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Ms Beth Andrews
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15 May 2018

Dear Ms Andrews,

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

We welcome the opportunity to respond to the government's proposals to allow Entrepreneurs' Relief on gains before dilution.

The Quoted Companies Alliance Tax and Share Schemes Expert Groups have examined your proposals and advised on this response. A list of members of the Expert Group is at Appendix A.

Although we welcome proposals to reform Entrepreneurs' Relief which encourage investment in small and mid-size quoted companies, we do not consider that the proposed reforms sufficiently incentivise or reward entrepreneurs who, with significant initiative and risk, play a key role in building and growing a business.

We believe that a simpler and fairer approach would be to allow tax payers to qualify for Entrepreneurs' Relief if they satisfy the 5% shareholding condition for 12 months at any time in the previous six years.

We have responded below in more detail to the specific amendments from the point of view of our members, small and mid-size quoted companies.

If you would like to discuss our response in more detail, we would be happy to attend a meeting.

Yours sincerely,

Tim Ward
Chief Executive

Response

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

We welcome any proposal seeking to reform Entrepreneurs' Relief in a way which encourages investment and business growth in the UK. However, we do not consider that the proposed reform goes far enough in incentivising and rewarding entrepreneurs who, with significant initiative and risk, play a key role in building and growing a business.

We fail to see why individuals who have either (a) participated as a founder shareholder; (b) invested in; or (c) acquired shares at a crucial time in the early stage of a business and have since been, and remain, involved in the growth of that business as a director or an employee, should not benefit from a lower capital gains tax rate of 10% in the same way as external investors who qualify for Investors' Relief or EMI option-holders, or members of an LLP who qualify for Entrepreneurs' Relief regardless of the extent to which their shares have been diluted below 5%.

Whilst the proposed reform allows such individuals to benefit from Entrepreneurs' Relief on gains up to the point at which they are diluted below 5%, a significant proportion of the growth in a company's value could take place following this dilution. If the individual continues to be involved with the business as a director or employee, and the possibility of further growth of the business only arises as a result of the initiative and risk taken by the individual at the beginning of the lifecycle of the business, we believe they should also be able to benefit from the reduced 10% rate in respect of the future gain. The loss of the 10% rate to a significant proportion of any ultimate gain will still act as a barrier to growth for some firm.

For the reasons set out below, we also consider that the proposed approach would add considerable complexity, including in relation to obtaining relevant valuations (and disadvantage taxpayers who were not able to obtain professional tax advice).

A simpler and fairer approach (if it is not possible to remove the 5% requirement entirely so as to level the playing field as set out above), would be to introduce an approach similar to that recently adopted in respect of the substantial shareholding exemption – such that taxpayers could qualify for Entrepreneurs' Relief if they had satisfied the 5% shareholding condition for 12 months at any time in the previous six years.

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

If taxpayers are properly advised (and provided that it is possible, as proposed, to claim deferral of the gain until eventual disposal of the shares) then, in most circumstances where a taxpayer will be diluted below 5% following an investment, we anticipate that they would make the election to crystallise the gains made prior to dilution, particularly where there have already been significant gains made on the shares.

However, we are concerned that taxpayers who cannot afford expensive legal advice may be unaware of the need to make the election. In the context of a transaction which did not in fact involve any disposal of their shares, they may not even notify their individual tax advisers that the further investment has taken place.

We believe that a better approach would be for the crystallisation and hold over of the gain to occur automatically but with an option to elect otherwise if, in the particular circumstances this gave a better outcome.

However, we question whether there would be an assumption that the value of the shares was the price implied by the third party investment, or if a separate valuation exercise would be required. The valuation exercise could be fairly simple, where investors are subscribing for the same class of shares as the taxpayer. However, more complexities would arise where investors are subscribing for different classes of shares. In such a case, the proposed route may require an expensive valuation exercise to be undertaken at a time when the taxpayer and the company would be better focussed on the continued growth of the business.

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

We consider that if the deemed disposal and reacquisition route is adopted, then there should be automatic deferral of the gain. We have not identified any circumstances where we would envisage that a taxpayer would elect for deemed disposal and reacquisition but not then claim deferral of the gain.

We cannot see why taxpayers would choose to pay the "dry" tax charge, in particular where there was no prospect of setting any subsequent losses off against that gain if the shares subsequently fell in value.

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?

See comments above.

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

Given the constituency we represent, we do not regularly come across issues relating to the loss of Entrepreneurs' Relief by trustees.

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

We consider that the challenges are more likely to relate to whether taxpayers are sufficiently well advised in the first place so as to be aware of the need to make the election and claim for deferral, and (potentially) around valuation.

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

We can see the logic in linking the amount of the deferred gain brought back into charge to the shares held at the time of the dilution which triggered the deferred gain, as they are being held in a separate ring fenced pool and treated as being the first shares subsequently disposed of.

However, we question whether the same approach applies from a base cost perspective (i.e. will the assumption also be that the first shares disposed of represent the original shares with the uplifted base cost obtained at the time of the deemed disposal and reacquisition), or whether the normal share pooling rules would apply.

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?

We have no comments.

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

Yes – we agree that this should be the time of the deemed disposal and reacquisition.

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

We are not aware of any circumstances where the capital raising condition would be problematic; nor do we consider other conditions being necessary to prevent abuse.

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

As we mentioned in our answer to Q2, the added complexity does disadvantage taxpayers who, for whatever reason, are not in a position to obtain professional tax advice.

APPENDIX A

Quoted Companies Alliance Tax Expert Group

Paul Fay (Chair)	**Crowe Clark Whitehill LLP**
Peter Attridge	Beavis Morgan LLP
Ray Smith	Clyde & Co LLP
Sam Dames Nick Burt Mark Joscelyne	CMS
Daniel Hawthorne	Dechert
Hannah Jones	Deloitte LLP
Emma Bailey	Fox Williams LLP
Holly Edwards	Frontier Developments PLC
Douglas Tailby	Grant Thornton UK LLP
Mark Allwood	haysmacintyre
Peter Vertannes	KPMG
Matthew Rowbotham	Lewis Silkin
Catherine Hall	Mazars LLP
Alex Barnes	Memery Crystal LLP
Tom Gareze	PKF Littlejohn LLP
Emma Locken	PricewaterhouseCoopers LLP
Dan Robertson	RSM
Vijay Thakrar	Unattached

Quoted Companies Alliance Share Schemes Expert Group

Fiona Bell (Chair)	**RSM**
Emma Bailey (Deputy Chair)	Fox Williams LLP
Phil Norton	Aon Hewitt
Andy Goodman Philip Fisher	BDO LLP
David Daws	Blake Morgan
Graham Muir	CMS
Caroline Harwood	Crowe Clark Whitehill LLP
Juliet Halfhead	Deloitte LLP
Danny Blum	Eversheds Sutherland
Richard Sharman	FIT Remuneration Consultants
Isabel Pooley	Grant Thornton UK LLP
Sara Cohen	Lewis Silkin
Travis Adams	Link Asset Services
Liz Hunter	Mazars LLP
Stephen Diosi	Mishcon De Reya
Stuart James	MM & K Limited
Michael Carter	Osborne Clarke
Robert Postlethwaite	Postlethwaite Solicitors
Daniel Hepburn	PricewaterhouseCoopers LLP
Jennifer Rudman	Prism Cosec
Martin Benson	RSM
Dave Bareham	Smith & Williamson LLP
Barbara Allen	Stephenson Harwood
Elissavet Grout	Travers Smith LLP