SUMMARY - HM Treasury/QCA meeting (4 March 2014)

Meeting with Roland Phillips and members of the QCA Tax Expert Group regarding the QCA Budget 2014 Representations on costs of raising equity being tax deductible

HM Treasury considered this measure last minute due to interest from a number of parties. HM Treasury was considering two options:

- A cautious one: to announce a consultation in view of Budget 2015
- An ambitious one: to announce a measure in this Finance Bill

HM Treasury needs input from the QCA on the details of these measures. Any measure would be subject to threshold cap: 1) cap the size of equity issuers or 2) cap the equity amount of all sizes of issues; they would be interested in assessing both their advantages and disadvantages. The alternative of explicitly targeting the relief to SMEs would be more difficult to do, as they do not want a measure that discriminates. HM Treasury is only considering a self-contained measure, nothing more ambitious than that, but a hybrid cap could also be considered.

Raised issues of concern to HM Treasury:

- Thresholds. The QCA submission mentioned this as a possibility. But what would be the level at which the measure would best target SMEs? Would the threshold be more appropriately applied to issue size or to the deductible amount? Which companies to target in view of potentially targeting smaller companies?

- Types of equity issue. Would the measure more appropriately apply to all types of issues, including secondary raisings, or merely to IPOs? Should/could the measure be available to all types of issuance (e.g. to fund an acquisition) or solely issues where cash is being raised for specified purposes (e.g. to invest in the issuer’s business). What would be the practical challenges of seeking to limit the relief in such a way? HM Treasury is interested in finding out what is the rationale behind an issuance, and whether there would be a policy case in making the distinction (concerned about restructuring).

- HM Treasury would like to understand the reasons why companies float, and why equity is a preferable solution to debt.

- How practical is it to distinguish between expenses incurred as a direct result of an IPO / issuance event, and other fees?

- There are various types of listing costs (underwriting fees, professional advisers’ fees, direct listing costs, marketing costs, PR etc.). Which of these – if any – do you think should be excluded from the scope of the measure?

- Would the measure more appropriately apply to ongoing listing costs (e.g. annual listing fees), or just costs arising from the issuance event?

- HM Treasury would like to have an estimate of all the costs in detail (listing and ongoing).

- How significant is the risk that the measure would lead to higher fees in the markets for advice, underwriting etc.? HM Treasury is concerned that banks, for example, would raise their fees as a creeping economic effect over time.

- Timing. How long could the deductions span over time (e.g. 2/3/4 years) and when would it start (e.g. year it was incurred)?

- Which would be the best way to bring this measure into effect (tax years/ accounting periods/ set date in legislation/ sunset clause for review)?

- What happens if the issuance does not come through?

Key Aspects To Add to 2015 Budget Representations:

- Which types of companies would benefit in practice (so for example some data and commentary on how many new and further issues are conducted by growing, finance-constrained corporates versus, for example, distressed corporates or investment trust companies)

- How much it would cost the exchequer with the chosen (500k?) relief threshold, and the workings for that

- Various details in designing a relief including the treatment of costs incurred for rights issues that are subsequently cancelled, etc

(2014) DETAILED PROPOSALS - Creating a level playing field for equity and debt

i. Tax relief for the costs of raising equity

There is a specific entitlement to claim a tax deduction for costs incurred in raising debt finance, whereas the costs of raising finance through the issue of equity is not tax deductible. This represents an unnecessary and pronounced distortion in the tax system, which has been referenced in the recent Mirrlees Review[1] and raised in a number of debates surrounding the causes and consequences of the financial crisis.

Raising debt is failing small and mid-size companies – we need to shift the focus to long-term, permanent capital – equity finance. A tax relief for the costs of raising equity will level the playing field between debt and equity finance and encourage more companies to raise public equity.

For a smaller company, the costs of raising equity represents a disproportionately large percentage of funds being raised and is, therefore, a major disincentive to seeking a listing on a public equity market.

The UK is at a competitive disadvantage compared to other European regimes, such as Austria, Belgium, Bulgaria, France, Germany, Greece, Hungary, Italy, the Netherlands, Luxembourg, Poland, Portugal, Russia, Serbia, Spain, Switzerland and the Ukraine, which provide some form of corporation tax relief for raising equity finance. We have included our analysis of this in Table 2 below.

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[1] The Mirrlees Review – Reforming the tax system for the 21st century, *Tax by Design* (September 2011), available at: http://www.ifs.org.uk/mirrleesReview

Also, recent VAT case law confirms that VAT costs of raising equity funding are deductible on input tax, if the company's activities are taxable. Hence, there is currently inconsistency between direct and indirect tax in terms of the ways of raising equity finance.

Table 2 – Comparison of European states' regimes for tax relief for the costs of raising equity

Country	**Is there any corporate tax relief for flotation costs?**	**Are the costs of issuing new equity generally deductible for corporation tax purposes?**
United Kingdom	No	No
Austria	Yes Flotation costs are generally deductible for corporate tax purposes without any restrictions (cf. sec. 11 (1) (1) of the Austrian Corporate Income Tax Act).	Yes The costs of issuing new equity are generally deductible for corporate tax purposes without any restrictions (cf. sec. 11 (1) (1) of the Austrian Corporate Income Tax Act).
Belgium	Yes Flotation costs and, more generally, restructuring costs can be tax deductible if incurred to develop taxable income.	Yes In order to align the tax treatment of equity financing on the one hand and debt financing on the other, Belgium legislation provides for a notional interest deduction ("Déduction pour capital à risque" – "Aftrek risicokapitaal"). A fictitious interest calculated on the "net equity" of companies or branches can be deducted for their cost of capital. The notional interest is calculated as risk-free interest with reference to 10 year government bonds. The rate to apply in tax year 2014 (income 2013) is 2.742% for large companies and 3.342% for small companies. The "net equity" is determined by adjusting the equity, primarily by deducting the tax book net value of any financial fixed assets that are grouped under "participations and other shares" on the company's balance sheet. There are other deductible items, such as the net equity assigned to foreign permanent establishments or non-Belgian real estate property.

Bulgaria	Yes Flotation costs (i.e. costs incurred by a publicly traded company with regards to issuing new securities) are not subject to a specific tax regime in Bulgaria and are generally deductible for corporate tax purposes.	Yes The costs of issuing new equity should generally be tax deductible for corporate tax purposes.
France	No	Yes The costs of issuing new equity are deductible expenses for the financial year in which the costs are incurred. The taxpayer may also elect to capitalise those costs and amortise them over a maximum period of 5 years. However, such costs are not deductible in specific cases where they are not incurred in the interests of the company, e.g. upon capital reduction followed by a capitalisation of retained earnings (which protects only the interests of shareholders).
Germany	Yes Flotation costs (underwriting fees, management fees, selling concessions, legal fees and registration fees) for primary offerings are deductible as business expenses. The same is true for secondary offerings if they are conducted mainly in the interests of the company (this is usually the case).	Yes In general, all costs of issuing new equity are deductible for corporate tax purposes. Only costs that are directly related to the acquisition of shares by shareholders (e.g. notarisation costs for a takeover agreement, if notarised separately) may be treated as a hidden profit distribution when paid by the company (and therefore not subject to relief).
Greece	Yes	Yes
Hungary	Yes	Yes
Italy	Yes Based on Italian accounting principles, flotation costs may generally be capitalised. In this case, they may be depreciated (and deducted) over five fiscal years.	Yes Based on Italian accounting principles, the costs of issuing new equity may generally be capitalised. In this case, they may be depreciated (and deducted) over five fiscal years.

Luxembourg	Yes Flotation costs are tax deductible as general expenses.	Yes The costs of issuing new equity are considered as operating costs. In principle, they are tax deductible for the issuer for corporation tax purposes to the extent they are booked as expenses in the Luxembourg GAAP accounts of the issuer. However, if the new equity finances assets that generate exempt income, the portion of the costs that finances the exempt income is non-tax deductible.
Netherlands	Yes Costs that do not qualify as equity (e.g. management and underwriting commission) are allowable as deductions under Dutch jurisprudence.	Yes Dutch corporate income tax law approves the deductibility of incorporation costs and costs related to the issue of capital.
Poland	No	Yes The law is not clear on the tax deductibility of the costs of issuing new equity. According to the most common interpretation, public and similar costs (such as court fees, administrative charges, stock exchange fees and notary fees) related to the issue of new shares on a stock exchange are not tax deductible. Other costs , such as advisory costs, are tax deductible.
Portugal	Yes Pursuant to Portuguese GAAP, which follows IAS, such costs do not meet the criteria to be treated as intangible assets and therefore should be treated as a cost in the P&L. From a corporate tax perspective, such costs are therefore tax deductible on the basis that they are necessary for the company to run its business.	Yes Any administrative and similar costs incurred are tax deductible on the basis such costs are necessary for the company to run its business.
Russia	Yes Expenses associated with	Yes Expenses associated with

	affecting an issue of securities (in particular the preparation of an issue prospectus, the manufacture or acquisition of blank forms and the registration of securities) as well as expenses associated with the servicing of own securities are accounted for as non-sale expenses for Russian tax purposes (Article 265 Item 1 Subitem 3 of Russian Tax Code). The above rule applies only for the issue of securities by the taxpayer. If, however, there are costs for setting up a subsidiary, these costs may become tax deductible only after disposal (retirement) of the subsidiary shares. All expenses recognised for Russian tax purposes should be properly documented and economically justified (Article 252 Item 1).	affecting an issue of securities (in particular the preparation of an issue prospectus, the manufacture or acquisition of blank forms and the registration of securities) as well as expenses associated with the servicing of own securities are accounted for as non-sale expenses for Russian tax purposes (Article 265 Item 1 Subitem 3 of Russian Tax Code). All expenses recognised for Russian tax purposes should be properly documented and economically justified (Article 252 Item 1).
Serbia	Yes	Yes
Spain	Yes No restrictions on the tax deductibility of flotation costs are established in the Corporate Income Tax ("CIT") Law, as long as they are duly recognised in the P&L.	Yes No restrictions on the tax deductibility of flotation costs are established in the Corporate Income Tax ("CIT") Law, as long as they are duly recognised in the P&L.
Switzerland	Yes The general principles regarding costs of issuing new equity should apply to the tax deductibility of flotation costs. That is, such costs can either be capitalised and depreciated over five years or booked directly as an expense, in both cases with tax deductible effect provided that the costs are economically justified.	Yes The costs for incorporation, capital increase and general company organisation can either be capitalised and depreciated over five years or booked directly as an expense, in both cases with tax deductible effect provided that the costs are economically justified.
Ukraine	No	Yes As there are no direct restrictions in the Tax Code regarding deductibility of the costs of issuing new equity, one may assume that such costs are

		generally tax deductible. However, the Ukrainian tax authorities may try to challenge deductibility claiming that such costs are not directly related to the issuer's business activity.

Proposals for reform

[More detail needed here based off discussions with HM Treasury]

We believe that all costs in connection with the issue of new shares as part of a public offering (either at IPO or in a secondary fundraising) should be tax deductible. This would help increase the flow of equity funds into the SME sector, which will create jobs and tax revenues within the UK and thereby support the Government's drive to stimulate growth UK economy.

The costs to the Treasury could be managed by, for example:

- Making the relief subject to an upper limit;
- Restricting the relief to those companies considered 'small and mid-size' under an appropriate definition; or
- Writing the costs off over a five year period.