not have held the shares for at least 3 years.

The owner of the company was eventually able to get shareholder approval as the fund director considered his fiduciary duty required him to act in the company's best interests rather than to protect his investors' tax relief.

Nevertheless, this example shows that shareholders' and businesses' interests can be misaligned as a result of the tax treatment.

Interaction between Entrepreneurs' Relief and EIS

3.58 The interaction between Entrepreneurs' Relief and EIS can present problems to founder shareholders.

3.59 Entrepreneurs' Relief applies a 10% rate of tax to qualifying gains (up to a maximum of £10m) on a sale of shares in a trading company if the shareholder has a "material interest" of not less than 5% of the ordinary share capital and controls 5% of the voting power in it. So, when share capital is issued under EIS, the founder shareholder needs to ensure that at least 5% is retained if Entrepreneurs' Relief is to apply on a later sale. This arithmetic constrains the amount of EIS share capital that can be issued to ensure the 5% interest can be maintained, and even more so if there are several founders all of whom wish to retain their 5% interests.

3.60 The same issue arises when a private equity investor invests for 75% of equity, leaving room for only a maximum of five founding members to continue to qualify for ER. On a second round of funding, the problem of retaining ER entitlement becomes insurmountable, as any further dilution of the founding shareholders will take them below 5%. The use of preference shares for the PE and second round funding can alleviate these effects but can also lead to additional complications.

3.61 In the November 2017 Budget, the Government announced a consultation on options to address these problems and the consultation document was published at Spring Statement 2018[11]: The OTS welcomes this.

Restrictions on employee tax-favoured share schemes

3.62 The involvement of PE houses or venture capital funds can adversely affect the availability of tax reliefs for employee shareholders. Often, the shareholder will have been awarded shares or options under tax-favoured schemes in such a way that no income tax is due on the acquisition of the shares and favourable tax treatment might also be available on the sale of the shares. Generally, realised increases in share value are taxable as capital gains. However, in the case of the Enterprise Management Incentive (EMI) scheme a 10% CGT rate can be claimed under the Entrepreneurs' Relief rules.

3.63 All of these tax-favoured schemes require that the issuing company is not under the control of any other company. Although both PE house and venture capital funds are usually partnerships so that no one partner controls an investee company, their modus operandi (management through a

---

11 https://www.gov.uk/government/consultations/allowing-entrepreneurs-relief-on-gains-made-before-dilution

corporate general partner in the case of PE houses, and venture capital funds acting in concert in particular defined circumstances) can lead to situations where there is deemed control so that the tax reliefs attaching to the employee share schemes are lost.

Chapter 4

Succession (passing on a business)

Illustrative case study: MJ Business Systems Ltd, continued

Several years on, Mike and Jenny's business has prospered. In addition to the core trade, MJ Business Systems Ltd has acquired several office units on a local business park that generate significant amounts of rental income. Mike and Jenny still each own 20% of the shares in the company (after the reduction in their shareholdings resulting from the earlier EIS investment).

Tragically, Mike dies in a car accident. His shares in the company are inherited by his widow, Paula. For capital gains tax purposes, she is treated as acquiring them at full market value. The family solicitor advises Paula that the value of Mike's estate for inheritance tax purposes is reduced by 100% of the value of the shares, because they qualify for business property relief. This is because the main part of the business is the trade of software development, not the property letting activity.

Paula does not wish to become involved in the business, and Jenny also decides that it is time for her to step down and pass the business on to successors.

There are a number of options open to them including:

- Jenny and Paula each have adult children who work for the company and are able and willing to take on the management of the company. This is the option they both favour
- Alternatively, members of the workforce have suggested that they would be interested in a management buy out

From Paula's point of view, because she has inherited her shares at full market value, she can transfer the shares by sale or gift without incurring any capital gains tax liabilities. Paula gifts her shares to her son, Steven, who is treated as acquiring them at full market value for capital gains purposes.

Jenny also would like to gift her shares, equally, to her two children, Anita and Sonya. However, she is advised by her accountant that she will not be able to claim gift relief from capital gains tax on such a gift or Entrepreneurs Relief (ER) (10% capital gains tax on qualifying gains up to £10 million).

This is because the rental activity is sufficiently large that the company will fail the "substantial extent" test for gift relief and ER, even though it was not so large that the business failed to meet the "wholly or mainly" test for Inheritance Tax Business Property Relief.

As she cannot afford to pay the estimated capital gains tax of £1m that would arise on a transfer of all her shares without realising cash, Jenny must sell at least some of them. The potential management buy-out team are not interested in acquiring a minority shareholding, so Jenny sells some of her shares to a local business angel and gifts the remainder to Anita and Sonya. She uses the cash generated from the sale to pay the capital gains tax on the sale and gift.

Paula has passed all her shares to her son without incurring any tax liability, whereas Jenny has had to sell some of her shares to pay a tax bill, leaving fewer shares to pass on to her children.

4.1 In the context of this paper, the term succession means the transfer of a business other than a sale at market value. This means passing on shares in a private company, or an interest in an unincorporated private business, to enable the business to continue under the ownership of the family or families or a chosen successor. Such transfers will potentially create tax charges under two capital taxes: capital gains tax (CGT) and inheritance tax (IHT). Each is considered separately below, as they apply to both lifetime transfers and to transfers on death, together with the potential reliefs.

Lifetime transfers

CGT

4.2 The transfer of shares in a company, or of an unincorporated business or a partnership share, entails a disposal of one or more assets for CGT purposes, on which gains or losses may arise. Where those transferring and receiving the shares are connected persons,[1] or the transfer is not by way of a bargain at arm's length (as with a gift), the disposal and acquisition is deemed to be made at market value.[2] Gains are charged at 10% insofar as they are within the individual's income tax basic rate band, and 20% thereafter.[3]

4.3 The following CGT reliefs are potentially available (see Annex A for a summary of the conditions that apply):

a) Relief for gifts of business assets or shares. If both the transferor and the recipient claim relief, the transferor will not pay tax on the gain and the recipient's allowable CGT cost (the market value at the time of transfer) is reduced by the amount of the gain held-over. That then increases the gain chargeable on the recipient when subsequently disposing of the asset or shares.

1 Connected persons are defined at s268 TGA 1992

2 S17 TCGA 1992

3 18% and 28% respectively for gains on residential dwellings

b) Relief for gifts of business assets which are immediately chargeable to IHT, also by way of a joint claim for relief, which has the effect that CGT is not paid at the time of transfer but may be payable in future.

c) If gift hold over relief is not claimed, relief from capital gains tax is potentially available under Entrepreneurs' Relief, reducing the rate of CGT to 10% on lifetime-eligible gains of up to £10m.

d) The Employee Ownership Trust scheme was introduced in 2014. It applies when individual shareholders sell their holding to a qualifying trust, for the benefit of the employees having a controlling interest in the company, by the end of the tax year in which the acquisition takes place.[4] The scheme has the effect that the latent gain realised on the sale is held over and passes to the trustees.

IHT

4.4 Gifts of a business, or of shares in a company, to an individual during the transferor's lifetime will be potentially exempt transfers (PETs), so that no IHT is payable at the point of transfer. If the transferor dies within seven years of making the gift, the PET is no longer exempt (unless the gift was exempt anyway - for example, if it was made to a spouse). IHT may become due if the value of the gift, together with any other gifts made during the seven-year period before death and the value of other assets in the transferor's estate, is more than the IHT threshold (or 'nil-rate band').

4.5 However, in those circumstances relief for relevant business property (BPR)[5] or agricultural property relief (APR) can still be claimed if

a) the property was owned by the recipient throughout the two-year period to the transferor's death (or to the recipient's death if sooner), and

b) that property (or replacement) is still relevant business property, or agricultural property and occupied as such (see below).

4.6 A trust may be used to retain a level of control over the use of the assets by the beneficiaries, but will come with its own tax consequences. A transfer into trust is not a potentially exempt transfer, and will be immediately chargeable, subject to the IHT nil-rate threshold, although BPR and APR may be claimable if the conditions for relief are satisfied (see Annex A). There may also be periodic IHT charges within the trust, and charges when capital is distributed to the beneficiaries.

Observations

Interaction between Gift Relief and Entrepreneurs' Relief (ER)

4.7 Gift hold-over relief and ER are mutually exclusive. The complex and often unknown evolution of the future plans of the new owner of the assets will determine which is the most appropriate course of action, a situation which can cause great uncertainty.

4 s236H-U TCGA 1992

5 Defined under 'Business property relief (BPR)' in Annex A

4.8 If gift relief is claimed on the disposal, no chargeable gain arises and a claim to ER is not needed. Under ER, the transferor would be charged tax at 10% on lifetime gains of up to £10m and at 20% thereafter.

4.9 In deciding which relief to claim, the transferor is likely to consider whether the new owner expects to make an early disposal. This is because one of the requirements if ER is to be available to the recipient is that they have held the asset for at least a year. If a disposal were made within a year any held-over gain arising from a gift relief claim will become liable to tax at full CGT rates. In such a case, the original transferor would need to consider revoking the gift relief claim and claiming ER instead. This is illustrated in Example 3.

Example 3

A business with nil base costs and current market value of 10, which has been in the founder's ownership for several years, is gifted to the next generation.

A claim to gift relief on the gift, and a subsequent sale within one year at the same market value at the time of the gift, will expose the whole gain on sale to capital gains tax at up to 20%.

In contrast, if Entrepreneurs' Relief had been claimed on the gift, the subsequent sale would not be exposed to tax, so that the overall gain of 10 is taxed at 10% rather than up to 20%. Time limits allow the original gift relief claim to be revoked in favour of Entrepreneurs' relief, but the original transferor is left with a tax bill with no additional cash resources with which to pay it.

4.10 The OTS notes the considerations that arise in deciding which relief to claim. The potential jeopardy of claiming hold-over relief could be alleviated by allowing the ER period of ownership condition for the recipient to take account of the period of ownership of the transferor.

Loss of BPR where PET becomes a chargeable transfer

4.11 The tax treatment of the transfer can be impacted by subsequent events. For example, property qualifying for BPR at the time of transfer will no longer qualify for relief if the transferor dies within seven years and the recipient has sold the property in the meantime.

Transfers on death

CGT

4.12 Assets are deemed to transfer to personal representatives, and in turn to those inheriting them, at their market value at the date of death, but for CGT purposes the deceased is not treated as making a disposal.[6] This is what gives rise to the so-called 'tax-free uplift' on death.

6 S62 TCGA 1992

IHT

4.13 The value of any chargeable assets in an estate, together with any chargeable lifetime transfers made in the seven years before death is taxed at 40% to the extent that it exceeds the available nil-rate bands.

4.14 However, the value of those chargeable assets would be reduced by BPR on relevant business property, or by APR on agricultural property, usually at 100% or sometimes at 50% (see Annex A for a summary of the conditions for relief).

Relief for Business Property (BPR) and Agricultural Property Relief (APR)

4.15 BPR is seen as an important means of facilitating transfers of existing businesses to future generations without IHT arising and causing a business to be broken up to enable the tax to be paid. The OTS have been told that in previous generations, when BPR wasn't available, businesses either actively limited growth in the period leading up to a transfer to minimise death taxes, or alternatively the potential tax charge on death necessitated setting aside significant sums – money which otherwise could have been reinvested into the business.

4.16 There was similar support for APR, which offers relief for agricultural assets and farmhouses that would not qualify for relief under BPR.

Observations

4.17 The tax reliefs available following a death each have their own set of rules. The OTS consulted a number of advisers and representative bodies. Consultees generally considered that they understood these provisions, and thought most served an important purpose. Nevertheless, there were a number of areas where some simplification might be helpful.

Definitions

4.18 The OTS have been told on several occasions that aligning definitions would represent a significant simplification. In particular, the difference between a "trading company" for CGT hold-over and ER purposes, and "relevant business property" for IHT BPR purposes, can lead to misunderstanding.

4.19 A company treated as a trading company for CGT hold-over relief and ER purposes will qualify for IHT BPR relief, but a business qualifying for IHT BPR might not necessarily qualify for those capital gains reliefs. This is because IHT BPR has a different test in terms of level of activity (activities representing 50% or more trading for IHT, 80% or more for CGT).

4.20 There are also certain underlying statutory rules within the IHT and CGT regimes that give rise to inconsistency. An example is that of furnished holiday lettings, specifically treated as a trade where qualifying conditions are met[7] for pensions relief, loss relief, capital allowances, CGT holdover and ER purposes.

---

[7] S241 TCGA 1992

4.21 The test for BPR, however, is quite different. To qualify for BPR a business must not be wholly or mainly an investment business. Case law has held that rental activity generally constitutes the holding of an investment, and that furnished holiday lettings constitute investment activity.[8]

4.22 Advisers told the OTS that clients do not understand why an activity is treated as a trade and so qualifying for some tax reliefs (income tax and capital gains tax), but as an investment activity for other taxes, and not qualifying for an inheritance tax relief. Diversification within the farming industry has increased in recent years, particularly into areas such as holiday lettings and agricultural visitors' attractions. This distinction and possible restriction can influence business behaviour. Examples were quoted of businesses deciding against holiday lets because of the danger of losing BPR on the whole business when looked at in the round.

4.23 One example mentioned to the OTS was that of a large farm owned and run by three siblings. Two owned and managed the farming business (BPR available), while one owned and ran a substantial furnished holiday letting business (no BPR). In the context of an economy where farms need to diversify to remain profitable, the investment treatment of furnished holiday letting seems anomalous. The treatment depends on the facts in each case and BPR may still be available if more than 50% of the business as a whole is trading. Among large private trading companies, the OTS has been told that activities are monitored and constrained to remain within the provisions for BPR.

4.24 Convoluted and artificial ownership structures are sometimes adopted in an attempt to ring fence the qualifying activity from non-qualifying activities for BPR purposes.

APR

4.25 APR is also not without its anomalies.

4.26 APR is available where a farm or part of a farm is let to tenants, as long as those tenants continue to engage in relevant agricultural activities. If APR were not available when farms are let, large estates (many of which have a significant number of small tenant farmers) would be likely to re-consolidate to retain APR for transfer to the next generation. This may reduce land available for tenancy.

4.27 However, some letting activities may result in loss of relief. For example, allowing a third party to remove grass from land by grazing can prejudice APR or BPR, unless the correct type of lease is implemented – a simple grazing agreement under which the grazier may mow the grass may indicate the farmer is not in charge of husbandry of the land, while a 'profit a prendre' agreement typically will not allow the grazier to mow, and where this reflects the genuine arrangements, reliefs should be preserved.

4.28 Issues may be met on approaching retirement where the landowning farmer is less active than in the past. If the farmer does not have access to the

[8] Held recently on furnished holiday lettings in Executors of Marjorie Ross v HMRC [2017] UKFTT 507 (TC)

specialist advice necessary, a simple mistake could lead to loss of relief on the farm estate, including the farmhouse itself.

4.29 Significant increases in the value of houses and land in recent years potentially create an inheritance tax charge as APR is limited to the agricultural value of the property (the value the property would have if subject to a perpetual covenant permitting only agricultural use). This may fall short of its market value, where other prospective purchasers of farms may want to buy for reasons other than agriculture. This higher price may be obtained even where the successful purchaser intends to farm the land.

4.30 The determination of agricultural and market values is a matter for the district valuer – the Lands Tribunal determined the agricultural value to be 30% less than market value in a high-profile case, but a fixed percentage deduction is not generally considered appropriate.[9] These house price increases potentially also result in CGT liabilities, which can create a disincentive to sell.

Succession during lifetime or after death?

4.31 Passing on a business or farming estate at death is significantly more tax efficient than succession during the owner's lifetime.

4.32 A gift during one's lifetime may be exempt from IHT as a PET (assuming the transferor survives for seven years), but the recipient will not benefit from the uplift in the base cost for CGT purposes that would arise on death. Selling a business or farm during the owner's lifetime may attract ER and so be taxed at only 10% for CGT purposes, but when the owner dies the cash or other assets that do not qualify for APR or BPR will be liable to IHT.

4.33 So a sale during the owner's lifetime followed by transfer of the cash or other assets after death is potentially taxed at 46% (£100 @ 10% (ER), leaving a balance of £90, which is subsequently taxed at @40% (IHT), leaving a net balance of £54).

4.34 This differential can influence decisions such as keeping the business ticking over until the owner dies and thus retaining BPR for their successors' benefits. The OTS has been told the CGT cost uplift on death may reinforce this behaviour. While anecdotal, this evidence was convincing.

4.35 One view is that succession should be undertaken during lifetime, to ensure that businesses continue to be actively managed by people with a stake in their long-term success. One professional firm told us they typically aim to start the conversation with clients at age 55.

4.36 Hold-over relief from CGT is available for gifts, however this only defers the gain, and the disparity in taxation is significant - is it right that a person who holds on until death gets more CGT relief, as opposed to someone who sells during their lifetime?

4.37 For many committed entrepreneurs, the important issue is for the business to keep going. This could necessitate bringing in employees where family

[9] Lloyds TSB (Personal representatives of Rosemary Antrobus deceased) v Commissioners of Inland Revenue (Antrobus No.2), see https://www.gov.uk/hmrc-internal-manuals/inheritance-tax-manual/ihtm24150

members do not want to take over. The Employee Ownership Trust scheme facilitates such transfers (a sale to such a trust is exempt from CGT) and has been welcomed by advisers. However, as with all sales of shares potentially qualifying for BPR, an inheritance tax issue arises since the shares would have qualified for BPR whilst the replacement cash does not.

4.38 Where owners do not choose to hold onto the business until death, other approaches may be adopted to minimise the IHT charge on death. In addition to the option to gift the non-BPR qualifying assets and hoping to survive 7 years so that the gift falls outside the estate, other approaches are

a) Reinvesting the proceeds of selling the business in investments that continue to qualify for BPR. Annex A sets out the assets qualifying for BPR, which include unquoted shares in a company. These are defined as those not listed on a recognised stock exchange.[10] The Alternative Investment Market (AIM) was launched in June 1995, with the purpose of attracting new, small and growing companies. AIM shareholdings are regarded as unlisted for the purpose of BPR (and losses on sale of EIS/SEIS shares)[11] provided there is no secondary listing on a recognised stock exchange. Of course, this option raises the question of whether the risk of 100% of the capital is worth the saving of 40% IHT.

b) Or, as is common where there is little or no appetite for the risk of investing in AIM shares, the individual may take out life assurance cover, written in trust, to cover the IHT liability that will arise on death.

Limited liability partnerships

4.39 The OTS Partnerships Review[12] found two schools of thought existed on whether a limited liability partnership holding shares in a trading group would qualify for BPR. HMRC guidance currently suggests it does not, although this interpretation was not free from doubt, and it appears anomalous that the result would be different to that of a holding company, which specifically qualifies for BPR under the legislation.[13] IHT legislation was built on the historic capital transfer tax and death duty provisions, and may not have kept pace with modern business structures (even LLPs are relatively new, being introduced in 2000[14]) and issues such as diversification with holiday lets referred to above.

---

10 S105(1ZA) IHTA 1984

11 HMRC manuals IHTM18336

12 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/274278/PU1619_OTS_Partnerships_Interim_report.pdf

13 S105(4)(b) IHTA 1984

14 Limited Liability Partnership Act 2000

Chapter 5

Disposal or cessation of a business

Illustrative case study: MJ Business Solutions Ltd, continued

A few years later, a large UK technology company subscribes for new shares in MJ Business Systems Ltd, which then has the financial resources needed to acquire a local competitor. As a result, Steven now owns only 8% of the shares and Anita and Sonya 3% each. The investment properties were sold several years ago, and MJ Business Systems Ltd now operates as a wholly trading company.

The company moves into international markets. It opens sales offices in the United States, Japan and Germany. The company enjoys a further period of growth and takes market share from some of its multinational competitors. Two of those competitors make approaches with a view to buying MJ Business Systems Ltd. The shareholders realise that this could make them wealthy individuals. They also recognise that the company could continue to grow and become a major international player in its own right.

A cash offer is made by one potential buyer. Steven will be able to claim Entrepreneurs Relief and pay 10% capital gains tax on the first £10 million of his gain, and 20% on gains above that amount. The EIS investors and the corporate shareholders will enjoy unlimited tax-free gains (through EIS relief and Substantial Shareholding Exemption respectively). Anita and Sonya (now CEO and Chief Scientific Officer respectively) will pay 20% capital gains tax on all their gains. They do not qualify for Entrepreneurs Relief, as their respective shareholdings are below 5%.

Another offer is made consisting of a small cash element and a potentially much larger amount of contingent consideration depending on future trading results. Anita and Sonya favour this offer, because of the potential upsides. It would also defer their capital gains tax liabilities. Steven and the EIS and corporate shareholders are less keen, not least because the future contingent consideration in excess of its value at the time of sale of the company will be fully exposed to tax with no reliefs, because Entrepreneurs Relief, EIS relief and SSE are not available in respect of gains on future contingent consideration.

Another alternative is a flotation. Steven and the corporate shareholder could dispose of their shares and enjoy the tax reliefs outlined above, but pre-flotation share conversions might prevent EIS relief being available.

Anita and Sonya, as the key executives, would be expected to continue working for the company. Their shares could only be sold after future defined and commercially expedient dates, and when they might have greater opportunity for tax planning.

The commercial complexities of the decision faced by the Board and shareholders of MJ Business Systems Ltd are considerable. The different tax treatments of the shareholders in different scenarios adds to the complexity and creates conflicts of interest among them.

It is notable that the most recently-arrived shareholder, the corporate investor, enjoys the most tax advantageous exit, the EIS shareholders might or might not have a tax-free exit, and the children of the founders, especially Anita and Sonya, have the least tax-efficient exit.

5.1 The disposal of a business, or part of a business, by the founders or owners will generally fall into one of the following categories:

a) a sale of a business by its owners, or a sale of the shares of a company that is carrying on a business by its shareholders, to another person (often referred to as a "trade sale")

b) the sale of all or, more commonly, a proportion of the existing shares together with the issue of new shares for subscription, on a stock market (commonly referred to as a flotation or, in the USA, as an Initial Public Offering (IPO))

c) the cessation of a business and the disposal of its assets

d) the sale or cessation of a business owned by a company followed by the winding up of that company

5.2 Because this paper is concerned with tax charges and reliefs that affect the individual owners of a business, the sale of a business or company by a company which itself continues in business is not addressed here.

5.3 Each of the categories referred to above is considered separately below.

"Trade sale"

5.4 Businesses, or more often companies carrying on a business, are generally sold either to another company that is a competitor or other operator in the same field, to a private equity fund, or to a management buyout team.

5.5 If the business or company is purchased by a company, the motivation will normally be one or more of the following - opportunity to grow and increase market share, reduction of competition, enhanced economy of scale or vertical integration.

5.6 The relatively modern phenomenon of the private equity purchase, frequently accompanied by a management "buy in" (the imposition of new or additional management), is generally driven by a desire to grow the business to the next level with a view to another trade sale or flotation. Management buy-outs, funded either by bank borrowing or private equity, can be for job or business preservation purposes or with an objective of capital growth and future exit.

5.7 Except for a sale to an Employee Ownership Trust, the tax consequences of which were discussed in Chapter 4, the tax treatment of the vendors is not dependent on the nature of the buying entity.

5.8 The sale by the owners of a business is a disposal of one or more capital assets (either the business assets of an unincorporated business, or the sale of shares in a company) which generate a capital gain (or loss).

5.9 Those capital gains are subject to capital gains tax at 10% (within the basic income tax rate band) or 20% (above that).[1] However, a number of reliefs can significantly reduce the tax payable.

a) The individual vendor might qualify for ER. Where ER applies, any chargeable gains, up to a lifetime limit of £10m per individual, are chargeable to capital gains tax at only 10%.

b) If the shares being sold are qualifying EIS or SEIS shares, and have remained qualifying for the required minimum holding period, any gain on disposal is exempt from capital gains tax. Any gains deferred as a result of the original EIS investment become chargeable on disposal of those EIS shares. When SEIS shares are disposed of no such charges arise as 50% of gains reinvested in SEIS shares are exempted rather than deferred.

c) Employees who hold shares are indirectly part-owners of the business and may have acquired them under one of four current tax-favoured schemes whereby the initial granting of an option to acquire shares and its subsequent exercise have not given rise to any tax charge and will generally give rise only to capital gains tax on their disposal (with the exception of shares acquired under a qualifying share incentive plan). By far the most commonly used such scheme is the Enterprise Management Incentive (EMI) share scheme.[2] Employees holding such shares also enjoy, on the sale of their shares, the right to claim Entrepreneurs' Relief so long as one year has passed between the grant of the option to acquire the shares and the disposal of the shares, without having to satisfy the 5% minimum holding test that is a requirement of ER generally. The relief provides for lifetime gains up to £10m to be taxed at only 10%. However, if employee-owned shares are not qualifying EMI or employee shareholder shares, the employee is likely to be exposed, on the sale of shares, to capital gains tax without any reliefs, (unless he or she otherwise qualifies for ER by virtue of a 5% shareholding).

Observations

Rates of tax on exit

5.10 Although Entrepreneurs' Relief (ER) at 10% is less generous than the relief available to investors under SEIS/EIS, anecdotal evidence suggests that

---

[1] These rates were 18% and 28% respectively for recent years up to and including 2015/16.

[2] In 2015/16 8,610 companies were operating EMI schemes, whereas only 2,470 companies were operating any of the other tax-favoured schemes- National Statistics on the tax-advantaged employee share schemes 30 June 2017

taxpayers generally are reasonably comfortable with paying the tax at that modest rate, and indeed the tax-avoidance industry no longer provides tax mitigation solutions in this area. However, the OTS has seen no evidence that Entrepreneurs' Relief encourages further investment in new business ventures.

5.11 There is something of an anomaly between the position of a founder, who might qualify for the ER 10% capital gains rate on exit on life-time gains up to £10m, and SEIS/EIS investors who not only benefit from generous up-front income tax reliefs on their investment, but also enjoy a nil capital gains rate on exit on the totality of gains. Similarly, the sale of shares in a trading company by another company can attract 100% relief from corporation tax on chargeable gains under the Substantial Shareholdings Exemption (SSE).

Nature of consideration

5.12 Where a business, or shares in a company, are disposed of partly for cash and partly for contingent future consideration (the amount of which depends on future events such as future business performance), this has a particular effect on the tax treatment. ER/SEIS/EIS reliefs are available on the total value of consideration received at the time of the initial disposal, being the initial cash plus the value of the contingent consideration at that point: however, no such relief is available on a gain realised when any contingent consideration is paid at a later stage.

Flotations/IPOs

5.13 Flotations or IPOs represent a tiny fraction of the number of trade sales. Although statistics on numbers of trade sales are hard to come by, anecdotal and circumstantial evidence suggests that they far exceed the number of new listings on the London Stock Exchange main market and Alternative Investment Market AIM combined (generally less than 200 a year).[3]

5.14 For a company to be in a position to be listed on a stock market it is likely to have grown to a significant size and have been in businesses for some years. A decision to seek a stock market listing will generally be taken because the company wishes to embark on a programme of major expansion requiring the raising of many £millions, although the listing will often also involve the sale of some of the founder-owners' or employee-shareholders' shares.

5.15 The choice of stock market on which to list depends on factors such as size, industry sector and market sentiment. Within the UK, companies will sometimes first list on the Alternative Investment Market (AIM), with a view possibly to graduating to the London Stock Exchange (LSE) later. An alternative that has sometimes been used, for example by technology companies, is the USA NASDAQ market.

5.16 The choice of market is entirely neutral from the perspective of the capital gains tax charges and reliefs available to the shareholders who are selling shares as part of the flotation. However, a holding of shares on AIM can carry future tax advantages in terms of being able to access capital gains gift relief and investors reliefs. Shares listed on a recognised stock market such as

3 LSE Main Market Factsheets and LSE AIM-Statistics

the LSE (if they give the owner control over the company) and AIM shares can qualify for business property relief (IHT).

5.17 For the founders and SEIS/EIS shareholders, disposals of shares generally give rise to capital gains tax on the sale proceeds less original cost. However, if the one year (ER) or three year (SEIS/EIS) qualifying periods have been met, along with other qualifying conditions, these shareholders are likely to qualify for ER, SEIS relief (initial investors) or SEIS/EIS relief (second and third-round investors).

5.18 The position of employees holding shares is as set out in the Trade Sale section above.

Observations

Reliefs

5.19 The availability of tax reliefs is not a major consideration when a company looks at the possibility of a flotation/IPO.

5.20 Such business decisions generally involve the raising of very large amounts of money for the business and its shareholders. In most cases, the company will have been trading for several years so that the time requirements for shareholding for Entrepreneurs' Relief and EIS/SEIS (one year and three years respectively) will have been comfortably met. The OTS has found no evidence of companies deferring or postponing a flotation/IPO because of the personal tax position of shareholders. On the contrary, in the, albeit rare, case of a flotation/IPO opportunity arising before the three-year qualifying holding period for EIS shareholders has run its course, one would expect those EIS shareholders to forego their capital gains exemption in the wider interests of the company and its shareholders by exploiting the flotation opportunity.

5.21 Where founders and venture capital investors do enjoy capital gains reliefs on exit, there is the same anomalous position highlighted in the previous section whereby the founder, and employee shareholders under EMI, pay tax at 10% on the first £10m of gains, whereas the SEIS/EIS investors have unlimited 100% capital gains tax relief. Furthermore, an employee not within EMI is likely to pay full rates of CGT.

New investor position

5.22 The tax position of the new investor subscribing for or buying shares in a newly listed company has generally been less advantageous than that of earlier investors.

5.23 Where the company is listed on a recognised stock exchange, neither EIS nor Investors' Relief is available in respect of new subscriptions or share purchases, so that the investor receives no tax relief on investing and is fully exposed to capital gains tax on a subsequent sale of the shares. Also, because it is highly unlikely that an investor will have a material interest in the company through a 5% shareholding, Entrepreneurs' Relief will not be available on a subsequent sale.

5.24 So the tax position of the investor in the flotation/IPO is in marked contrast to all the pre-flotation shareholders (founders, later-stage investors and employee-shareholders) all of whom enjoy income tax or capital gains tax reliefs, providing an incentive to buy and sell shares.

5.25 The introduction of Investors' Relief for subscriptions from April 2016 does now enable such a subscriber in an AIM company, but not one listed on a recognised stock exchange, to be relieved from capital gains on sales of shares at least three years after subscription.

The cessation of a business owned directly by its founders and the disposal of its assets

Illustrative case study: MJ Business Systems Ltd, continued

In an alternative scenario, MJ Business Systems Ltd never becomes a major business and does not raise any external financing. Mike and Jenny's children, Steven, Anita and Sonya were instead given the shares many years ago by their respective parents.

They run the business and make a decent living out of it. The company owns three units on a local business park. One of these is occupied by the company itself, with the others being let out. The company also owns software licences that generate royalty income.

After some years, Steven, Anita and Sonya, in the absence of anyone with the skills or commitment to take over the business, decide to sell it. They are unable to find a buyer for the company and therefore decide to sell the assets of the company piecemeal. Those disposals realise gains chargeable to corporation tax in the company at 19%. The company is then wound up and the net, after-tax, cash in the company is distributed to the shareholders.

Subsequently, Steven continues to do a small amount of consultancy work for one of MJ Business Systems Ltd's previous clients. HMRC initially challenge whether the winding-up of the company is a tax-motivated avoidance scheme. The company's accountants eventually persuade HMRC that that is not the case, so that the winding-up distributions are treated as proceeds of disposal of the individuals' shares, realising capital gains. After further discussion with HMRC, the accountant has to concede that the company is, by virtue of its property holdings, not a trading company for Entrepreneurs' Relief purposes, so the shareholders' capital gains do not qualify for that relief. Accordingly all the shareholders have to pay capital gains tax at 20%.

Anita and Sonya learn from HMRC that the base cost of their shares is the original subscription price, £50 in total, because gift relief was claimed when the shares were transferred to them. The effect is that all but £50 of the distributions are taxable at 20%.

The effective tax rate on the sale proceeds of assets in the company, after corporation tax and personal capital gains tax, is nearly 35%. In addition, a large bill from the accountant is payable for his work in dealing with HMRC.

Cessation of a business and the disposal of its assets

5.26 Where the owners of an unincorporated business cease to trade, rather than sell the business or give it to successors as a going concern, any assets of the business will belong to the owner. The disposal of those business assets will give rise to chargeable capital gains. However, if the disposal is within three years after the cessation the resulting capital gains will qualify for Entrepreneurs' Relief, subject to satisfying the other conditions for the relief to apply. Accordingly gains up to £10m (lifetime allowance) will be taxed at 10%.

Sale or cessation of a business owned by a company followed by winding up

5.27 When disposing of a business owned by a company, which is in turn owned by individuals, a decision must be made whether

a) to sell the shares in the company - in which case the tax consequences discussed above under "Cessation", will apply. This means that the capital gains on the sale of shares can attract Entrepreneurs' Relief if other qualifying conditions are satisfied, or

b) to sell the business assets, with the owners then accessing the proceeds either by way of dividends or winding up the company

5.28 Incidentally, the disposal of any business assets held outside the company by the shareholder will generally qualify for Entrepreneurs' Relief.

5.29 If the decision is taken that the company should sell the assets, any gains (capital gains or income gains on disposals of intangible fixed assets such as goodwill and intellectual property) on the assets disposed of (whether by sale, or by distribution to the shareholders) are subject to corporation tax within the company, without any tax relief.

5.30 A subsequent winding up of the company will involve a distribution of the company's cash or remaining assets to the shareholders. This is treated as a disposal of the shares which potentially gives rise to a capital gain, chargeable on the shareholder. Such gains will qualify for Entrepreneurs' Relief if the qualifying conditions are met.

5.31 Accordingly, there is a double charge to tax, one in the company and one on the shareholders. Only the latter can be relieved, by Entrepreneurs' Relief.

5.32 Any assets received by a shareholder as a distribution in the course of the winding up of a company will be received at deemed full market value, so no further gains would arise in the event of an immediate disposal of those assets by the shareholder at that value. Any disposal of assets above the market value at acquisition will be subject to capital gains tax.

5.33 An anti-avoidance measure introduced in 2016 (colloquially known as the anti-phoenix rule) has the effect that the capital gains treatment of the distributions in the course of winding-up, and thus the availability of Entrepreneurs' Relief, can be denied by HMRC if the business is started up again, under the same or connected ownership, within 2 years of the commencement of the earlier winding up, if the winding up was undertaken for tax avoidance purposes. The effect of this is to reclassify the capital distributions, which would otherwise attract Entrepreneurs' Relief and so be taxable at 10%, as income distributions liable to income tax at rates of up to 38.1%.[4]

Observations

Potential double tax charge and asymmetric tax treatment of vendor and purchaser

5.34 In this situation, business owners are faced with a dilemma. From a tax perspective, a sale of shares will generally qualify in full for Entrepreneurs Relief, but a sale of assets by the company and a subsequent winding up will result in an additional tax charge in the company. However, purchasers will generally wish to buy assets from the company, rather than buy shares in it, to avoid inheriting the corporate history and to be able to claim tax reliefs (capital allowances, intangible assets allowances) on the consideration paid for plant & machinery and qualifying intangible assets.

5.35 So a tension is created between the vendor (favouring a share sale) and the purchaser (favouring an asset purchase). This tension can cause difficult negotiations and distortions in sale prices to deal with the asymmetric tax impacts. Consideration of how these difficulties and distortions could be reduced, to better facilitate commercial transactions, would be welcomed.

Anti-phoenix rule

5.36 The recently introduced anti-phoenix rule can lead to uncertainty as to how it is to be applied notwithstanding recent HMRC guidance, partly because the legislation applies a "tax avoidance motive" test, but without there being a clearance facility that would provide advance assurance.[5] The OTS understands that HMRC is in discussions with representative bodies with a view to clarifying this uncertainty.

[4] This is a rate applicable only to dividends taxable at the additional dividend tax rate, which is designed to recognise the withdrawal of the dividend tax credit from April 2016

[5] Chartered Institute of Tax letter 3 November 2017 to HMRC

Annex A

Overview of reliefs

Relief	Maximum investment or relief	Income tax relief	Capital Gains Tax relief	Inheritance Tax relief	Minimum holding period	Conditions
Incorporation	None	N/A	100% hold-over of gains (proportion where consideration only partly shares) s162 TCGA 1992.	N/A	No	Business assets (trading or investment) transferred in exchange for shares.
Seed Enterprise Investment Scheme (SEIS)	£100,000 investment per individual per annum	50% Part 5A ITA 2007	Exemption from tax on 50% of gains in tax year of disposal, if reinvested into SEIS. Schedule 5BB TCGA 1992 100% capital gains relief on disposal of SEIS shares. s150E TCGA 1992	N/A	Three years from subscription.	Trading company (property dealing, professional services etc. excluded). Maximum raised by company £150,000. Maximum value co. assets (before issue) £200,000. Max employees 25 at start. Not an employee. No substantial interest.[1]

[1] An individual has a substantial interest if he/she is entitled to more than 30% of the ordinary or issued share capital, or voting power, or the assets on a winding up of the company or any subsidiary.

Relief	Maximum investment or relief	Income tax relief	Capital Gains Tax relief	Inheritance Tax relief	Minimum holding period	Conditions
Enterprise Investment Scheme) EIS)	£1,000,000 investment per individual per annum. Increasing to £2m from 6 April 2018, where balance over £1m in knowledge intensive co. ITA 2007 Part V	30%	Deferral of gains reinvested into EIS in period one year before to three year after disposal. TGCA 1992 Sch 5B 100% capital gains relief on disposal of EIS shares. TGCA 1992 s105A	N/A	Three years from subscription.	Trading company. Maximum raised = £5,000,000 (£10 million for knowledge intensive cos). Max value assets £15m before issue, £16m after. Maximum employees 250 at outset (500 for knowledge intensive cos). Not connected.[2]
Venture Capital Trusts (VCTs)	£200,000 per individual per annum. ITA 2007 Part 6	30% No income tax on dividends.	100% capital gains relief on disposal of VCT shares. TCGA 1992 s151A	N/A	Five years from subscription (except CGT disposal relief).	Must invest in qualifying companies (same characteristics as EIS qualifying companies)
Gift Relief	None	N/A	Hold-over of whole gain until later disposal by transferee. If gift is a sale at under value, any consideration in excess of base cost is liable for CGT with the balance held over. TCGA 1992 s165	For transfers into trust where IHT is chargeable on the transfer, whole gain held over until later disposal by the trustees. See also APR and BPR below. TCGA 1992 s260	None	Assets used in a trade. Unquoted shares in trading co./ group or quoted shares in personal trading co./ group co. No substantial[3] non-trading activity. Agricultural property. (Applies to CGT relief only.)

2 An individual is connected for these purposes if he/she, together with associates, is entitled to more than 30% of the ordinary share capital, loan capital or voting power of the investee company, or subsidiary, or is an employee, partner or director of the company, unless an unpaid director or a business angel.

3 HMRC guidance sets out that the test is a measure of the company's activities, whereby substantial means more than 20%, measured against some or all of: income, assets, expenses incurred or time spent by employees, company history.

Relief	Maximum investment or relief	Income tax relief	Capital Gains Tax relief	Inheritance Tax relief	Minimum holding period	Conditions
Entrepreneurs' Relief	Maximum qualifying gains £10 million in individual's lifetime.	N/A	Capital Gains Tax charged at 10%. s169H-SA TCGA 1992	N/A	One year	Trading company definition as for gift relief. Minimum 5% holding of shares + voting rights in a company, and an employee/officer of the company (5% rule need not apply for EMI shares).
Investors' Relief	Maximum qualifying gains £10 million in individual's lifetime.	No	Capital Gains Tax charged at 10%. s169VA-VY TCGA 1992	N/A	Three years from subscription	Trading company definition as for gift relief.
Transfer/sale to Employee ownership trust	None	N/A	Exempt from Capital Gains Tax (trustees will take on original cost). Schedule 37 FA 2014	N/A	None	Trading company definition as for gift relief. Trust for benefit of employees. Trust acquires (and retains) controlling interest. Continuing shareholders not more than 40% of employees.

Relief	Maximum investment or relief	Income tax relief	Capital Gains Tax relief	Inheritance Tax relief	Minimum holding period	Conditions
Agricultural Property Relief (APR)	None	N/A	N/A	100% (or 50% if no right to vacant possession within one year) of agricultural value. Part V Chapter II IHTA 1984	Two years, or 7 years if tenanted	Land and buildings used or occupied for agriculture; relief is on agricultural value.
Business Property Relief (BPR)	None	N/A	N/A	100% of value of a business or shares in unquoted trading company. 50% on controlling interest of quoted company or assets held outside but used by a business. Part V Chapter I IHTA 1984	Two years	Wholly or mainly (50%+) trading – i.e. not wholly or mainly investment.
Enterprise Management Incentive (EMI)	£250,000 per employee	No income tax on exercise provided at least option value is paid. Schedule 5 ITEPA 2003	ER at 10% on lifetime gains up to £10m, provided at least one year from grant to date of disposal.	N/A		Trading company (property dealing, professional services etc.) excluded. Company assets no more than £30m.

Annex B

Take-up and costs of reliefs

Year	2013-14		2014-15		2015-16		2016-17		Notes
Relief	Number of claimants 000s	Relief £millions	Number of claimants 000s	Relief £millions	Number of claimants 000s	Relief £millions	Number of claimants	Relief £millions	
Income tax									
VCTs	13.5	130	13.1	120	13.3	*130*	*	*165*	Individual subscriptions (not investors)
NB actual nos, not 000s	66		57		45		38		No. of trusts (ie investment vehicles)
EIS	124	450	155	480	176	*455*	*	*375*	Individual subscriptions (not investors)
	2.8		3.4		3.5		*		Claimant companies
SEIS	33	85	33	85	30	*85*	*	*95*	Individual subscriptions (not investors)
	2.1		2.4		2.4		*		Claimant companies
Capital gains tax									
Entrepreneurs relief	43	2700	47	3500	*	*4200*	*	*2400*	
		2000		2500					Net relief after losses etc
EIS		*115*		*120*		*100*		*60*	
SEIS		*5*		*5*		*5*		*5*	
VCT		*15*		*15*		*15*		*10*	
Inheritance tax									
APR on death	2	395	1.8	*435*	*	*510*	*	*500*	
BPR on death	2.6	580	2.6	*575*	*	*690*	*	*655*	
Transfers to charities on death	9	640	9.5	*620*	*	*790*	*	*810*	
* No data available at this time									

Source: HMRC. See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/675345/Dec_17_Main_Reliefs_Final.pdf

Annex C

List of observations

Start-up and Incorporation

1 The absence of any immediate tax relief for the capital contributed by the start-up owner contrasts sharply with the plethora of tax reliefs that are available to subsequent investors. (Paragraph 2.3)

2 The capital gains relief on incorporating a company is generally well-known and understood by professional advisers, but it is less well understood by business people. Significant professional fees are often incurred, by businesses that can least afford such costs at the early stages of development, to undertake tax-free incorporations. (Paragraph 2.6)

3 A company's annual return and accounts can be submitted to both Companies House and HMRC from the same portal (although it is necessary to input many of the figures twice). However, the anticipated one-stop shop for registering a limited company, as proposed in the OTS small company report, has not (yet) materialised. (Paragraph 2.16)

Financing for growth

Structural

4 The complex rules for SEIS mean that the administrative burden to obtain SEIS status is disproportionately large. The advisory fees involved in putting an SEIS scheme in place are significant compared to the level of investment allowed. (Paragraph 3.34)

5 The SEIS limit of £150,000 per company is considered by some advisers to be too small, whereas some investors think the limit is too high. There is also a perception that SEIS has created a competitive market in high-tech start-ups, driving up demand for and thus salaries of qualified specialists. (Paragraph 3.35)

6 There are various reasons for the relatively small amounts invested annually in VCTs, as compared to SEIS/EIS investments, including less generous entry capital gains tax reliefs and the different profile of the type of investor VCTs attract. (Paragraph 3.36)

7 The role of VCTs is not as well recognised within the business community seeking finance as SEIS and EIS. VCTs have historically invested in more mature companies and have also tended to attract a different type of investor. However, recent changes requiring VCTs to focus on investing in companies whose objectives do not include capital preservation might cause them to compete in the market traditionally occupied by EIS. The absence of entry roll-

over relief and the longer holding period required for income tax relief will continue to make VCTs less attractive to some potential investors. Further clarification of and focus on the role of VCTs would be welcomed. (Paragraphs 3.37 and 3.38)

8 The absence of any entry relief for corporate investors in venture capital appears to have virtually shut down this potential source of investment. The recent relaxation of the SSE rules, whereby the investing company no longer needs to be a trading company or a member of a trading group might encourage more activity. Further encouragement by way of an entry relief might free up this potential source of venture capital. (Paragraphs 3.39 and 3.40)

9 Some individual investors who invest in small or early stage start-ups can put at risk the EIS relief they and other investors might be entitled to. This is a risk in cases where the investors provide their expertise to the company in which they have invested, and are rewarded for their services. The possible loss of tax reliefs can discourage individuals from contributing their time in this way. (Paragraphs 3.41 to 3.43)

Administrative

10 Investors in some SEIS, EIS and VCT schemes often have to wait a long time to receive the documentation needed to claim tax reliefs. The OTS considers that the administration of the schemes would benefit from an in-depth review with a view to identifying options to streamline the process. (Paragraph 3.44)

11 There appear to be instances of long delays in the advance assurance process, under which companies can receive conditional agreement from HMRC that they qualify for EIS or SEIS. Recent efforts by HMRC to speed up the process are welcome. The OTS considers that the public-facing guidance on information needed for a successful application should be fully updated. The OTS also suggests that HMRC consider whether the advance assurance process could be automated, so that assurance on straightforward applications could be obtained instantly. (Paragraphs 3.45 to 3.49)

12 The records that a SEIS/EIS investor needs to maintain are quite extensive if both income tax and capital gains deferral relief is claimed. Ideally, it might be helpful for both taxpayers and HMRC if a shared, permanent, workspace could be established in the personal tax account. (Paragraph 3.50)

Technical Complexity

13 The complexity of SEIS and EIS reliefs means it is challenging for the potential investee companies and most professional advisers (outside the specialist/niche advisors or dedicated departments of large accounting firms) to understand them comprehensively. The differences between the reliefs, and thus the choices available to investors and investees, inevitably leads to complexity and uncertainty. (Paragraphs 3.51 and 3.52)

14 Companies frequently fall foul of the SEIS/EIS rules either before or after initial approval has been granted because they don't understand all the complexities, or unintentionally take actions that can cause them to lose their EIS/SEIS status. The OTS understands from HMRC that some such challenges could be alleviated with legislative changes to allow HMRC to intervene in

cases where this would support valid applications. The OTS would welcome such changes. (Paragraphs 3.53 and 3.54)

15 The qualifying holding period required to retain tax relief on SEIS/EIS shares can disincentivise venture capital shareholders from agreeing to company sales or takeovers. While some relief has been introduced for share-for-share acquisitions, it might be worth looking at whether other events (for example, acquisition by a third-party company within three years of issuing EIS shares, consolidations and share reorganisations) could be treated as not prejudicing the available tax reliefs. (Paragraphs 3.55 to 3.57)

16 The interaction between Entrepreneurs' Relief and EIS can present problems to founder shareholders. If an EIS investment reduces a founder shareholder below 5%, he or she will lose entitlement to ER on sale of shares. The same issue arises when a private equity investor has invested say 75% of equity, leaving little or no room for second stage financing that won't prejudice founders Entrepreneurs relief. In the November 2017 Budget, the Government announced a consultation on options to address these problems and the consultation was launched at Spring Statement 2018: the OTS welcomes this. (Paragraphs 3.58 to 3.61)

17 The involvement of PE houses or venture capital funds can also adversely impact the availability of tax reliefs for employee shareholders who have been awarded shares/options under tax favoured schemes. (Paragraphs 3.62 and 3.63)

Succession (passing on a business)

Lifetime transfers

18 The interaction between gift relief and Entrepreneurs' Relief (ER) can be complex, and decisions on which relief to claim can only be taken properly in the full knowledge of the future plans of the recipient of the gift. The potential jeopardy of claiming hold-over relief when a claim to ER would have been more appropriate could be alleviated by allowing the ER period of ownership condition for the recipient to take account of the period of ownership of the transferor. (Paragraphs 4.7 to 4.10)

19 Gift relief may also be impacted by subsequent actions of the recipient. For example, property qualifying for BPR at the time of transfer will not qualify for relief in cases where the transferor dies within seven years of the gift if the recipient has sold the property in the meantime. (Paragraph 4.11)

Transfers on death

20 Aligning definitions and treatment of the same business activities for CGT and IHT purposes would represent a significant simplification. In particular, the difference between a "trading company" for CGT purposes, and "relevant business property" for IHT BPR purposes, can lead to misunderstanding. (Paragraphs 4.18 to 4.22)

21 Convoluted and artificial ownership structures are sometimes adopted in an attempt to ring fence qualifying and non-qualifying activities for IHT BPR purposes. (Paragraph 4.23)

22 APR is available where a farm or part of a farm is let to tenants, as long as they continue to engage in relevant agricultural activities. If APR were not available when farms are let, large estates (many of which have a significant number of small tenant farmers) would be likely to re-consolidate. (Paragraph 4.26)

23 Significant increases in the value of houses and land in recent years potentially create an inheritance tax charge, as APR is limited to the agricultural value of the property. This may fall short of its market value. (Paragraphs 4.29 and 4.30)

24 Passing on a business or farming estate at death is significantly more tax efficient than succession during the owner's lifetime. (Paragraphs 4.31 to 4.38)

25 IHT legislation has not always kept pace with modern business practices. One particular example is that of a limited liability partnership, where there is uncertainty whether such a body holding shares in a trading group would qualify for BPR. (Paragraph 4.39)

Disposal or cessation of a business

Trade sale

26 Evidence suggests that taxpayers generally are comfortable with paying the tax at 10% where Entrepreneurs' Relief (ER) is available. However, the OTS has seen no evidence that Entrepreneurs' Relief encourages further investment in new business ventures. (Paragraph 5.10)

27 There is an anomaly between the position of a founder, who at best can claim ER and pay capital gains tax at 10% on realised gains, and other shareholders such as SEIS, EIS and corporate investors, all of whom can enjoy tax-free capital gains on disposal. (Paragraph 5.11)

28 Where a business, or shares in a company, are disposed of partly for contingent future consideration ER, SEIS and EIS reliefs are available on the total value of consideration received at the time of the initial disposal, but no relief is available on a gain realised when any contingent consideration is paid at a later stage. (Paragraph 5.12)

Flotation/IPO

29 The availability of tax reliefs is not a major consideration when a company looks at the possibility of a flotation/IPO. The OTS has found no evidence of companies deferring or postponing a flotation/IPO because of the personal tax position of shareholders. (Paragraphs 5.19 and 5.20)

30 The tax position of the new investor subscribing for or buying shares in a newly listed company is generally less advantageous than that of earlier investors. (Paragraphs 5.22 to 5.25)

Winding Up

31 A sale of shares will generally qualify in full for Entrepreneurs Relief, but a sale of assets by the company and a subsequent winding up will result in an additional capital gains tax charge in the company. A tension is created

between the vendor (who wants to sell shares) and the purchaser (who wants to buy assets and thus obtain more tax relief, and also to avoid any potential liability from acquiring the company). This can cause difficult negotiations and distortions in sale prices to deal with the asymmetric tax impacts. (Paragraphs 5.34 and 5.35)

32 The recently introduced anti-phoenix rule can lead to uncertainty as to how it is to be applied notwithstanding recent HMRC guidance, partly because the legislation applies a “tax avoidance motive “test, but without there being a clearance facility that would provide advance assurance. The OTS understands that HMRC is in discussions with representative bodies with a view to identifying options to reduce this uncertainty. (Paragraph 5.36)

Annex D

Organisations and people consulted

Association of Tax Technicians

Association of Chartered Certified Accountants

BDO LLP

Bishop Fleming Chartered Accountants

Country Land and Business Association

Deepridge Capital LLP

Deloitte LLP

Federation of Small Business

FTI Consulting

HM Revenue & Customs

HM Treasury

Institute for Family Business

Institute of Chartered Accountants England & Wales

Institute of Chartered Accountants Scotland

Kathleen Russ

London Stock Exchange Group

Philip Hare Associates

Richmondgate House (chartered accountants)

Scale -up Institute

UK200 Group