# Entrepreneurs’ Relief and the impact of financing

OMB Personal tax

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The CIOT and ATT have responded to the HMT and HMRC consultation on changes to Entrepreneurs’ Relief intended to ensure that entrepreneurs are not discouraged from seeking finance to enable their companies to grow.

Both the CIOT and ATT have responded to the consultation ‘Financing growth in innovative firms: allowing Entrepreneurs’ Relief on gains made before dilution’.

The consultation re-states the objective of Entrepreneurs’ Relief (ER) as being ‘to promote enterprise by offering a reduced rate of tax to individuals who, with significant initiative and risk, have contributed to the creation and growth of a business’.

The consultation sought views on a proposed solution to the situation where a shareholder loses entitlement to ER because their shareholding is diluted below the minimum 5% holding of ordinary share capital and voting rights following the issue of shares as part of a fundraising exercise for the purposes of the trade. The concern is that the loss of ER at this point could discourage entrepreneurs from seeking funding to grow the business or, alternatively, exit the business too soon.

The consultation proposed that entrepreneurs in this position should still be eligible for ER on any gains realised up to the point that their shareholding is diluted. Such individuals would elect to be treated as having disposed of, and then reacquired, their shares at their market value at the time of the financing. They could then further elect to defer the gain arising until they disposed of their shares. When the gain was brought back into charge, ER would apply to the pre-dilution gain.

In their response, both the ATT and the CIOT expressed concerns over the costs of obtaining a valuation of the shares at the time of the investment. For some

shareholders, the cost of establishing the pre-dilution value of their shares could exceed the benefit of the relief.

To resolve this, both bodies suggested that, rather than require a valuation at the point of dilution, the pre-dilution gain eligible for relief could be calculated on a time-apportionment basis. Alternatively, the original shareholdings could be valued based on the amount paid for the newly-issued shares.

A condition for the new rules to apply is that the issue of shares is part of a commercial scheme or arrangement which has as its main purpose, or one of its main purposes, the obtaining of capital as new consideration subscribed for the issue of new shares. The CIOT is concerned that there are examples of commercial arrangements for funding that give rise to dilution that may not fit neatly into the parameters of this condition.

If the new approach is adopted, the CIOT recommended that take-up should be monitored and evaluated through a formal post-legislative review mechanism (such as a sunset clause or mandatory re-authorisation) to ensure that it meets the objective.

Overall the ATT felt that the proposed relief would not have a significant impact, but that it may be an appropriate time for the government to consider if the 5% minimum holding test for shareholders seeking ER remains relevant.

The CIOT commented that to the extent there is a link between the re-stated objective for ER and the rationale for the 5% test in the ‘personal company’ definition, it appears somewhat tenuous. While there may be some merit in a ‘bright line’ condition, there are inherent anomalies in its application and complexity in its accommodation of which this consultation is a part. However, the CIOT recognised that the condition is a long standing and well recognised aspect of the relief and that the government has no current plans to review it further.

The CIOT response can be found on the CIOT website and the ATT response on the ATT website.