Breaking barriers

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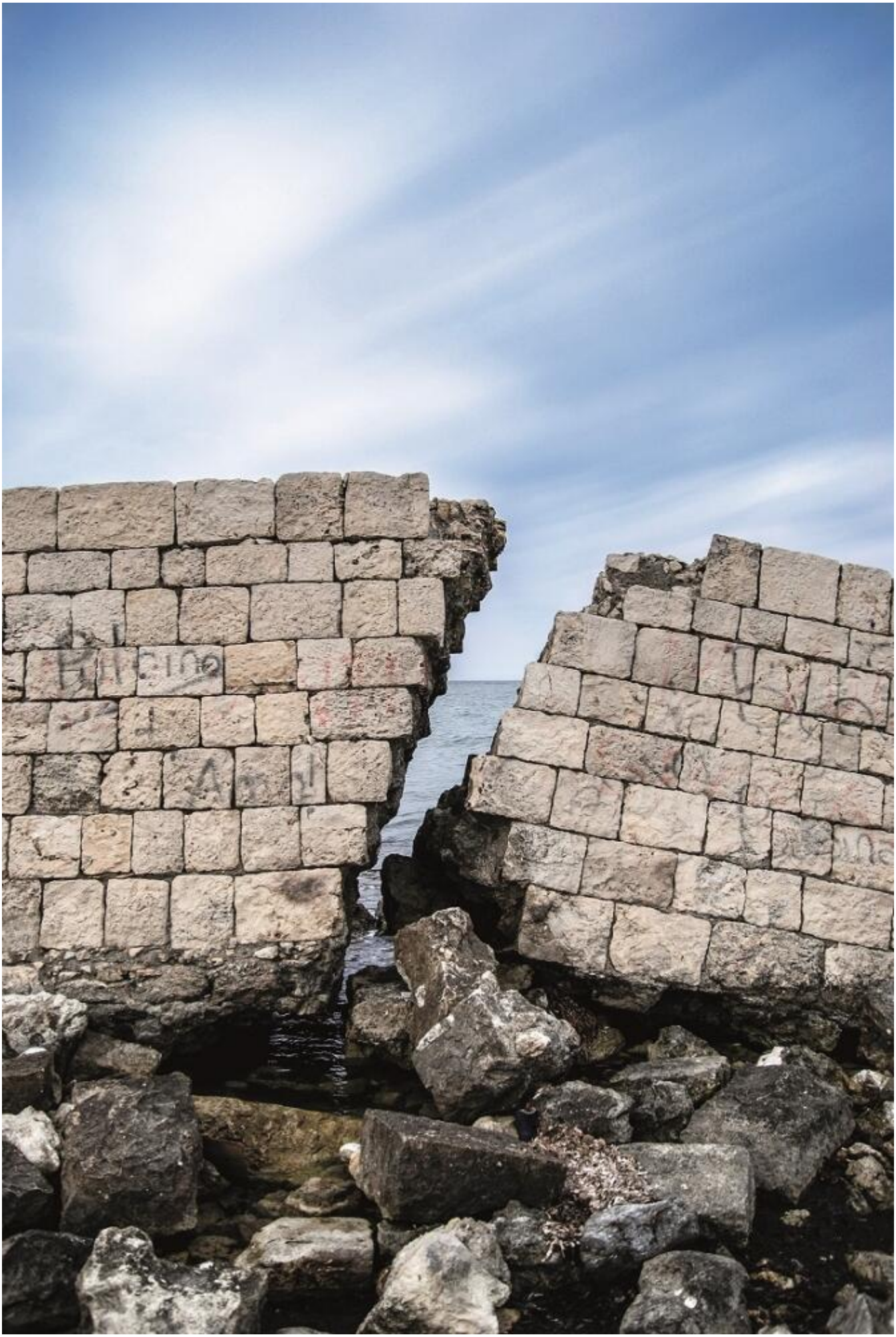

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Stephen Woodhouse examines the impact of FB 2019's dilution protection for entrepreneurs' relief

Key Points

What is the issue?

At its inception in 2008, ER was 'introduced to incentivise and reward entrepreneurs who, with significant initiative and risk, play a key role in building and growing a business'. A difficulty, though, is that amongst the various requirements for obtaining ER, the company must be the individual's 'personal company'.

What does it mean to me?

A recent government consultation highlighted that the loss of this relief on a dilution was a 'perverse consequence'; actively discouraging entrepreneurs from seeking outside investment which would dilute their shareholding below the 5% threshold and jeopardise their coveted reduced rate of CGT.

What can I take away?

In so far as the loss of ER on dilution acts as a barrier to growth, the draft Finance Bill 2019 makes some headway towards remedying this outcome of the tax system.

'*Tax free gains! Get your tax free gains!*' harked no tax policy adviser in the history of tax policy advisers. Yet, for those seeking to make the most of government-backed tax advantages, the clamour to obtain and retain at least 5% of a company for Entrepreneurs' Relief (ER) purposes has been relentless (or so it was until the government's publication of the draft Finance Bill 2019).

Background

At its inception in 2008, ER was 'introduced to incentivise and reward entrepreneurs who, with significant initiative and risk, play a key role in building and growing a business'. In their bid to promote entrepreneurial exploits, the cost of ER to the

Exchequer is currently forecast to be in the region of £2.7 billion. Where applicable, it affords a reduced rate of CGT at 10% on qualifying disposals of business assets up to the lifetime limit of (currently) £10 million, rather than 20% for higher or additional rate taxpayers (excluding gains on residential property and carried interest). This offers a potential total saving (at a 20% tax rate) of £1 million per person. This is a substantial potential benefit for entrepreneurs and obtaining the relief is a main focus for the owners of many fledgling businesses.

A difficulty, though, is that amongst the various requirements for obtaining ER, the company must be the individual's 'personal company'. In order to be an individual's 'personal company', the individual must be able to exercise at least 5% of the voting rights of the company and hold at least 5% of the ordinary share capital of the company throughout the period of one year ending with the date of the disposal. However, a recent government consultation highlighted that the loss of this relief on a dilution was a 'perverse consequence'; actively discouraging entrepreneurs from seeking outside investment which would dilute their shareholding below the 5% threshold and jeopardise their coveted reduced rate of CGT. Further concerns were raised in the consultation that entrepreneurs may seek an early exit to obtain ER in advance of a fundraising, rather than remaining and contributing to the future growth and success of that business.

Proposals

As part of the government's response to the 'Patient Capital Review', the draft Finance Bill 2019 posited a potential remedy. For dilutions occurring on or after 6 April 2019 which result in an individual's shareholding falling below the 5% threshold, an individual may effectively 'crystallise' their gain up to that point. The individual must elect for their shareholding to be treated as disposed of and reacquired immediately before the point of dilution (thus creating a chargeable gain to which ER may apply).

A second election may be made by the individual for that chargeable gain to be treated as accruing to them on a subsequent disposal of shares. This effectively prevents a 'dry' tax charge from arising on the notional disposal of the shares, with no proceeds of sale to cover the tax.

Initial structuring

From a structuring perspective, the government's proposals will not eradicate pressure to incorporate anti-dilution provisions into arrangements in an attempt to preserve an individual's entitlement to a fixed percentage of a company after the economic dilution resulting from a capital raising. Despite the potentially detrimental impact of these provisions on other shareholders and a company's propensity to raise funds in the future, this anti-dilution protection is still likely to be significant for owners.

The new legislation effectively caps ER where dilution happens to the value of the company's shares, ignoring minority discounts, at the point of dilution. However, for a start-up business coming to maturity, substantial share value growth often occurs at two points:

- First, when external funding is obtained. This is when the issue with dilution arises. Provided that HMRC accept that the value has accrued at the point when there is an agreement to provide the funding but before the dilution happens, so that the resulting valuation increase is captured within the protection of the legislation, this should not be problematic.
- Second, at the point of exit. In practice, the valuation curve for the company is likely to show a high proportion of value growth arising after the funding (as the benefit of the additional funds is realised) and culminating in a peak at the point of sale or other exit. The new legislation will not protect that gain.

For that reason, it would be prudent for the share rights for companies to include anti-dilution wording from inception rather than relying on the Finance Bill protection.

DOTAS

This is particularly pertinent when the impact of the Disclosure of Tax Avoidance Schemes (DOTAS) regime is considered.
Since their introduction in 2004, the scope of DOTAS rules has broadened considerably and, following the introduction of Hallmark 9 in February 2016, they cover arrangements involving specified financial products including shares. Where one of the main benefits of including shares is to give rise to a tax advantage, and either the shares include a term which is unlikely to have been included by the persons were it not for the tax advantage, or the arrangements involve at least one contrived or abnormal step without which a tax advantage could not be obtained, an

obligation to disclose will be triggered.

If anti-dilution provisions are included in the original share structure, it seems that this should not trigger disclosure under Hallmark 9 as the dilution protection would be incidental to the main commercial purpose of issuing shares to reflect investment and the resulting ownership.

This is more difficult, however, if shares are issued at a later date which serve no purpose other than to provide dilution protection in order to preserve entrepreneurs' relief. In this circumstance, it seems that disclosure would be required under the DOTAS rules. Further, once the Finance Bill legislation is in force, it would be difficult to argue that the tax advantage obtained is one intended by the legislation as the point of the shares would be to extend the availability and quantum of the relief beyond the point of dilution.

Valuation

How will the value of a shareholder's shareholding be determined on this notional disposal? The draft legislation requires the value to be apportioned on a pro rata basis, assuming that the whole of the issued share capital of the company is to be sold immediately before the relevant share issue for consideration equal to its market value at that time.

A number of issues arise with this. First, the need for a valuation contributes cost and complexity to this ER preservation mechanism. In particular, respondents to the consultation noted that '*the personal cost of obtaining a valuation of their shareholding may outweigh any benefit of securing the tax relief on the gain from the individual*'.

Second, the influence of hindsight could leave the valuation open to future challenge in light of HMRC's withdrawal of post-transaction valuation checks in 2016. While both HMRC and taxpayers are prevented by case law from applying hindsight to determining share values, this has limitations. First, hindsight can be applied to assess the validity of circumstances at the time of the valuation – e.g. company forecasts. Second, it is difficult when determining the value of shares a substantial time after the valuation applies, not to be influenced by subsequent events.

Third, HMRC and taxpayers may find themselves with different interests for different valuations. For instance, if EMI options were to be granted at the time of the fund

raising leading to the dilution, the Company may wish to argue for a low valuation when granting options (albeit with the benefit of minority discounts) but a high value for the purposes of ER protection. This is likely to lead to complexity with valuations and resulting risks for taxpayers and their advisers.

Additional issues

The draft provisions apply where shares are issued to an external investor wholly for cash consideration. Although most investment transactions will involve the issue of shares in exchange for cash, the draft provisions will not be available where alternative methods of payment are adopted.

An individual seeking to defer their chargeable gain under the second election must also grapple with the question of whether ER will be available at the point of an actual disposal. Footing the bill for a dry tax charge on a notional disposal at the outset may be worth the risk to the individual when balanced against the prospect of ER being reduced or abolished in the interim.

Finally, a simpler approach would be to have the second election to defer their gain as the default. We suspect that few individuals will be clamouring to pay a dry tax charge on a notional disposal when they could defer it to a point where they will have proceeds of sale to foot the bill.

Conclusion

Whether a company’s decision to seek external funding is dictated by an individual’s personal tax position remains to be seen but, in so far as the loss of ER on dilution acts as a barrier to growth, the draft Finance Bill 2019 makes some headway towards remedying this outcome of the tax system. In this respect, the government should be praised for its pragmatic proposals.