

Tax Support for Entrepreneurs: CenTax Response

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1 About CenTax

We are researchers at the Centre for the Analysis of Taxation (CenTax), a research centre co-hosted by LSE and University of Warwick. CenTax is dedicated to improving public understanding of tax policy and helping to design a better tax system, by generating evidence that is rigorous and relevant to policymakers and the public. Further information about CenTax is available via our website.

Our work focuses on tax policy design and the measurement of tax policy outcomes. We conduct cutting-edge research on the behavioural and economic impacts of tax policy changes and have contributed substantively to debates on tax policy in the UK over recent years. We use HMRC administrative data accessed through a secure research environment that allows us to compare academic research findings with official government costings, providing insight into how policy analyses are conducted.

We sent this in response to the government's call for evidence on Tax Support for Entrepreneurs which can be found [here](#).

2 Introduction

Entrepreneurs found and build new businesses, taking on risk to generate profits. If successful, a large share of their compensation is typically in the form of a capital gain, reflecting the value of the business they have created. The current tax incentives for entrepreneurship are therefore predominantly channelled through Capital Gains Tax (CGT).

The Call for Evidence is narrow in asking questions about specific reliefs (VCT/EIS/SEIS, EMI and BADR). However, these operate within the broader system of CGT. Hence, a key part of discussing the effectiveness of these regimes is to consider the strengths and weaknesses of the wider system in which they operate.

It is important to recognise in the setting of policy that CGT applies not only to entrepreneurial businesses which may potentially grow, creating jobs and innovation, but also to any taxpayer holding assets and realising a gain on their disposal. This includes individuals that provide their services through personal service companies (PSCs). PSCs are typically one person businesses, providing the owner-manager with limited liability and

associated legal benefits, but typically without the intention to expand substantially. Liquidation of these businesses on the retirement of the owner also receives CGT treatment.

These personal service companies account for a large proportion of UK gains, even when we only focus on large gains. For example, looking at gains from businesses above £5 million, around a third had an initial investment of less than £500, strongly suggesting they are not genuine entrepreneurial businesses, but returns to work repackaged as capital gains.¹ A key challenge is, therefore, to distinguish between entrepreneurial businesses, and these latter businesses that have no case for preferential treatment.

When discussing support for entrepreneurs, there are two distinct issues that government intervention may wish to address. One is to create incentives for entrepreneurs to found companies in the UK, while the other is about supporting entrepreneurs to grow (scale-up) their businesses here. While both issues are related (i.e. if the environment were not right for growing companies, that would presumably also discourage founding activity) they lead to different policy designs depending on what is the direct objective of the policy.

The Call for Evidence states that the UK is already a “great place to start a company” but there is a challenge in ensuring “that the UK is not just a launchpad”. We are unable to evaluate whether the government’s assessment is correct, so we take it at face value. In line with that, our submission focuses on incentives for entrepreneurs to *grow* their companies in the UK, although these should also indirectly make the UK more attractive as a place to found their start-ups in the first place.

Our response to the Call for Evidence is structured as follows:

- Summary of the possible market failures that could justify government intervention in this area.
- Our view of the current weaknesses of the CGT system, highlighting how these distort the allocation of capital in the UK.
- Our view on how the government can support the scale-ups challenges of start-ups, through wider policy.
- The principles that should guide the design of tax reliefs (if the government concludes this is the optimal way of supporting

¹The productivity cost of low Capital Gains Tax rates (Advani, et al., 2024).

entrepreneurs) to ensure they effectively and efficiently achieve their objectives.

- A broad design for a potential new tax relief targeted at high-growth founders, which could be a direction for reform if the government is concerned about the positive externalities and tax mobility of these individuals.

3 The case for government support for scale-ups

There are three possible arguments for government intervention to support entrepreneurs, both in founding and scaling up their businesses. The first two of these arguments refer to market failures that would justify government support to correct them. The last (tax competition) refers to the mobility responses of entrepreneurs and would justify having a targeted tax relief to reduce the deadweight loss of our tax system.

- **Positive spillovers:** entrepreneurial activity can have positive spillovers if it leads to jobs creation. Job creation would be positive both fiscally (reduced benefit spending and additional tax on labour earnings and consumption) and socially (self-esteem and skills for workers). If these spillovers are not internalised by the entrepreneurs and investors, then government intervention to increase these activities could increase social welfare.
- **Financial market failures:** entrepreneurial investment often requires access to external capital. Entrepreneurial risk is also typically uninsurable. If entrepreneurs struggle to access capital or are unable to get insurance due to a market failure, then there is a case for government intervention. The ideal solution would be for government intervention to improve the functioning of the financial market to directly address this problem.
- **Tax competition:** additionally, if entrepreneurs are more mobile than the rest of the taxpayers, then there could be a case for having targeted reliefs to both attract and retain them in the UK. However, their mobility in response to tax is not a structural parameter but determined by the features of the tax system in which they operate.

It is important to note, however, that all these arguments rely on empirical questions that the government should properly assess before introducing or expanding (tax or non-tax) reliefs to address them. However, for the purpose of this response we will assume that the market failures identified in the Call for Evidence are genuine and that government intervention is required.

4 Structural reforms to UK's capital gains tax

The Call for Evidence rightly mentions that the UK faces a capital allocation challenge. Our view is that the current structure of our CGT system is contributing to this misallocation problem. In 2024 we published a [report](#) presenting a package of structural CGT reforms that would (among other things) reduce the distortions to optimal capital allocation,² and we briefly explain these structural reforms below.

4.1 Improvements to capital allocation

Our policy proposal includes five reforms: equalising the CGT rates with Income Tax rates, introducing an investment allowance, removing the CGT uplift at death, introducing a rebasing on arrival and deemed disposal on departure (DDD), and increasing the generosity of the treatment of losses. All of these reforms would improve the allocation of capital in the UK.

First, equalising CGT rates with Income Tax rates removes the allocation distortions created by the current tax wedge. The tax wedge creates strong incentives for individuals to shift income into capital returns. This is seen in many areas of our economy, including executive pay packages shifting salaries into shares, investors shifting dividend payments into capital growth or zero-coupon bonds instead of interest-paying ones. This tax distortion means that the current choice of capital or income returns is economically suboptimal.

Similarly, the tax wedge also distorts the choice between being employed, self-employed or incorporating, creating the incentive to set up small businesses even where these are less productive than other working arrangements (employed or self-employed). This, in turn, means that the value created by owners setting up these businesses is smaller, but their private returns remain larger because of the preferential CGT treatment.

Secondly, the introduction of an investment allowance would guarantee no tax is imposed on the risk-free rate of return on capital, which would remove the distortions against saving and investment that our system currently creates, or the disincentive to borrow when interest rates increase.

Third, the current CGT system distorts decisions around the holding of capital assets. This occurs for two main reasons: the CGT treatment on death and on emigration. On death, the CGT system gives an uplift in the base cost to those receiving property through inheritances. This means that the

²Reforming Capital Gains Tax: Revenue and Distributional Effects (Advani, Lonsdale and Summers, 2024). See also Capital gains tax reform (Adam, Advani, Miller, and Summers, 2024, IFS Report No. R336).

system exempts from tax all the gains made on these assets during the deceased's lifetime. This creates a strong 'lock-in' effect that contributes to the misallocation of capital by incentivising older taxpayers to hold onto assets that have a large accrued gain even when the expected future returns are low and the capital could be used more productively elsewhere. Removing this uplift at death would remove the 'lock-in' effect and produce incentives to improve capital allocation.

A similar CGT exemption can be achieved by emigrating, as the current CGT system allows individuals that depart the UK holding assets with accrued gains to escape taxation. This creates a strong incentive for those expecting to leave the UK in the future to hold on to assets with accrued gains, even when that capital could achieve better returns if invested elsewhere. More problematically, this feature of our CGT system creates incentives for successful entrepreneurs to leave the UK before selling their companies to avoid paying CGT on the accrued gains.

Furthermore, once they have left the UK (even when not tax motivated) the CGT temporary non-resident rules strongly encourage them to stay out of the UK for at least six years. This feature of our CGT system distorts the optimal allocation of capital and creates incentives to leave (and not return to) the UK which are likely contributing to the UK's weaker reinvestment cycle identified in the Call for Evidence.³

Implementing a DDD charge would remove these undesirable incentives.⁴ Combining this with a Rebasing on Arrival would remove the disincentive to come to the UK where someone has large existing gains on a private business, which can be hard to 'wash out' using the UK's four-year FIG regime, potentially bringing gains accrued while not in the UK into charge.

Lastly, the UK CGT loss relief system is quite restrictive. Although some of these restrictions are required to prevent tax avoidance schemes that use 'artificial' losses, many other restrictions are required to prevent tax arbitrage that exploits the difference between CGT rates and income tax rates (which is why, in general, capital losses cannot offset other forms of income). This disincentivises investment in high risk-high growth companies, as CGT taxes the potential gains but does not (fully) relieve the potential losses. Implementing the broader reforms described above would

³Supra n. 1, p. 20.

⁴The charge need not be immediately payable, but it should be calculated at this point. Similar to other countries which impose such systems, temporary periods abroad would not trigger a charge.

allow the CGT system to offer much more generous CGT loss relief, which would reduce the current distortion against high-risk investments.

Besides these improvements to the allocation of capital in the UK, this structural reform package has the merit of raising significant revenue (around £12bn per year according to our estimates)⁵ which would enable the government to introduce strong (tax and/or non-tax) policies to support entrepreneurs in a revenue-neutral way.

4.2 Changes to mobility responses of structural reform

As we mention in Section 1, there is some case for having special tax reliefs for entrepreneurs based on their mobility responses to taxes: if these individuals are more responsive to tax in their location decisions, there may be a case for having a targeted tax relief. The mobility responses, however, are (at least partially) determined by the features of the tax system in which taxpayers operate. The current CGT system allows individuals to avoid tax on accrued gains by leaving the UK, and this clearly augments the mobility responses of successful entrepreneurs, as they can reduce their tax on disposal to zero by emigrating. Our reform package addresses this issue by imposing CGT on departure, which removes the current tax incentive to emigrate if you have built up a highly valuable company (or to hold on to assets when expecting to leave the UK in the future). In that respect, the DDD charge reduces the mobility responses of entrepreneurs.

However, the introduction of a DDD charge does not entirely remove tax incentives for entrepreneurs' location decisions. Even though it removes the incentive to emigrate for entrepreneurs that have already accrued large gains, it instead creates an incentive for entrepreneurs that expect to accrue large gains in the near future to leave the UK before their business substantially increase in value, so as to avoid the CGT (on disposal or under DDD) on the gain that will accrue in the future. This latter group is likely to be a very small number of taxpayers, as they would need to expect a very large gain in the future, and for this gain to accrue even if they are not present in the UK, so that the expected future tax savings can offset the tax on departure.

Whether a new relief to account for mobility is justified depends both on the number of people who would respond to this relief, and the number of people who would not have left even in the absence of relief. If the latter group is large relative to the former, then it may be optimal to have no

⁵Supra n. 3 (our estimation in October 2024 was £14bn, which we have now updated to account for the reforms to CGT since then).

specific policy response. If the response group is large enough, then potentially a targeted relief could be justified if the government consider that retaining this small group will have a sufficiently large fiscal benefit to offset the cost of the targeted relief, or because they will generate more broad social benefits (reinvesting in UK businesses, positive spillovers, etc.). We suggest what a relief targeted at this group could look like in Section 5 below.

5 How can the government intervene to support scale-ups?

As noted at the outset, our submission focuses on incentives for entrepreneurs to grow or ‘scale-up’ their companies in the UK, although these should also indirectly make the UK a more attractive place to found their start-ups in the first place. There are several policy tools that can be used for that purpose, and it is far from obvious that the tax system is the optimal one. In this Section we provide brief comments on the wider policy tools that government could use to support scale-ups, and highlight the targeting challenges for tax reliefs.

5.1 Wider policy tools and policy coherence

The effectiveness of tax support for entrepreneurs depends on the wider policy environment. Before considering new or expanded tax reliefs, the government should consider other areas of policy which may be more cost-effective or better targeted. A broader suite of policy measures can be used in conjunction with, or instead of, tax support.

Regulation: Government intervention could come through regulation, which already significantly affects the allocation of capital in the UK. Rules governing pension funds shape the balance between different asset classes that they choose to invest in and influence how much capital flows to different parts of the economy. Given the size of capital managed by institutional investors,⁶ this approach can potentially have a much larger impact than tax reliefs affecting only UK individual taxpayers.

Spending: In some cases, direct spending tools may be better tailored to the issues identified in the Call for Evidence than tax reliefs. Direct grants or loans can provide capital to entrepreneurs at the point when it is most needed. This gives money up front to entrepreneurs. This is in contrast with CGT-related tax reliefs, which are only valuable on exit.

⁶According to research by the Department for Work & Pensions, UK pension funds managed around £3 trillion, and they are increasingly investing in non-UK assets.

Other policy levers: Wider policy coherence matters in other areas too. For example, one of the challenges identified in the Call for Evidence is about retaining talent. Tax reliefs such as EMI and CSOP aim to help founders in this area. But for founders looking at worldwide talent, immigration policies will arguably be as (or more) important in attracting foreign talent.

5.2 The problem of targeting support through the tax system

A key difficulty with using the tax system to support entrepreneurs is that it is extremely difficult to effectively target tax reliefs. As it stands, there are issues with both over and under coverage of existing reliefs.

The first (and most obvious) problem is that tax reliefs will benefit taxpayers who are not those the policy is trying to support (over-coverage). A substantial share of any broad-based relief will go to individuals who would have engaged in the same activity regardless of the tax incentive. This is pure deadweight cost. Second, poorly targeted reliefs can actively encourage individuals to change their economic behaviour in unproductive ways. This is most clearly the case with BADR which, given the current structure of our CGT system, incentivises individuals to repackage their returns from work as gains on liquidation of personal service companies.

The second targeting problem is the opposite (under-coverage), as reliefs will only benefit a sub-set of individuals within those that should be targeted. Other reliefs (such as BADR, Investors' Relief, EIS, VCT) have the problem of being inherently backward-looking and often reward investors or founders only after value has been created and realised.

Supporting entrepreneurs by giving a tax relief to individual investors has serious problems of both over- and under-coverage. The reliefs are over-inclusive because they are available to all investors. More problematically, tax reliefs for investors have a major problem of under-coverage. There are multiple sources of investment, and the latter group (domestic individuals) is likely to be the least relevant in terms of scale of investment yet is the only one that would benefit from tax reliefs for investors. UK corporate investors will usually be exempt under the substantial shareholding exemption, while other domestic institutional investors such as pension funds are tax exempt. Foreign investors will also see no benefit from UK tax reliefs.

6 Principles for designing tax reliefs to support scale-ups

Improving the economic environment for scale-ups does not necessarily require tax reliefs. However, in some cases tax reliefs may be an appropriate

intervention. With that in mind, we set out three basic principles that should be followed to ensure the continued value for money of any reliefs:

- Targeted design
- Clear evaluation frameworks
- Sunset clauses with mandatory evaluation

These principles are useful in both the design of new reliefs to support scale-ups and in evaluating the current reliefs provided through the tax system.

6.1 Targeted design

Relief should address specific identified market failures, not serve as blanket support, and the rationale for the relief should be clearly stated. Among the reliefs within the scope of the consultation, BADR is probably the relief with the most problems in terms of poor targeting. As currently designed, it offers a blanket tax relief to any owner or employee holding at least 5% of the shares in a trading company.⁷ This has exacerbated the distortion arising from the lower CGT rates (relative to Income Tax) resulting in individuals repackaging their income from work into capital gains. In previous work we have estimated that at least half of all capital gains are actually returns from work, and this is the case in almost all the gains on unlisted shares.⁸

Tax reliefs should clearly identify the market failure they are addressing, and target the relief to taxpayers with observable characteristics that most precisely match the intended beneficiaries. Clear policy choices around the aims of the relief should be identified; these should, in turn, inform decisions about the stage at which, and beneficiaries to whom, tax reliefs are made available.

- Tax relief to the business: One alternative is to offer a reduced corporate tax rate for early-stage businesses. This has the benefit of allowing the business to retain more of its profits to reinvest in its growth, but it might not be particularly valuable in the early stage of businesses when most are not yet profitable.
- Tax relief to investors: In this case the relief would be given to the taxpayers providing capital to the entrepreneur. As we highlight in Section 3.2.3, for most potential investors UK tax relief will have little to no value.

⁷Provided they have been held for at least 2 years. If the individual is not an employee or officer of the company, Investor Relief will usually be available offering a similar tax relief (with a 3-year holding period).

⁸Supra n 1.

- Tax relief to founders: In contrast to the previous option, this would target the relief at the individuals who are building the business. A CGT relief has the effect of targeting the relief only at successful entrepreneurs.

6.2 Clear evaluation frameworks

For any new relief, the government should consider how to systematically collect data to assess its effectiveness and identify the metrics that will be used to do so at the outset. The government should publish these evaluation frameworks at the introduction of any new relief. Designing this framework and publishing it will help others, including those who benefit from the relief, understand at the outset what success looks like.

We have independently developed a detailed research plan identifying the specific data sources available for the reliefs identified in the Call for Evidence which incorporates Income Tax Self-Assessment records, scheme compliance forms companies submit to HMRC, certificates issued to investors, and employment-related securities returns. By linking these data sources, it is possible to construct comprehensive panels tracking relief recipients from investment through to company outcomes. We would be happy to share this research plan with HMT.

6.3 Sunset clauses with mandatory evaluation

Tax reliefs are sticky. Without an automatic review, government can easily become locked into reliefs even when evidence shows they are not working. To ensure their continued value for money, we propose that for any new reliefs introduced the government should commit to:

- Built-in sunset clauses: Reliefs should expire after a specific period unless explicitly reauthorised by Parliament. The period should be appropriate to the relief, occurring as soon as possible whilst allowing sufficient time to evaluate its success.
- Mandatory evaluation before reauthorisation: At each sunset point the government should publish an assessment of the relief against the evaluation framework. The evaluation should be performed independently, either by the National Audit Office or by commissioning independent experts.

7 Potential Targeted Relief for Scale-Up Founders: “Unicorn Relief”

Implementing the structural reforms mentioned in Section 2 would solve most of the distortions of the current system and improve the allocation of capital in the UK. The most relevant improvement in relation to the issues raised by the Call for Evidence is the removal of the current strong incentive for successful entrepreneurs to leave the UK.

As we mentioned in Section 2.2 above, although the structural reforms remove tax migration incentives for most taxpayers and entrepreneurs, they do not eliminate them entirely. The current reliefs are clearly inappropriate to address mobility concerns relating to this small group of entrepreneurs. BADR and Investors Reliefs, as currently designed, do little to address the tax migration incentives of entrepreneurs building high value businesses. Their broad eligibility criteria mean that most of their revenue goes to individuals disposing of personal service companies. This poor targeting necessarily means the relief needs quite a restrictive lifetime limit (currently set at £1m since 2020).⁹

7.1 The case for a targeted relief

There are two arguments for offering a tax relief to founders of genuinely high-growth businesses:

- Positive externalities: Founders who build businesses to significant scale create net additional employment, generating fiscal benefits, along with innovation and social benefits. These spillovers are not fully captured by the entrepreneur, which can lead to socially sub-optimal levels of entrepreneurship.
- Tax mobility: If this group of individuals is highly internationally mobile and has access to substantially lower effective rates in competing jurisdictions, then there may be a case for a targeted relief to retain them and the economic activity they generate in the UK.

These are theoretical arguments that need to be substantiated by empirical evidence. But if the government concludes that these are concerning issues, then the case for a tax relief would be (at least theoretically) justified.

7.2 Goal and design principles

The new relief should aim to encourage founders and early-stage staff to remain in the UK whilst building their businesses and to reinvest any

⁹For example, on a gain of £100m, BADR reduces the effective tax rate from 24% to 23.9%.

proceeds in the UK post-sale. It should do so without being prohibitively expensive or incurring a high deadweight loss. The approach proposed here uses the ex-post outcome of building a high-value business as the qualifying criterion.

The proposed qualifying criteria would broadly include: a qualifying individual test (founder or early employee with historical shareholding requirement and active engagement test), a qualifying disposal test (high-value disposal with the business sold at a valuation exceeding a substantial threshold, proposed as at least £100 million), and UK nexus criteria (individual nexus for mobility concerns and/or company nexus for positive spillovers).

A reduced CGT rate of 10% on qualifying gains is proposed. Under a CGT regime following the structural reforms presented in Section 2, this represents a very generous reduction from 45% to 10%.¹⁰ However, when designing a new relief, the broader CGT incentive structure should be properly assessed. This new relief will only be able to substantially improve the incentives for successful entrepreneurs if the possibility of realising gains tax-free by emigration has been removed, which requires the introduction of a CGT charge based on a deemed disposal on departure.

Alongside the main relief, an expanded rollover relief could allow founders who have qualified for Unicorn Relief to defer their CGT liability by reinvesting the proceeds from the disposal into another qualifying business. This directly supports the reinvestment cycle identified in the Call for Evidence as a policy priority.

7.3 Interaction with existing reliefs

Our view is that if the government is convinced that a new relief is needed to support scale-up founders and early employees of start-ups, a generous and properly targeted relief along the lines suggested above should replace BADR and Investors' Relief and not simply be built on top of the existing reliefs. If the government thinks there is a case for an additional relief, this suggests that the current reliefs are not working properly, so we should assess those that are more poorly performing and repeal them.

It is also worth repeating that assessing the broader CGT framework is also key to ensuring that the proposed new relief has the intended incentive

¹⁰But effective rates on nominal gains (as they apply currently) would be lower than 45% and 10% due to the investment allowance.

effects. Most importantly, this translates into removing the current strong incentive to leave the UK to realise accrued gains tax-free.