ICAEW

REPRESENTATION 49/18

FINANCING GROWTH IN INNOVATIVE FIRMS: ALLOWING ENTREPRENEURS' RELIEF ON GAINS BEFORE DILUTION

Issued 11 May 2018

ICAEW welcomes the opportunity to respond to the financing growth in innovative firms: allowing entrepreneurs' relief on gains before dilution consultation published by HM Treasury and HMRC in March 2018.

This response of 11 May 2018 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, ICAEW Tax Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

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MAJOR POINTS

1. We welcome the opportunity to comment on the consultation document allowing entrepreneurs' relief on gains made before dilution published by HMT and HMRC in March 2018.

2. Entrepreneurs' relief (ER) is a very valuable relief to investors and we are pleased that the government is looking at ways to ensure the availability of the relief is not lost due to factors beyond the investor's control.

3. This consultation document highlights the need to consider the 5% test that must be met in order to secure ER for shareholders in a trading company, and presents an opportunity to consider a number of questions about the policy behind ER. In particular:

    a. We would like to seek to understand the policy reason why the individual must hold 5% of the shares of a company to demonstrate that they are an entrepreneur.

    b. It is unclear why the legislation differentiates between shareholders of a company and partners in a partnership, as partners do not have any minimum holding requirements, which discriminates against shareholders of companies.

    c. There is no requirement for holders of EMI options to own 5% of the shares in the company, which effectively means that the shareholders that are being genuinely entrepreneurial are at a disadvantage compared to holders of EMI options, who are generally only employees.

    d. There is no requirement for an individual to meet the 5% test to secure investors' relief which, on the face of it, puts entrepreneurs' at a disadvantage.

4. We have significant concerns about the proposal put forward. Specifically we are concerned that it may not deliver the stated policy objective of ensuring that "entrepreneurs are not discouraged from seeking external investment to finance business growth in circumstances where their own shareholding becomes diluted."

5. The crux of the current issue is that the entrepreneur may eschew further funding because he will lose his entitlement to ER on a future disposal of his shares. Rather than addressing this the proposal put forward appears to only 'lock in' ER on the minority discount value of his shares when in reality any exit event is likely to mean the entrepreneur receives full value.

6. If the shares have a minority discounted value today of (say) £5 per share, an (unanticipated) sale of 100% of the company tomorrow would likely see the individual receive full value of (say) £20 per share. Thus, even if this proposal is brought forward, the choice facing the entrepreneur today would be:

    a. Take on additional funding and lock in a minority discounted value of (say) £5 per share which will qualify for ER; or,

    b. Do not take the funding and, even if there is no growth in the interim, receive £20 on a sale all of which qualifies for ER.

7. It is not clear to us that the proposal removes the disincentive sufficiently that entrepreneurs will always seek appropriate external investment when this would be commercially beneficial. As such, the policy objective will not be wholly fulfilled and this will be a wasted opportunity.

8. We are also concerned that the proposal put forward in the consultation document is too complex. Apart from the elections and claims required, it appears that shareholders will also be required to obtain share valuations. This is an expensive process and the professional fees may of obtaining a valuation, in some cases, wipe out any tax benefit.

9. For the reasons set out above we do not think that the proposal put forward in the consultation document is viable. A simpler alternative is required. Two such possibilities are explained in paragraphs 10 and 11.

10. Time apportionment of the gain arising on the eventual disposal of the shares would be far simpler. It would remove the need for the shares to be valued at the time of dilution and there would be no need for the taxpayer to make any elections. It would also mean that the disincentive arising from the minority discount point discussed in paragraph 6 would fall away.

11. Another (simpler and fairer) alternative would be a look-back mechanism similar to the substantial shareholding exemption test. This could, for example, allow the individual to qualify for ER provided they held say x% in the last z years. This would also allow individuals who sell their shares piecemeal to benefit from the relief.

12. If the share valuation approach proposed in the consultation document is taken forward, such that our alternative suggestions will not be considered, we would suggest that the external investment effectively fixes the value for these purposes. For example, one extrapolates such that, an external investment of £2m for a 25% shareholding is taken to mean that the company is worth £6m immediately before the investment, and therefore 5% is worth £30k, with no discount for a minority holding. However, there may still be problems with this approach in some cases as many companies have share structures which are not simple enough to allow such an extrapolation to take place.

13. As a final point, while we welcome the government's proposal to alleviate the unanticipated effects of the 5% ER threshold on capital raises, and while raising capital is clearly important and central to the issue of financing growth, dilution below 5% also poses an impediment to other commercially attractive behaviour that the government wishes to promote.

14. The most obvious examples are employee share schemes and share option schemes.

15. Other commercial activities which are potentially prejudiced by the 5% threshold include converting shareholder or 'friendly' debt to equity – this can often be a requirement for grant applications or raising third party debt finance.

16. We would therefore welcome, contrary to paragraph 4.10 of the consultation document, an expansion of the scope of the proposed change such that all dilutions below the 5% threshold are included subject to an overriding commercial test and/or anti-avoidance test (ie, a wider class of dilutions are protected than the proposal at paragraph 4.10).

RESPONSES TO SPECIFIC QUESTIONS

Making an election to crystallise gains

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

17. The availability of ER is very valuable to investors and many deals will be structured to ensure that the relief is available now or on the future share disposal. We are aware that where companies require equity investment to grow the business and have few other options available, it is probable that they will raise finance regardless of the ER impact. However this does appear to be the minority, and in those circumstances where the loss of ER may act as a barrier to growth, then the elective disposal and reacquisition approach is helpful. However, as mentioned above it does not go far enough.

Making a claim to defer the gain

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

18. We think the new facilities may be used fairly frequently, although the fact that ER is only gained on the value up to the point of dilution means that, for those taxpayers where the loss of ER may act as a barrier to growth, they are still potentially going to be incentivised to either resist the dilutive financing or to undertake some form of tax planning or restructuring in order to ensure that ER remains available going forwards.

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

19. We believe it would be unlikely that an individual would wish to pay tax when they have not sold any shares, and therefore that making a claim to defer the gain is likely to be favoured by virtually all taxpayers. This is especially so given the proposals regarding the offset of losses whereby a deferral will allow any loss to be offset whereas paying the tax upfront would not.

20. On this basis, to avoid an unnecessary administrative burden our view is that the deferral of the gain should be automatic (with an opt out possibility) rather than the taxpayer being required to make a claim.

21. We would have thought that the only taxpayers who may not wish to defer their gains are those who are concerned that the tax law will change in the period between the dilution and the exit event and result in their deferred gain being taxed at a higher rate.

Q4: Are there circumstances in which electing to be treated as having disposed of shares, or allowing an individual to defer the gain would not remove the obstacle to refinancing?

22. There could be numerous circumstances where this would not remove the obstacle to financing. For example, the refinancing and dilution may occur at a time before the company's shares have accrued significant value (after all it is seeking finance in order to grow), so the deemed disposal and deferral at the time of dilution may not materially change the tax position on exit if it is envisaged that the company will only be sold when it is worth say ten times the value at the point of dilution.

23. This is a key issue with the proposed changes, and links back to our wish to understand the 5% requirement for shares, which is not replicated for unincorporated businesses.

Interaction with trusts

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

24. We do not believe that trustees represent a significant proportion of investors losing entitlement to ER as a result of dilution.

25. However, any changes introduced should be extended to include trustees too.

Accrual of the deferred gain

Q6: Do you foresee challenges around keeping track of deferred gains so as to ensure they are correctly notified to HMRC when they are treated as accruing?

26. Yes. Obtaining historic information from clients can be difficult, in particular where elections have been made.

27. To overcome this, we recommend adopting a time apportionment method instead. Information regarding the ownership of shares could be easily obtained from Companies House without having to rely on clients to provide information. It would also remove the need to value the shares at the time of dilution.

Q7: Do you agree that accrual of the deferred gain should be linked to a disposal of shares or securities equal in number to those in respect of which the gain was computed?

28. Yes, this would appear to be the simplest approach and would ensure that the taxpayer had sufficient proceeds to pay the tax charge on the deferred gain.

29. Consideration should be given to the treatment of the deferred gain (and the calculation of the correct number of shares) in the event of any reorganisation or reduction of a company's share capital, as well as any share exchange or scheme of reconstruction.

Interactions with associated disposals

Q8: Do companies which raise capital by means of issuing new shares commonly use assets owned privately by their shareholders? Will the effect of these proposals be significantly reduced by excluding private assets from their scope?

30. We are not aware of significant numbers of companies in this scenario, therefore would not consider that excluding private assets from the scope of these provisions would significantly reduce their effect.

Determining the time of dilution

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

31. Yes

Conditions to prevent abuse

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

32. This condition appears somewhat restrictive. Whilst we are aware that the provisions are targeted at finance raising, we would suggest there are other legitimate circumstances where dilution happens and minority shareholders' ER position should be protected in the same way, as they are no less entrepreneurial, and are taking no less risk, as a result of their shareholding being diluted.

33. For example the exercise of employee share options may dilute a shareholder to below 5%, as might the conversion of some shareholder debt into equity for commercial reasons.

34. Perhaps if the present policy approach is to be adopted, ER should be preserved for the period before any dilution (time apportioning the eventual gain), subject to an overriding tax avoidance motive test.

Assessment of impacts

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

35. No.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

- Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
- Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
- Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
- Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
- Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
- Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
- Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
- Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
- Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
- Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see https://goo.gl/x6UjJ5).