

BIA consultation submission: Allowing Entrepreneurs' Relief on gains made before dilution

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Introduction

The BioIndustry Association (BIA) welcomes the opportunity to input into the HMRC and HM Treasury's consultation on allowing Entrepreneur's Relief on gains made before dilution.

The BIA is the trade association for innovative life sciences in the UK. Our goal is to secure the UK's position as a global hub and as the best location for innovative research and commercialisation, enabling our world-leading research base to deliver healthcare solutions that can truly make a difference to people's lives.

Our members include:

- Start-ups, biotechnology and innovative life science companies
- Pharmaceutical and technological companies
- Universities, research centres, tech transfer offices, incubators and accelerators
- A wide range of life science service providers: investors, lawyers, IP consultants, IR agencies

We promote an ecosystem that enables innovative life science companies to start and grow successfully and sustainably.

Overview of the BIA's response

The government should be commended for its focus on supporting the life sciences sector through the Patient Capital Review, the Industrial Strategy and Life Sciences Sector Deal. There are many features of the UK which make it an attractive place to start and grow life science companies. There are many factors, and the UK tax system is one of them, given the ability to benefit from R&D tax credits, the patent box, venture capital schemes and EMI share option schemes is very helpful.

However, the BIA has long highlighted the 5% shareholding cap in the Entrepreneur's Relief (ER) regime as a problem for the life sciences sector, most recently in our submission to the *Financing growth in innovative firms* consultation¹. The capital-intensive nature of life sciences R&D means successive fundraising rounds are necessary, which rapidly dilute founding shareholders below 5%. They are therefore ineligible for the relief, even though they have built a personal company at risk over several years. This can be a barrier to successful bioscience entrepreneurs exiting companies in a financial position where they are able to reinvest in new ventures, creating a virtuous cycle of entrepreneurship, which the government should be promoting. Due to the capital-intensive nature of life sciences, this problem is more acute than in other sectors and represents an inbuilt inequality in the tax system for life sciences entrepreneurs, whom the government should be supporting, not placing at a disadvantage.

The BIA is therefore pleased that the government has chosen to consult on the way in which ER is provided. However, we are of the firm view that the proposal in the consultation will not address the problem described above, will not achieve its policy aim to remove the disincentive for investment as outlined in the consultation, nor will it work in

¹ BIA (2017), *The BIA's submission to the Patient Capital Review: Financing growth in innovative firms*: <https://goo.gl/F8CgQh>

practice. This is primarily due to the fact that share-value creation largely occurs much later in the development of R&D-intensive companies and the practical difficulty in valuing shares in early-stage companies with unproven technology or other intellectual property.

The BIA urges the government to reconsider its approach and recommends the 5% cap is abolished for entrepreneurs of knowledge-intensive companies where the founder held over 5% shares for 24 months or more.

The challenge of building life science companies and its impact on entrepreneurs' shares

The UK is a world-leader in medical research, in both academia and industry. This is an economic competitive advantage that the government should seek to exploit to the maximum. Part of doing this is promoting entrepreneurship so that the UK becomes more successful in commercialising new ideas and discoveries and building world-beating companies.

A challenge and barrier to growing life science companies is the long time and great cost it takes to get new medical technology to the market due to the high regulatory burden and the need for extensive clinical trials over many years (typically 15-20 years). That in turn requires life science companies to raise large sums of money to bring their products successfully to market. Founding academics, who epitomise entrepreneurs in the life science sector, would usually take a stake in a new spin-out of anywhere between 10%-50% of the initial equity. At this point the company may typically have raised anywhere from £200,000-£1,000,000. The company is very likely to be in early-stage research and may not have achieved proof of concept. Research that precedes clinical trials may last from 4-10 years and could cost anywhere from £10m-£20m. As a consequence, the founding academic is likely to be diluted at a very early stage and before the company starts clinical trials, which provide data on which it becomes possible to appreciate the true value of the company and its IP asset.

The consultation is addressing the wrong problem

The consultation states that the current ER regime may create a barrier to entrepreneurs accepting dilutive funding. The BIA does not believe this to be an extensive problem; indeed, life science companies, and other science-based industries, cannot be built in any other way than through successive rounds of venture capital fundraising.

Government and industry share the aim of creating a dynamic and entrepreneurial knowledge-based economy in the UK. To do this we must support and not discourage entrepreneurship in all sectors. Scientists in universities and stable large companies take considerable risk founding a start-up and leaving their secure job to concentrate on growing that business. The financial return they expect – after tax deductions – will play a part in deciding if that risk is worth it; ER therefore impacts that behaviour and the expectation of dilution could dissuade entrepreneurial behaviour. Perhaps more importantly, loss of ER following dilution can often mean that individuals' financial return can be significantly impacted if ER were applied. That money cannot be recycled into a new business, allowing the entrepreneur to apply his or her skills to growing a second, third and fourth business. The 5% cap, as it currently operates *and* how it is proposed to operate in the consultation, therefore actively prevents the virtuous cycle of entrepreneurship that the government should be promoting.

Answers to the consultation questions

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

No. The BIA does not believe that entrepreneurs in the life science sector, or other science-based sectors, would feel that they have any other option than to accept dilutive equity funding. However, for those for whom losing ER might be a barrier to accepting financing, the proposed new regime is unlikely to remove that barrier. This is because the share-value increase during the early-stages of business development is not significant in such companies, meaning the financial gain from the proposed approach would be too small to drive overall behaviour change. For the same reason, the BIA does not believe the approach will address the problems described above: namely, that entrepreneurs receive less money to compensate for the risk of founding a business and also less money to reinvest into new businesses following final exit.

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

They would be considered at the point of dilution but, in most cases, the cost and uncertainty may well outweigh the benefit.

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

No, it seems unlikely that someone would choose to pay tax on cash they do not yet have access to.

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?

The BIA disagrees with the premise of the question. The problem is not companies refusing refinancing but to generating a non-permissive environment for entrepreneurship.

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

N/A

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?

Yes – rules for share reorganisation and spousal transfers will also need to accommodate this.

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?

Yes.

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?

N/A

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

Please see our recommendation below.

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 believe that this should be sufficient.

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

No.

Problems to the functioning of the proposed approach

As well as not meeting its policy objective of promoting entrepreneurship and removing disincentives for accepting dilutive finance, the proposed approach will be difficult to work in practice. This is because:

- It requires a valuation that would be inherently difficult at a time where there remains significant scientific uncertainty
- That valuation creates an additional compliance burden
- At 5% it will be necessary to apply a discount for the shareholding being a minority interest. This will reduce the amount of the gain eligible for entrepreneurs' relief
- Shareholders will not be able to gain any certainty over their tax position until after the enquiry window for self-assessment. For this reason, any intended incentive will be compromised
- Individuals will be required to finance their own financial advice to comply with the regime
- If a company subsequently fails and the shares become worthless, the individual may be left with a capital gains tax bill for gains that have not been realised.

Proposed solution

We believe that the issues identified in this response could be addressed if entrepreneur's relief would apply for the entire gain after dilution provided that the shareholder had retained a shareholding of greater than 5% for a qualifying period. Our proposal would be for that period to be twenty four months. This could also be only applied to knowledge-intensive companies, which would ensure effective targeting of the policy and reduce its cost to the Exchequer

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