



Response from ICAS

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

14 May 2018

About ICAS

1. The following submission has been prepared by the ICAS Tax Board. The Board, with its five technical committees, is responsible for putting forward the views of the ICAS tax community, which consists of Chartered Accountants and ICAS Tax Professionals working across the UK and beyond, and it does this with the active input and support of over 60 committee members. The Institute of Chartered Accountants of Scotland ('ICAS') is the world's oldest professional body of accountants and we represent over 21,000 members working across the UK and internationally. Our members work in all fields, predominantly across the private and not for profit sectors.

General comments

2. ICAS welcomes the opportunity to respond to the consultation "Financing growth in innovative firms: allowing Entrepreneurs' Relief on gains before dilution" published on 13 March 2018.
3. We broadly welcome the proposal, but it is only likely to have a limited impact, in part due to the decision not to extend relief to gains following loss of eligibility. In view of the comments in paragraphs 1.7 and 2.5 of the consultation document we assume that more radical changes have been ruled out on cost grounds.
4. The government notes that it recognises the importance of Entrepreneurs' Relief (ER) to claimants and wants to improve targeting and the value for money it provides for the taxpayer. However, it is questionable whether these aims will be achieved by piecemeal changes of the type currently proposed. Other problems, such as the dilution of shareholdings due to conversion of loan capital, will not be addressed by this proposal. It is also proposed that trustees should be excluded from the ability to make an election. There will be an increase in complexity and the introduction of further distinctions between different types of claimant – both of which we believe are unhelpful.
5. A more radical way of addressing the concerns noted in paragraph 1.4 and Chapter 2 of the consultation document and of simplifying ER – which would also address other dilution issues (and would not exclude trustees) - would be to remove the minimum 5% shareholding requirement for ER. Investors' Relief (introduced by Finance Act 2014 and intended to encourage investment in unquoted trading companies) does not require any minimum shareholding. There is therefore a case for removing the requirement from ER. Removal of the 5% requirement would also align the ER treatment of share disposals more closely with the treatment of partners disposing of their business and with the treatment of employees in the Enterprise Management Incentive scheme.
6. Removing the 5% shareholding requirement would have cost implications. In this context we note recent comments from the Office of Tax Simplification (OTS) about ER in its [Business Lifecycle Report](#) highlighting that the cost of tax relief on claims to ER is greater than that of any of the other reliefs considered in the report and questioning whether ER meets the objectives of encouraging investment in young and growing businesses, or preserving existing business from break-up.
7. We agree with the OTS conclusion that 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 maximise economic opportunities and to make the system clear and simple to understand and use. This review should include a review of ER, including a cost benefit analysis and consideration of whether targeting could be improved.

Specific questions

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

8. Yes, but only to a limited extent. Under the proposal ER will not be extended to any gains that follow the loss of eligibility. It is likely that in most cases additional shares will be issued in the expectation that this will lead to significant future growth. The prospect of obtaining ER on the small(er) gain before the loss of entitlement may not be enough to remove the disincentive to seeking finance to grow.
9. As noted in our general comments the proposal also only addresses one of a number of issues arising from the 5% shareholding requirement. This will also limit its usefulness.

10. There is no comment in the consultation document on the valuation issues which are likely to arise in calculating the gain to be deferred. We believe that valuation will present significant challenges because of the difficulty in valuing start-ups. Lack of certainty about the correct value of the shares (and hence the amount of the gain to be deferred) might act as a deterrent to potential users of the election.
11. Claimants are likely to wish to argue for a high valuation to maximise the deferred gain. There is no explanation of the mechanism (if any) which will be used to establish/agree the deferred gain with HMRC. Would post-transaction valuation checks (CG34) be available once the new shares have been issued, so that the claimant can check the valuation and hence the amount of the deferred gain included in their self assessment return? What will happen if agreement cannot be reached on the valuation? It is important that the calculation is agreed at the time of the election to avoid the risk of an HMRC challenge years later, when the deferred gain is treated as accruing; as noted in paragraph 3.4 of the consultation document, important information (such as valuations) will be more easily available at the time of the election.

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

12. The elective disposal and reacquisition process might be particularly relevant to sectors which require large cash injections in order to grow – for example technology and life sciences. However, as noted above its usefulness in removing barriers to growth may be limited.

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

13. It seems very unlikely that taxpayers will not claim deferral of the gain. Many will not have funds to pay the 'dry' tax charge and even where they do, the proposed treatment of any subsequent losses would be a significant deterrent to crystallising the gain at the time of the election.
14. It might therefore be simpler to make deferral the default option in the legislation – with the possibility of electing for immediate crystallisation instead. As noted in our response to Question 1 there will need to be a clear process for agreeing the amount of the deferred gain with HMRC at the time of the election.

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

15. See our general comments and our responses to Questions 1 and 2 above.

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

16. If the government decides to proceed with implementation of this proposal we believe that it should be extended to cover trustees. We do not support the introduction of additional distinctions between different types of ER claimants.
17. We note the comments in paragraph 4.2 of the consultation document that the inclusion of trustees would result in complexity. However, as set out in our general comments this type of piecemeal change adds to complexity anyway.
18. Removal of the 5% shareholding requirement would be a simplification of ER and would more closely align the treatment of different types of claimant. It would also be more likely to address the problems which have given rise to the consultation.
19. As noted in our general comments we recognise that this would have cost implications, so we support a broader review of ER, including a cost benefit analysis and consideration of improved targeting.

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

20. There are other deferral mechanisms in TCGA 1992: we do not anticipate that this deferral mechanism would give rise to any challenges beyond those which exist for the others. As noted in our response to Question 1 above, a process for agreeing valuations and the amount of the deferred

gain with HMRC at the time of the election will need to be in place, to ensure that disputes do not arise years later when the evidence will no longer be readily available.

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

21. Yes. We agree that a proportionate part of the deferred gain should be brought into charge on the disposal of some of the rebased shares, as illustrated in the worked example in paragraph 4.5 of the consultation. Where further shares have entered the pool, after dilution and before a disposal, we also agree that the proportion of the deferred gain brought into charge should be calculated by reference to the number of shares in respect of which the crystallised gain was computed – as illustrated by the example in paragraph 4.7 of the consultation.

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

22. We have no comments on this question.

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

23. Yes.

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

24. As noted in our general comments there are other circumstances where dilution of shareholdings may arise in commercial circumstances – which would not be within the scope of the proposed election. This will restrict the usefulness of the proposed election.

25. We have not identified any other conditions which might be necessary to prevent abuse. However, we believe there will be difficulties in agreeing share valuations for the calculation of the deferred gain, as discussed in our response to Question 1.

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

26. No.