



ENTREPRENEURS' RELIEF: COMPANY CEASING TO BE INDIVIDUAL'S PERSONAL COMPANY (CL15, F3B17-19)

Issued 29 August 2018

ICAEW welcomes the opportunity to respond to the **consultation on draft Finance (No.3) Bill 2017-19 legislation: Clause 15: *Entrepreneur's relief: company ceasing to be individual's personal company*** published by HMRC on 6 July 2018.

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For more information, please contact: taxfac@icaew.com

EXECUTIVE SUMMARY

1. We welcomed the opportunity to comment on the consultation *financing growth in innovative firms: allowing entrepreneurs' relief on gains before dilution* published by HM Treasury and HMRC in March 2018, and to which we responded in [ICAEW rep 49/18](#).
2. However we are disappointed that the consultation did not present a variety of options to consider, nor was there a pre-consultation call for evidence. We believe this was a missed opportunity to consult thoroughly on the perceived issues and to identify a sensible solution to the problem, including our preferred method of time-apportionment.
3. Going forward, we would welcome the opportunity to work with HMRC on the guidance to accompany the legislation, including any updates required to existing self assessment helpsheets. In particular, we would like the guidance to make it clear that a dilution as a result of an employee exercising tax-advantaged share options would not fall within draft s169SC(6)(b).

THE MEASURE

4. This clause amends Part 5 of Taxation of Chargeable Gains Act 1992 to include a new Chapter 3A.
5. The purpose of this clause is to prevent the loss of entrepreneurs' relief (ER) in cases where an individual's shareholding is diluted below the 5% qualifying threshold as a result of a new issue of shares. This follows representations to government that the 5% requirement can act as a barrier to growth in some companies.
6. The mechanism requires two elections to be made; the first to determine the amount of gain at the time of dilution and the second to defer this gain until a subsequent disposal of shares.

MAJOR POINTS

7. We are concerned that the mechanism adopted (as put forward in the original consultation document) is too complex. In particular there is a need to:
 - a) Make two elections; one on dilution to calculate the notional gain and one to defer the notional gain. This is burdensome and, in our view, unnecessary. We believe there will be a general lack of awareness that an election is required on dilution resulting in the loss of ER for many taxpayers. It is clear from the summary of responses (para 3.4) that the government prefers this method as it demonstrates the link between the company's decision to seek (or otherwise) additional funding and the loss of entrepreneurs' relief for some shareholders. It seems unlikely that minority shareholders would be aware that this was the intention of government and therefore unfair to penalise taxpayers who do not make an election on dilution of their shareholding. We recommend that only one election is required and that this only be required on the eventual disposal of the shares, not at the time of dilution (see paras 13-18).
 - b) Obtain a valuation of the shares at the time of dilution. Share valuations are an expensive process and in some cases, the professional fees may wipe out the tax benefit of retaining ER. If the valuation is performed at the time of the dilution, there will also be an additional record-keeping requirement for taxpayers, which we believe makes this approach burdensome. Alternatively, the held-over gain will need to be computed when the tax becomes payable, so the valuation will have to be performed some time, possibly years, after the dilution, which will make the valuation exercise itself more difficult and expensive.
8. In ICAEW rep 49/18 we proposed an alternative method based on time-apportionment and we are disappointed that HMRC has not taken this suggestion further.

9. We expressed these concerns in a meeting with HMRC on 23 August 2018, and we understand that there is no scope for policy change given that the draft legislation has now been published.
10. We would like to confirm our understanding that the legislation, as drafted, can be triggered in the following instances:
 - a) Draft s169SC(2) – as currently drafted the legislation appears to allow ER in situations where the individual maintains a 5% holding of ordinary share capital but there has been a dilution in voting rights. Did HMRC intend this?
 - b) Draft s169SC(6)(b) – this requires the shares to be issued for genuine, commercial reasons and not as part of arrangements to secure a tax-advantage. Our understanding is that the exercise of tax-advantaged share options would not fall within this section. Therefore the legislation could be triggered on the exercise of share options or by other events, such as a further investment by existing shareholders. In other words, the new relief is not specifically restricted to third-party capital investment.

Relevant share issue

OUR CONCERN

11. Draft s169SC(6)(a) states that “shares are issued by the company for consideration consisting wholly of cash.” We are concerned that this excludes:
 - a) “In-kind” transactions. For example, it could be that an individual offers to inject a factory (or another asset) with a market value of £x in exchange for shares in the company. The current drafting of the legislation appears to exclude this as a “relevant share issue.”
 - b) The conversion of loans into equity.

In both of these cases the company would be receiving valuable consideration in exchange for shares. We cannot see any policy reason for not allowing a non-cash investment, nor any potential for any loss to the exchequer.

OUR RECOMMENDATION AND SUGGESTED AMENDMENT

12. We recommend that draft s169SC(6)(a) is amended so that it reads “the shares are issued by a company wholly for new consideration, as defined in section 1115 CTA 2010” to allow consideration in-kind to qualify as a “relevant share issue.”

Time limits for elections

OUR CONCERN

13. Under draft s169SE(2) the time limit to make an election under draft s169SC (ie, to determine the gain on dilution of the shareholding) is “on or before the first anniversary of the 31 January following the tax year in which the notional disposal is made”. This is less generous than the time limit to make an election under draft s169SD (ie, to defer the gain) which is stated in draft s169SE(3) as being within four years after the end of the relevant tax year.
14. Having multiple elections increases the risk of minority shareholders (and in particular, unrepresented taxpayers) being unaware of all they need to do to benefit from the relief. This is compounded when the elections have different time limits.

OUR RECOMMENDATION AND SUGGESTED AMENDMENTS

15. As noted in para 8, we recommend that a simple time-apportionment method is adopted which would remove the need for any elections.
16. Following discussions with HMRC we understand that any significant change to the mechanism is unlikely. As such we recommend that only one election is required to obtain ER after the sale of the relevant shares.
17. However, if that is not possible, we recommend that only one election is required to both calculate the deemed gain on dilution and automatically defer it until there is a subsequent disposal of shares as we believe that in the majority of cases the taxpayer would want to defer the dry tax charge at the point of dilution. There should not be a separate requirement to elect to defer the gain.
18. If this is not practically feasible for HMRC we would strongly recommend that both elections carry the same time limit ie, amending draft s169SE(2) so that it reads "must not be made more than four years after the end of the relevant tax year".

APPENDIX 1

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

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **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.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **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.
6. **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.
7. **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.
8. **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.
9. **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.
10. **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>).