

Entrepreneurs' relief and dilution

(Lecture P1089 – 21.35 minutes)

Gains made on the disposal of shares may attract the 10% rate of CGT under entrepreneurs' relief, provided that the following conditions are met by the claimant and his company throughout the 12-month period prior to the disposal:

- the claimant held at least 5% of the company's ordinary share capital;
- the claimant was able to exercise at least 5% of the company's voting rights;
- the company was a trading company or the holding company of a trading group; and
- the claimant was an officer or employee of the company (or of another company which was a member of the trading group).

In his Budget Speech on 22 November 2017, the Chancellor announced that changes would be made to these entrepreneurs' relief rules so as to ensure that owner managers are not discouraged from seeking external investment to finance business growth in circumstances where their own shareholding may become diluted.

Following the Spring Statement on 13 March 2018, a detailed HMRC consultative document ('Allowing Entrepreneurs' Relief On Gains Before Dilution') was published. This seeks views on a new process outlined by the Government by which individuals may remain entitled to claim entrepreneurs' relief on share gains relating to a time before their shareholding fell below the critical 5% parameter, but only where the fund-raising event occurs on or after 6 April 2019.

In essence, this will be achieved through:

- a special facility which allows individuals to make an election to be treated as having disposed of and reacquired their shares at what was market value immediately prior to the dilution; and then
- permitting those individuals to defer the taxation of the resulting gain until an actual disposal (e.g. a sale) of their shares takes place.

The Government says:

'To ensure this extension of the relief remains targeted, the dilution of the individual's shareholding must be a consequence of an issue of shares made by the company for genuine commercial reasons.'

Individuals will be required to make the election in their tax return for the year in which the shareholding is diluted. The normal self-assessment time limit for elections will apply. This should ensure that the claimant achieves certainty of tax treatment at an early stage when important data such as valuations should be readily available.

Illustration 1

In March 2022, Steven subscribes £40,000 for 40,000 ordinary shares of £1 each in a new trading company of which he is a director. He holds 10% of the company's ordinary share capital and voting rights.

15 months later, the company raises working capital by issuing 3,600,000 ordinary shares of £1 each. Immediately prior to this issue, Steven's shares were worth £3.50 each. He does not take up any of the new shares. His proportionate interest in the company therefore falls from 10% to 1%.

If Steven had sold his shares immediately before the latest issue, he would have been able to claim entrepreneurs' relief on his gain of £100,000, which is computed as follows:

	£
Market value (40,000 @ £3.50)	140,000
Less: Cost (40,000 @ £1.00)	<u>(40,000)</u>
	- <u>£100,000</u>

Under the Government's proposals, Steven will be able to elect in his 2023/24 tax return to be treated as having made a disposal and an immediate reacquisition of the same shares at the same price. His tax return will reflect this gain and he will be entitled to claim entrepreneurs' relief in respect of the deemed disposal.

The interesting question, however, is to consider what value does one take for Steven's shares prior to the dilution. Is it the isolated minority value of a 10% holding or alternatively 10% of the value of the company as a whole (which would be the position if the company had been sold)? This decision could make a significant difference! One fears that it will be the former.

The Government appreciate that many taxpayers will not want, or indeed be able, to pay the 'dry' tax charge arising from this election and so they plan to allow individuals to make a claim to defer the accrual of such gains until the occasion of an actual disposal of the shares.

The consultative document continues:

'Where this claim is made, entitlement to entrepreneurs' relief on the deferred gain will be preserved so that (the relief) can be claimed under the then-current rules at the time the gain is treated as accruing. Where the individual has chosen to pay the dry tax charge at the time of the first election, subsequent losses will not be (permitted) to be set against the gain on the deemed disposal of the shares and so will not give rise to an effective repayment of tax.'

An exception would of course be if the capital loss arose in the tax year of the shareholder's death – see S62(2) TCGA 1992.

Illustration 2

If Steven in Illustration 1 does not wish to pay CGT on his 2023/24 gain of £100,000, he can claim for the accrual of the gain to be deferred. Such a claim must be made in his 2023/24 tax return or by some other legitimate means, but no later than 5 April 2028.

Illustration 3

In November 2029, Steven resigns from the company and sells his shares. By now, the shares are worth £11.80 each, i.e. his sale proceeds will be £472,000.

Steven's gain breaks down into two parts:

- The first part is his pre-dilution gain of £100,000. He is able to claim entrepreneurs' relief on this amount.
- The second part is the growth in value of his shares since that election. This works out as $£11.80 - £3.50 = £8.30 \times 40,000 = £332,000$.

Steven's tax bill on his 2029/30 disposal will therefore be:

	£
£100,000 @ 10%	10,000
£332,000 @ 20%	<u>66,400</u>
	<u>£76,400</u>

The Government have confirmed that this new procedure will not be extended to disposals by trustees. Nor will the elective facility apply to associated disposals.

Contributed by Robert Jamieson