The Quoted Companies Alliance

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2012 Budget

Outline Proposals for Taxation Reform

December 2011

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1. THE QUOTED COMPANIES ALLIANCE – INTRODUCTION AND CONSTITUENCY

The Quoted Companies Alliance is a not for profit organisation which works for small and mid-cap quoted companies in the UK and Europe to promote and maintain vibrant, healthy and liquid markets. The Quoted Companies Alliance is the only organisation dedicated solely to promoting and pursuing the interests and concerns of small and mid-cap quoted companies.

Small and mid-cap quoted companies are the approximately 2,000 companies outside the FTSE 350 on the Main List and those quoted on AIM and PLUS, which comprise 85% of all UK quoted companies. The total market capitalisation of the small and mid-cap quoted company sector in the UK is £72 billion (as of November 2011). The total turnover of small and mid-cap quoted company sector totals £105 billion (as of November 2011).

Small and mid-cap quoted companies employ some 1 million people, representing 4% of private sector employment. Every 5% growth in employment in this sector could reduce unemployment by a further 50,000.

The members of the Quoted Companies Alliance Tax Committee, who compiled these proposals after discussion with the QCA's corporate members, can be found in **Appendix E**.

The Quoted Companies Alliance Share Schemes Committee also supports these proposals. A list of the committee members is available in **Appendix E**.

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2. EXECUTIVE SUMMARY

With banks' financing still in short supply, the ability of small and mid-cap quoted companies to obtain and maintain funding for economic growth is a crucial issue for the UK economy. Our proposals, which include suggestions for funding, are designed to help drive private sector growth and employment and focus on four areas:

- **Encouraging long-term investment and funding for growth**

With the Government exploring how to encourage long-term investment and growth in UK companies, we believe that now is the time to focus on **capital gains tax reform (CGT) for Entrepreneurs' Relief**, which is desperately needed.

It is well known that SMEs are the core to economic growth in the UK and it is time for the Government to give these companies the support they require and target investment into the sector. We suggest the removal of the arbitrary 5% threshold for CGT Entrepreneurs' Relief for employees/officers of companies, funded by extending the minimum holding period for the relief from one year to three years. This will encourage the alignment of employee and management goals in driving growth and to promote fairness. In fact, in the first 2 years after introducing such a measure, the Exchequer should benefit from a reduction in CGT Entrepreneurs' Relief costs. If a two or three month window is provided before the holding period is extended, then this could help accelerate certain commercial transactions in the pipeline. This could also boost Exchequer receipts as was seen with the abolition of Business Asset Taper Relief in early 2008.

We also suggest expanding this relief to long-term investors in SMEs to recognise all stakeholders that make a meaningful and important contribution to growing businesses.

We believe that long-term investment could be further encouraged through **reinstating the dividend tax credit for pension funds** and changes to **the types of shares allowed to be included in ISAs**.

- **Simplifying tax rules to encourage economic growth**

The UK now has the reputation of having one of the most complex tax systems in the world. We fully support the creation of the Office of Tax Simplification to explore ways to simplify it.

Nonetheless, we have become increasingly concerned that some areas of tax legislation impose a disproportionate compliance burden on small and mid-cap quoted companies, including the **worldwide debt cap rules**, **transfer pricing, senior accounting officer requirements**, **size tests** in tax legislation, and **disguised remuneration** legislation. We have included suggestions for how these areas could be simplified.

- **Increasing investment and liquidity**

We argue for the **abolition of stamp duty** in order to stimulate activity in the shares of small and mid-cap quoted companies, which will help drive investment in the sector.

- **Creating a level playing field for equity and debt**

The tax treatment of raising equity versus debt financing is one that has been a key feature of debates on the causes and consequences of the financial crisis of 2008. We suggest that **the costs of raising equity should be tax deductible** in order to create a more level playing field and encourage more companies to raise equity. Case law in the VAT area already supports this principle and aligning the direct and indirect tax treatment would achieve greater consistency in the tax system.

3. Summary of Proposals

Encouraging long-term investment and funding for growth

Issue	Proposals	Appendix
Capital Gains Tax (CGT) Reform of Entrepreneurs' Relief	**Short-term proposals:** Abolish the condition that someone must have 5% of the voting rights and 5% of ordinary share capital in the company in order to qualify for the relief ('5% Requirement'). Have the relief applied from the date shares are acquired, or the date the option is granted (rather than exercised) for HMRC "approved" schemes, including Enterprise Management Incentive Schemes. To fund the above relaxations and to promote long-term investment, extend the current holding period from one year to three years. **Long-term proposals:** Rebrand Entrepreneurs' Relief as **'Stakeholders' Relief'** to identify those parties that make a meaningful contribution to the success of a business and more clearly align employee and shareholder interests to promote long-term growth and employment. In addition to employees and officers, target this relief for **long-term investors**: • Remove the 5% Requirement and the condition that only officers and employees can qualify for CGT Entrepreneurs' Relief. • Introduce a five year holding period for shares for persons other than employees/officers to attract and reward long-term investment. • Consider targeting this relief to the SME sector.	**A.i**
Dividend Tax Credit for Pension Funds	Explore reinstating the Dividend Tax Credit for pension funds, targeting this relief to investment in the SME sector. To encourage long-term investment, only apply the credit if shares have been held for at least five years	**A.ii**
ISAs	Allow investments quoted on exchange regulated markets (e.g. AIM and PLUS) to qualify for inclusion in ISAs.	**A.iii**

Simplifying tax rules to encourage economic growth

Issue	Proposals	Section
Worldwide Debt Cap	Eliminate the exclusion of debtor balances of less than £3m so that, effectively, the gateway test is on a total UK net debt basis. If necessary, this exclusion could be restricted to groups that meet certain size criteria.	**B.i**

	In certain circumstances, allow groups below a certain size threshold to calculate net debt on the basis of UK consolidated group accounting figures. Make the gateway test optional, which would permit groups, if they so wish, to go straight to the detailed calculations.	
Transfer Pricing	Confirm that medium-sized groups are not required to compile contemporaneous evidence to support pricing policies, unless they wish to. Confirm that HMRC will not seek to discount the value of evidence compiled at a later date following the commencement of HMRC enquiries.	**B.ii**
Senior Accounting Officer Requirements	Amend the tests of whether companies need to file for a senior accounting officer certification, so that they are by reference to group consolidated figures, which better reflect a commercial groups overall position.	**B.iii**
Size Tests	Align size definitions for tax purposes as far as possible.	**B.iv**
Disguised Remuneration	Simplify the overall complexity of the legislation and guidance and bring it into line with the Government's simplification agenda. Have a general exclusion for the provision of shares and benefits to employees from an EBT, which are not loans, regardless of the structure of the scheme, albeit with an underlying anti-avoidance test.	**B.v**
Increasing investment and liquidity		
Stamp Duty	Eliminate Stamp Duty on shares quoted on exchange regulated markets (e.g. AIM and PLUS-quoted) and announce the intention to eliminate Stamp Duty for all shares over a three year period.	**C.i**
Creating a level playing field for debt and equity		
Cost of raising equity	Costs to be deductible up to a limit of £500,000 or extended to "small or medium-sized" companies.	**D.i**

APPENDIX A

DETAILED PROPOSALS – Encouraging long-term investment and funding for growth

i. Capital Gains Tax (CGT) Reform of Entrepreneurs' Relief

- **Introduction**

The Quoted Companies Alliance believes that well targeted and cost effective capital gains tax reliefs to encourage equity investment in private and public companies will demonstrate that the Government is prepared to act quickly and decisively to promote entrepreneurial activity. It is generally accepted that the alignment of employee and shareholder interests promote long-term growth in corporate profitability and therefore a higher tax yield for the Exchequer.

Now is the time for the Government to address, for the long-term, this vitally important area of personal taxation. Removing restrictions to Entrepreneurs' Relief will help small and medium-sized companies to attract the necessary talent and investment to grow and create more employment, which will boost the economy and essential to the UK's economic recovery.

We are conscious that any potential additional costs for the Treasury involved in an extension of the current rules need to be carefully justified and any rebranded tax relief needs to be well targeted and effective. We have added some suggestions regarding how these changes could be funded in these proposals below.

- **The History of Entrepreneurs' Relief**

The introduction of Entrepreneurs' Relief was a reaction to the severe criticism accompanying the abolition of taper relief. The announcement that Entrepreneurs' Relief was to be introduced was made on 24 January 2008 (almost four months after the Pre-Budget Report which prompted such an outcry). The Finance Bill, which implemented this measure, was published only two months later. In view of this timetable the parliamentary draftsmen evidently decided to use the old retirement relief (abolished in 1999) as a basis for the new provisions.

Therefore the current definition of "personal company" is similar to, but not the same as, that for retirement relief. The key differences are the removal of the requirement for involvement in a "managerial or technical capacity" and the additional requirement to hold 5% of the ordinary share capital in the company, as well as 5% of the voting rights.

The 5% figure appears to have been lifted from retirement relief with little thought being put into whether or not this was appropriate. HMRC's representative to the House of Lords Select Committee on Economic Affairs, when asked to explain why this level was set, stated that "where to draw the line in determining the appropriate percentage was a matter for Ministers, but 5% had been in retirement relief". The relief was said to be directed at "those with a material stake in a company and those who play an active role in it"[1].

- **Proposals for Reform**

Our proposals are directed at more accurately targeting the relief by identifying those who make meaningful contributions to the growth of a business.

Our initial proposals focus on removing some of the restrictions on Entrepreneurs' Relief to make immediate changes that would help small and medium-sized businesses better incentivise their employees and officers to own shares in their companies, which will help these companies grow.

We also propose that the Exchequer rebrand Entrepreneurs' Relief as 'Stakeholders' Relief', creating a new category of those that qualify for the capital gains tax relief – long-term investors – in addition to that which exists currently for employees and officers.

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[1] Jane Kennedy, Public Bill Committee, 8 May 2008 (PM), column 136.

a. Removal of the 5% requirement

Share-based employee incentive packages are a key tool in a company's recruitment and retention arsenal, as well as the most tried and tested way to align the performance of the individual with the performance of the business. Providing capital gains tax relief to employees and officers who own shares in the business would help stimulate growth in the UK economy by rewarding employee contributions in growing the value of the business for which they work. It would also help close the "them and us" perception gap that often exists between management and employees and thereby promote fairness.

Employees' involvement in their businesses through ownership of shares is considered to be a significant contributor to employee engagement and economic growth. In many cases, it can represent a considerable exposure in terms of employees' own disposable wealth and is a risky one too, as their own financial prospects are already linked via their employment to the company. While the effect of the annual exemption is useful, a favourable headline rate for employees to align with investors would encourage further engagement and ultimately help drive growth through alignment of employee and shareholders' interest. This will help businesses to attract and retain the talented people they need to grow successfully – a company's personnel are its key stakeholders and key to the growth needed in the UK economy.

The personal company definition restricts businesses from incentivising employees and attracting new talent. The personal company definition in Entrepreneurs' Relief means that an individual must hold 5% of the voting rights and 5% of the ordinary share capital in the company in which he holds shares to qualify for relief (the "5% Requirement"). This is in addition to the need to be an employee or officer of the relevant company.

The 5% Requirement penalises those shareholders working within high-capital-requirement, high-growth businesses as their need for significant outside investment is more likely to result in those shareholders actually involved in the running of the business having to accept dilution of their rights (often to below the qualifying 5%) or not being able to negotiate 5% packages due to the high value of such a holding. This is at odds with the overarching aim of promoting entrepreneurial business activity.

The 5% Requirement can also lead to an anomalous 'cliff–edge' two-tier system amongst employees, with those unable to negotiate compliant packages now receiving even more unequal tax treatment in view of the fact that their colleagues will receive increased relief (following the welcome increase of the overall lifetime limit), whilst some of them will be subject to the newly increased 28% rate of capital gains tax.

We note that the 5% Requirement also can result in inequality between companies and LLPs. It is possible for a member of an LLP to qualify for relief on the sale of any part of his/her interest in the LLP, regardless of his/her percentage interest in the LLP. This inequality demonstrates that the business world has moved on since retirement relief was phased out in 1999, and questions again the appropriateness of the 5% Requirement for companies.

Such tension could perhaps be tolerated if there was a well-reasoned argument behind the 5% Requirement. However, the limit appears to be an arbitrary way in which to define a 'material stake' in a business – it was simply lifted from the old retirement relief with no critical thought as to whether it was appropriate.

For those reasons, we consider the 5% Requirement is inappropriate in the modern business world and should be abolished for employees/officers of the business.

We realise that dropping the 5% Requirement could be a cost to the Treasury. As such, we would propose that employees and officers could only claim the capital gains tax relief if the shares were held for an ownership period of at least three years (the current period under Entrepreneurs' Relief is one year). This would help defer the cost to the Treasury and also encourage these stakeholders to be long-term investors. Ultimately it should also lead to an increase in revenues for the Exchequer as a large number of employees/directors pay capital gains tax.

In fact, extending the one year holding requirement to three years should generate greater corporate activity and lead to an increase and acceleration of taxes payable. To support this claim, we can look back at when the CGT Business Asset Taper Relief was abolished in 2008. There is still evidence from HMRC that there was an increase in the CGT take in the early part of January 2009, which is when CGT for 2008 became payable.

b. Practical Difficulties with the 5% Requirement

The 5% Requirement creates unnecessary costs and difficulties for small and medium-sized businesses in practice. Costs are created through lost time and distraction in negotiating transactions and the delays caused in dealing with a tax point, rather than concentrating on the commercial factors and business. Below are some general examples of the practical difficulties:

- **Founding shareholders who have been diluted over time**

This can happen for different reasons over time. However, from the experience of advisors on the Quoted Companies Alliance Tax Committee, it is often due to shares being earned or passed to next levels or generation of management. To stop further dilution, founder shareholders place blocks to maintain a tax relief. This will certainly have a detriment to the business by discouraging changes in a company's capital and shareholder structure.

- **Obtaining new funding**

Deals for new funding can result in continuing management each holding less than 5% of the company's capital. The commercial transaction can be complete, with the price agreed and the funding ready. However, in our experience, far too much time can be spent on the negotiations of deals for new funding regarding Entrepreneurs' Relief points.

- **Specific examples**

We have collated several more specific and anonymised examples of small and medium-sized companies that have had practical difficulties with the 5% Requirement. The following examples illustrate the need to address this area for growing businesses.

Company A

Number of Employees- 20
Turnover- £6m

Company A had their advisors restructure a transaction to ensure that the relevant individuals had 5% of the voting rights. Commercially they were only meant to have 4.23% of the voting rights. Therefore the shares that were issued did not have straightforward rights and the deal was made much more complex by this issue.

Estimated extra cost to company in management time - £3,000
Estimated extra cost to company in advisor fees - £8,000

Company B

Number of Employees- 200
Turnover- £40m
Market Cap- £25m

Company B had inadvertently broken the personal company test for a short period, whilst in the process of a share reorganisation. It was due to a technicality in the "ordinary" share capital requirement.

Estimated extra cost to company in management time - uncertain over the management cost, however it cost the shareholder £1.8m in lost Entrepreneurs' Relief over the 12 months.

Extra cost to company in advisor fees - £10k in fees for reviewing the Entrepreneurs' Relief position.

Company C

Number of Employees - 75
Turnover - £20m
Market Cap- £5m

Company C had to seek advice on the application of Entrepreneurs' Relief to different types of consideration, namely loan notes and earn out. Individuals related to Company C assumed that they would receive Entrepreneurs' Relief on all proceeds, despite the loan notes and profit on earn out not qualifying for Entrepreneurs' Relief.

Estimated extra cost to company in advisor fees - £15k

Company D

Company D found that the conditions in its articles removing the voting rights of certain classes of shares in relation to certain decisions were causing issues with qualification for Entrepreneurs' Relief.

Estimated extra cost to company in advisor fees - £15k

Company E

Number of Employees - 100
Turnover - £30m
Market Cap - £25m

Company E was formed nearly 10 years ago by two entrepreneurs and some key managers. It floated nearly 5 years ago in order to grow the business and raise additional share capital.

The key managers, who are critical to the success of business (and growth of employment in UK), were diluted to below 5%; hence they did not qualify for the Entrepreneurs' Relief despite having invested both financial and human capital in a high growth business. Yet the original entrepreneurs will currently benefit from the relief.

The entrepreneurs feel embarrassed about this inequity in tax treatment and would happily agree to having to hold their shares for a longer time to benefit from the relief and have asked us to represent that the 5% artificial limit is abolished, replaced by a holding period for anyone working in the business as a Director / Employee for three years.

Estimated extra cost to company in management time - £20k
Estimated extra cost to company in advisor fees - £20k

Company F

A founding shareholder of Company F passed a class of non-voting share to management. Three individuals in the company each had a 9% share, but that 9% was non-voting shares. Upon an offer, Entrepreneurs' Relief has felt like the only point being negotiated and certainly took far too high a profile within the negotiations.

Company G

Company G is currently considering to reward employees and executives (and in particular an incoming CEO) and align their longer term goals to those of the current owners and the company. A form (or forms) of share scheme is recognised as ideal for this purpose. An inordinate amount of time, effort and cost arises to protect those existing shareholders' holdings for Entrepreneurs' Relief.

c. Application of the relief

To align the treatment of employees who own shares with those companies that have HMRC "approved" schemes (including Enterprise Management Incentive Schemes), we request that Entrepreneurs' Relief is applied from the date an option is granted (rather than exercised). For all other instances, the relief should be applied from the date the shares are acquired.

d. Stakeholders' Relief and Long-Term Investors

Investors who choose to invest over a period of years in small and medium-sized companies make a valuable contribution by providing the stable financial base necessary to promote growth. These individuals are true stakeholders in the business and a capital gains tax relief recognising this would encourage longer-term rather than speculative investing. Business Asset Taper Relief recognised and rewarded this (although we have sympathy with the view that the reduction in the qualifying period to just two years was too generous), and the current Entrepreneurs' Relief includes a general condition that the shares have to be held for one year.

We propose that, for those willing to invest in the long-term, investors should qualify for 'Stakeholders' Relief', with no minimum equity stake required nor a requirement to be an employee or officer, as currently outlined in Entrepreneurs' Relief. In order to ensure that their investments are truly 'long-term', we propose that there is a five year minimum holding period of shares.

In order to target this category of 'Stakeholders' Relief' more precisely to address the increased difficulties of obtaining equity investment in the SME sector, it may also be appropriate to set a limit on the size of the business whose shares can qualify. Such a limit should be straightforward to apply. Two potential qualifying options could be based on:

i. **Market Capitalisation and Market Segment** – Qualifying companies would be those whose shares are publicly traded on a regulated market below £100 million at the time of investment and 'unlisted' companies (with no such limit).We consider £100 million to be in line with the definition of a 'company with a reduced market capitalisation' as defined in the amending Directive of the Prospectus Directive; **OR**

ii. **Market Segment** – Qualifying companies would be those that are considered 'unlisted', including those that are private and/or quoted on exchange regulated markets (i.e. AIM and PLUS-quoted). This would be similar to the current qualifying criteria of the Inheritance Tax 100% Business Property Relief, which only applies to 'unlisted' companies.

e. Table 1 – Outline of the Stakeholders' Relief Proposals

Types of investor	Requirement to hold 5% voting and share capital	Requirement to be an employee/officer	Holding period	Application of the relief	Other conditions
Employees and officers	No	Yes	3 years	Applied from the date shares are acquired, or if an "approved" option, date that option granted.	None
Long-term investors	No	No	5 years	Applied from the date the shares are acquired.	Target relief to SME sector by requiring a qualifying company test based either on market cap or market segment, such as 'unlisted companies' (AIM/PLUS-quoted and private companies)

ii. Dividend Tax Credit for Pension Funds

The abolition of the dividend tax credit for pension funds in 1997 has resulted in the value of pensions being more uncertain and reliant on the contributions of an employee and employer only. At a time when Government is focused on encouraging people to save for their retirement and faced with a pensions crisis, reinstating the dividend tax credit would be a welcomed action.

We note that the Conservative Party has already indicated its intention to explore reinstating this relief in the Conservative Manifesto 2010[2] and also its document, 'A New Economic Model – Eight Benchmarks for Britain'[3].

We understand that there will be a cost to the Exchequer in reinstating this credit. In order to target this credit and encourage investment in the SME sector, we would propose that the Government could initially reinstate the tax credit for investments by pension funds in small and mid-cap quoted companies. This would have the dual effect of increasing pension certainty and increasing long-term investment in the small and mid-cap quoted company sector. This should help generate economic growth and lead to increases in the tax yield, for example from greater PAYE/NIC, increased employment, higher corporation tax receipts and increased profitability. We also propose that in order to encourage the long-term investment, the credit would only apply if the shares have been held for at least five years.

iii. Inclusion of investments on exchange regulated markets in ISAs

The tax status of AIM and PLUS quoted companies has changed radically following the abolition of Business Asset Taper Relief.

Consequently, companies quoted on an exchange regulated markets do not qualify for certain reliefs that are available to listed companies. Currently shares in AIM and PLUS-quoted companies do not qualify to be included as ISA investments.

This results in a number of complications. This can unduly influence a listed company's decision to move from the Main Market to AIM, with investors who have shares in ISAs having to move their shares out of the ISA once the company moves to AIM. At the same time, AIM and PLUS-quoted companies that have a dual listing on another exchange (that is a recognised stock exchange) are able to be included in ISAs.

With the loss in the CGT relief, support for small and mid-cap quoted companies is essential. The economy is relying on this sector to help rebuild and create growth and employment and we therefore recommend that AIM and PLUS shares should qualify for ISA relief.

We view this measure as supporting investment into a much-needed area and reducing complexity, and hence we believe it can be implemented without significant cost to the Treasury. It would help boost liquidity in AIM/PLUS shares and therefore stimulate investment and economic growth in the sector.

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2 *The Conservatives Manifesto 2010 – Invitation to join the Government of Britain*, p. 12, available at: http://www.conservatives.com/Policy/Manifesto.aspx

3 *A New Economic Model – Eight Benchmarks for Britain*, February 2010, p. 11, available at: http://www.conservatives.com/News/News_stories/2010/02/Osborne_outlines_eight_benchmarks_for_economic_growth.aspx

APPENDIX B

DETAILED PROPOSALS – Simplifying tax rules to encourage economic growth

We have become increasingly concerned that some areas of the tax legislation impose a disproportionate compliance burden on small and mid-cap quoted companies. We refer to areas of legislation that appear to have been introduced and targeted at the largest multi-national groups, but where the legislation is drafted in a way that it becomes necessary for small and mid-cap quoted companies to incur substantial costs to discharge their obligations under the relevant rules, even though any adjustment leading to additional taxes for the Treasury is extremely rare.

i. Worldwide Debt Cap Rules

We are concerned, given the length and complexity of these rules, that it is often very time consuming for taxpayers to collate the relevant information and perform the detailed calculations required. This results in a significant compliance burden and cost, which is disproportionate for small and medium-sized quoted companies. This compliance burden applies even where it is clear at the outset that no net adjustment will be required.

Similarly, the calculation of the gateway test is such that many groups fail the test and are required to incur additional time and costs in performing the detailed calculations, even though ultimately there is no adjustment.

a. Proposals for reform

We submitted representations on the operation of the debt cap rules during the recent HMRC consultation process and made a number of suggestions as to how we believe these rules could be simplified[4], including:

- We suggest that consideration is given to a means of avoiding the gateway test being failed unnecessarily whilst respecting EC requirements, perhaps by eliminating the exclusion of debtor balances of less than £3m so that, effectively the gateway test is on a total UK net debt basis. If necessary, this exclusion could be restricted to groups which meet certain size criteria.

- The need to undertake calculations on an entity by entity basis significantly increases the amount of information required and time to perform the calculations. We suggest that consideration is given to ways of simplifying this, perhaps in certain circumstances for groups below a certain size threshold, to calculate net debt on the basis of UK consolidated group accounting figures.

- We suggest consideration is given to making the gateway test optional and permitting groups, if they so wish, to go straight to the detailed calculations.

b. Practical difficulties with the Worldwide Debt Cap Rules

Below is a specific, anonymised example of a company that has experience practical difficulties applying the worldwide debt cap rules, which illustrates the complexities and costs for small and medium--sized quoted companies.

Company A **Number of Employees** - 500 **Turnover** - £100m **Market Cap** - £40m

[4] For more detail, our response is available at: http://www.theqca.com/about-us/responses/48292/qca-response-to-hmrc-consultation-on-potential-debt-cap-changes.thtml

Company A's Group has almost wholly UK operations (although exports to overseas customers). It has no actual debt cap restrictions (i.e. no additional tax take to the treasury), but has spent considerable time and expense undertaking the gateway tests, standalone company calculations etc, which generate no value either to the group or Treasury. They regard the Debt Cap rules as unnecessary red tape which needs to be eliminated immediately.

Estimated extra cost to company in management time - £20k
Estimated extra cost to company in adviser fees - £20k

ii. Transfer Pricing

For medium-sized groups (as defined in the legislation), transfer pricing rules provide a partial exemption, though leaving HMRC with the power to direct transfer pricing adjustments.

This leaves medium-sized groups in an untenable position of not knowing for certain whether or not transfer pricing adjustments may ultimately be required. The result is that such companies are compelled to collate, compile and update transfer pricing documentation and incur the necessary costs of doing so, in order to protect themselves from potential challenge by HMRC.

However, we understand that the number of HMRC directions issued to medium-sized entities is minimal indicating that the uncertainty of the application of these rules to medium-sized entities serves little purpose.

a. Proposals for reform

We suggest the position for medium-sized groups is clarified, and HMRC confirm that a taxpayer in these circumstances is not required to compile contemporaneous evidence to support pricing policies unless they wish to, and that HMRC will not seek to discount the value of evidence compiled at a later date following the commencement of HMRC enquiries.

b. Practical difficulties with Transfer Pricing

Below is a specific, anonymised example of a company that has experience practical difficulties applying the transfer pricing rules, which illustrates the complexities and costs for small and medium-sized quoted companies.

Company A

Number of Employees - 500
Turnover - £100m
Market Cap - £40m

Company A's Group has only UK to UK intercompany transactions, yet has to spend internal time and professional fees on a UK Transfer Pricing documentation, which generates no benefit to the group or UK Exchequer.

Estimated extra cost to company in management time - £20k
Estimated extra cost to company in adviser fees - £20k

iii. Senior Accounting Officer Requirement

Where the Senior Officer Accounting rules apply, taxpayers can incur significant costs in collating the necessary supporting documentation to enable the required certificates to be provided.

It would appear that these rules were intended to apply to only the largest groups. However, the tests of whether a group falls within the rules are based on simple aggregations of company numbers such that small and mid-cap quoted companies with relatively low entity values are caught.

The balance sheet total test is by reference to gross assets and liabilities are ignored. Intra group loans or intermediate holding companies inflate the gross asset value without any impact on the net asset value of an enterprise. Similarly, the turnover test is an aggregation of individual companies with no adjustment for intra group transactions. These rules can result in a mid-cap company/group with relatively low net assets and turnover falling within the ambit of the rules.

We suggest the tests are amended so that they are by reference to group consolidated figures which better reflect an entity's overall position.

iv. Size Tests

Tax legislation includes various differing tests of size for various purposes. For example, different definitions are used for Transfer Pricing, Research & Development Tax Credits, and the application of the full Corporation Tax rate.

These varying definitions complicate matters and add to compliance costs, particularly for mid-cap groups which may be medium or large for some purposes but not for others.

We suggest that size definitions for tax purposes should be aligned as far as possible.

v. Disguised Remuneration

The introduction of anti-avoidance legislation aimed at trust-based remuneration planning was widely anticipated following the issue of HMRC's "Spotlights" 5 and 6 covering particular uses of:

- Employer Financed Retirement Benefits Schemes (EFRBS) which are unapproved, trust-based pension schemes, generally used as a top-up or more flexible alternative to registered pension schemes; and

- General employee benefit trusts (EBTs) which can be used to provide shares, cash or other benefits to employees.

Further related pronouncements were also made in the June 2010 Emergency Budget.

The "Disguised Remuneration" rules were first published in draft on 9 December 2010. After consultation and lobbying, HMRC clarified and redrafted a number of provisions both in Finance Bill 2011 Clause 26 and Schedule 2 published on 31 March 2011 and at Public Bill Committee stage in May 2011. Several versions of Frequently Asked Questions were also published, followed by the issuance of more comprehensive guidance as part of the Employment Income Manual on 31 October 2011.

The resulting legislation, now contained in Part 7A ITEPA 2003 is complex and over 80 pages in length, half of which comprises exclusions to the general taxing provisions.

The legislation applies where:

- there is an arrangement which relates to an existing, former or prospective employee which is, in essence, a means of providing rewards, recognition or loans in connection with employment; and

- the "relevant third party" operating the arrangement takes a "relevant step".

The value of the cash or assets, which are the subject of the "relevant step", is treated as employment income subject to PAYE and NIC.

A "relevant third party" will, in most cases, be a trustee of an EBT or EFURB but could also include a shareholder or investor, for example, who wishes to offer their shares to employees. A group company will not normally be a relevant third party unless it acts as trustee or there is an underlying tax avoidance purpose, or an employer gives certain undertakings to an EFRBS.

There are three categories of "relevant step" as follows:

- earmarking of money or assets for an employee with a view to a later relevant step being taken (s554B ITEPA 2003)

- payment of sums to an employee, including the making of a loan or the transfer of an asset (s554C ITEPA 2003); and

- making an asset available to an employee as if the asset had been transferred outright (s554D ITEPA 2003).

The result of the rules is that, broadly, any arrangement which provides employment benefits through a third party such as an EBT is potentially chargeable unless a statutory exclusion applies.

a. Implications for employees' share schemes

Many companies operate EBTs in conjunction with their employee share schemes. Where trustees allocate shares held in an EBT in order to satisfy awards granted to employees under an employees' share scheme, this will be earmarking within s554B, even if the employee is not aware that earmarking has taken place and the award is subject to conditions, unless the arrangement falls within a statutory exemption.

If an EBT acquires shares to meet future requirements of a company's employees' share scheme, HMRC guidance suggests that there should not be a Part 7A charge, provided the shares are not earmarked for identifiable employees but are retained as part of a general pool of shares upon the terms of the EBT. But, EBT trustees may be reluctant to accept shares on such a basis as they will want to be clear about the uses of the shares they hold, particularly given the requirements of the exemptions set out below. They may also be concerned that any internal records, which give an indication of the likely recipients of shares would be sufficient to deem them to have earmarked shares. Also, it is unsatisfactory for companies to have to place reliance on guidance in order to determine whether or not there has been earmarking in these circumstances.

b. Proposals for reform

The statutory exclusions for earmarking in relation to share schemes are lengthy and in some cases overlap. They are generally subject to detailed conditions. For example, they require the number of earmarked shares not to exceed the maximum number that might reasonably be needed for meeting the award and require any earmarked shares to cease to be so held once a relevant award has lapsed, otherwise a tax charge arises. Similarly where shares are earmarked for certain employees and awards or options not granted within three months, a tax charge arises. This will give practical challenges to trustees and companies operating arrangements and will require close monitoring or shares held and in particular any leavers/lapses of award which will need to be communicated quickly.

The statutory exemptions are different for HMRC approved schemes and other types of share awards. The exemptions for HMRC approved schemes cover the grant of awards, the earmarking of shares held in an EBT and the final delivery of shares to participants. The exemptions for other types of awards are, for the most part, only applicable to exclude a charge for earmarking. If the trustees of an EBT grant awards or deliver shares to satisfy awards, these will be treated as separate relevant steps within s554C and separate exemptions or reliefs will need to be found to cover each of these steps and offset any potential tax charges.

One of the difficulties is that HMRC view the grant of options or share awards as involving two steps: the grant of an option and the earmarking of shares. For example, suppose the trustees of an EBT grant an award under a long-term incentive scheme in the form of a nil cost option. The shares are to be set aside for participants and released on the exercise of the award provided performance conditions are satisfied over a three year period:

- S 554N(2) will cover the grant of the award as it is in the form of an employment-related securities option, but not the earmarking or subsequent delivery of shares.

- The earmarking of shares should fall within s554J providing the conditions in that section are met (in summary, these are that the main purpose of the award is to defer the receipt of the shares, there is a reasonable chance that the award of the shares will be revoked because not all the specified conditions are met, the number of shares earmarked does not exceed the maximum number which might reasonably be expected to be needed for meeting the award and there is no tax avoidance motive). But this exemption does not cover the delivery of shares on vesting.

- The delivery of shares following vesting should be covered by s554N(5)(a) which exempts a chargeable event in the form of the exercise of an option.

If the award takes a form other than a nil cost option, for example, where it is simply a promise to set aside shares and deliver them in the future, subject to the performance conditions, different exemptions or reliefs will need to be found to cover the grant of the award and the delivery of shares.

Some provisions in Chapter 2 of Part 7A will give relief from potential double tax charges for example where an employee pays the exercise price of a market value option or gives consideration for shares or is otherwise subject to a general earnings tax charge. This is not as satisfactory as having an outright exemption; in some circumstances an application for relief will be required (see s554Z14 where earmarking has taken place but, by reason of an event, is not followed by a further "relevant step" - an application for relief must be made to HMRC).

HMRC have also retained the power to put in place further exemptions through regulation, signalling that there may be further changes to come as a result of this highly complex piece of legislation.

All of this adds a significant burden to employers and trustees in the operation of employees' share schemes, which is already a complex area, particularly where the requirements of HMRC approved schemes also have to be met. There is a real risk that the uncertainty over potential unexpected tax charges, and the further expenses involved in obtaining professional advice, will deter employers from offering shares to employees.

It would be preferable to have a general exclusion for the provision of shares and benefits to employees from an EBT, which are not loans, regardless of the structure of the scheme, albeit with an underlying anti-avoidance test.

APPENDIX C

DETAILED PROPOSALS – Increasing investment and liquidity

i. Abolition of Stamp Duty

At present, London is one of three major stock exchanges where a transfer tax is still in place. A study by the ABI, City of London Corporation, IMA and London Stock Exchange entitled "Stamp Duty: its impact and the benefits of its abolition" (May 2007) confirmed this and showed that Stamp Duty increases the cost of equity for publicly listed companies by 7-8.5%. The same report indicates that Government's tax-take could increase if Stamp Duty were abolished as a result of increased turnover. The study estimates that the annual tax-take could increase by as much as £4,000m, which would exceed the estimated cost of abolition by well over a £1bn. Also, the study indicates that its abolition would have a one-off increase in Capital Gains Tax intake of £281m.

Even a gradual reduction in Stamp Duty could yield significant up front benefits if there was a firm commitment from Government to abolish the duty over a period of three years. Such a commitment would have a beneficial impact on the markets as a result of increased investment.

We believe that the Government should announce its commitment to eliminating Stamp Duty/SDRT over a three year period. However, the Government should immediately remove Stamp Duty on shares which are quoted on exchange regulated markets (e.g. AIM or PLUS-quoted), as we do not believe that this would significantly reduce the Government's tax income and stimulate activity and investment in the shares of small and medium-sized quoted companies.

APPENDIX D

DETAILED PROPOSALS – Creating a level playing field for equity and debt

i. Tax relief for costs of raising equity (e.g. listing costs)

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[5] and raised in a number of debates surrounding the causes and consequences of the financial crisis.

For a smaller company, this cost represents a disproportionately large percentage of funds being raised and is, therefore, a major disincentive to seeking a listing.

The UK is at a competitive disadvantage compared to other European regimes, such as Germany, Switzerland, Austria, Greece and Bulgaria, which provide tax relief for flotation costs. In Germany, Greece and Bulgaria, costs for issuing new equity are also tax deductible. 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.

We believe that all costs in connection with the issue of new shares as part of a public offering should be tax deductible. If necessary, the relief could be limited to a specified amount, for example £500,000, or restricted to those companies that fall within the European Union small or medium-sized enterprise definition. This would target the relief and reduce the costs to the Treasury. The costs would be written off over the average period of a loan, e.g. 5 years, which would spread the tax cost. However, it would help increase the flow of equity funds into the SME sector, thereby supporting Governments' drive to stimulate growth in the SME sector and UK economy. This will help create jobs, growth and tax revenues within the UK.

We believe that all costs in connection with the issue of new shares as part of a public offering should be tax deductible for small or medium-sized companies and/or subject to an upper limit of £500,000.

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

APPENDIX E:

MEMBERS OF THE QUOTED COMPANIES ALLIANCE TAX COMMITTEE

Vijay Thakrar (Chairman)	Deloitte LLP
Tim Crosley (Deputy Chairman)	Memery Crystal LLP
Paul Barnes	KPMG LLP
Chris Bond	PKF (UK) LLP
David Boyd	Mazars LLP
Nick Burt	Nabarro LLP
Jason Collins	McGrigors LLP
Paul Fay	Crowe Clark Whitehill LLP
Stephen Goldstraw	Manches
Natasha Kaye	Olswang LLP
Lindsey Kutten	PricewaterhouseCoopers LLP
Neil Pamplin	Grant Thornton LLP
Michael Ridsdale	Wedlake Bell LLP
Amanda Solomon	Charles Russell LLP
Jennifer Wytcherley	Ernst & Young LLP
Kate Jalbert	Quoted Companies Alliance
Jacques Sultan	Quoted Companies Alliance
Tim Ward	Quoted Companies Alliance

MEMBERS OF THE QUOTED COMPANIES ALLIANCE SHARE SCHEMES COMMITTEE

Nicholas Stretch (Chairman)	CMS Cameron McKenna LLP
Fiona Bell (Deputy Chairman)	Memery Crystal LLP
Martin Benson	Baker Tilly
Danny Blum	Eversheds LLP
Anika Chandra	Stephenson Harwood
Stephen Chater	Postlethwaite & Co
Sara Cohen	Lewis Silkin
Christopher Connors	Charles Russell LLP
Karen Cooper	Osborne Clarke
Michael Deeks	Olswang LLP
Jared Cranney	Interior Services Group plc
John Daughtrey	Equiniti
David Ellis	BDO LLP
Matthew Findlay	Hewitt New Bridge Street
Philip Fisher	PKF (UK) LLP
Amanda Flint	BDO LLP
Stephen Goldstraw	Manches
Paula Hargaden	Burges Salmon
Colin Kendon	Bird & Bird
Michael Landon	MM & K Limted
Nigel Mills	MM & K Limited
Peter Mossop	Sanne Group
Robert Postlethwaite	Postlethwaite & Co
Colum Spillane	Sanne Group
Amanda Stapleton	Mazars LLP
Paul Twist	KPMG LLP
Nick Wallis	Smith & Williamson Limited
Kate Jalbert	Quoted Companies Alliance
Jacques Sultan	Quoted Companies Alliance
Tim Ward	Quoted Companies Alliance