Quoted Companies Alliance

Proposals for Taxation Reform

2013 Budget

Contents

	Page
Quoted Companies Alliance – Introduction and Constituency	3
Executive Summary	4
Summary of Proposals	5
APPENDICES	
A. Detailed Proposals – Encouraging long-term investment and funding for growth	7
i. Capital Gains Tax Reform of Entrepreneurs' Relief	
ii. Dividend Tax Credit for Pension Funds	
iii. Inclusion of Investments on Exchange Regulated Markets in ISAs	
B. Detailed Proposals – Creating a level playing field for equity and debt	18
i. Tax Relief for Costs of Raising Equity	
C. Detailed Proposals – Creating a simple and reliable tax system	19
i. Worldwide Debt Cap Rules	
ii. Transfer Pricing	
iii. Senior Accounting Officer Requirement	
iv. Size Tests	
v. Enterprise Investment Scheme and Permanent Establishment	
D. Detailed Proposals – Increasing investment and liquidity	23
i. Abolition of Stamp Duty	
E. Quoted Companies Alliance Tax and Share Schemes Expert Group Members	24

QUOTED COMPANIES ALLIANCE – INTRODUCTION AND CONSTITUENCY

We are the Quoted Companies Alliance, the independent membership organisation that champions the interests of small to mid-size quoted companies. We campaign, we inform and we interact to help our members keep their businesses ahead. Through our activities, we ensure that our influence always creates impact for our members.

Small and mid-size quoted companies tend to have market capitalisations below £1 billion. There are approximately 2,000 small and mid-size quoted companies on the Main List and quoted on AIM and ISDX, which comprise 85% of all UK quoted companies. The total market capitalisation of the small and mid-size quoted company sector in the UK is £237.4 billion (as of October 2012). The total turnover of the small and mid-size quoted company sector is £221.4 billion (as of October 2012).

Small and mid-size quoted companies employ approximately 1.7 million people (as of October 2012), representing 7% of private sector employment in the UK.

The members of the Quoted Companies Alliance Tax Expert Group, who compiled these proposals after discussions with our corporate members, can be found in Appendix E.

The Quoted Companies Alliance Share Schemes Expert Group also supports these proposals. A list of the group members is available in Appendix E.

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EXECUTIVE SUMMARY

With bank finance still in short supply, the ability of small and mid-size 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 inspire private sector growth and employment.

1. 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**.

SMEs are the core to economic growth in the UK. 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, funded by extending the minimum holding period for the relief. This will encourage the alignment of employee and management goals in driving growth.

In the first two years after introducing such a measure, the Exchequer should benefit from a reduction in CGT Entrepreneurs' Relief costs. If a three or four month window is provided before the holding period is extended, 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 who 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**.

2. Creating a level playing field for equity and debt

The tax treatment of raising equity versus debt financing has been a key feature of debates on the causes and consequences of the 2008 financial crisis. 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. Creating a simple and reliable tax system

The UK now has the reputation of having one of the most complex tax systems in the world. We fully support the work of the Office of Tax Simplification to explore ways to simplify it. We also are very supportive of the Government's reduction of Corporation Tax rates and its announcement to reduce it further over the coming years. Nonetheless, existing and new tax legislation is still increasing in length and complexity. One pronounced example of this is the disguised remuneration legislation (Part 7A ITEPA 2003), introduced in 2011.

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

4. Increasing investment and liquidity

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

SUMMARY OF PROPOSALS

<table>
<tr><th colspan="3">Encouraging long-term investment and funding for growth</th></tr>
<tr><th><u>Issue</u></th><th><u>Proposals</u></th><th><u>Appendix</u></th></tr>
<tr><td>Capital Gains Tax (CGT) Reform of Entrepreneurs' Relief</td><td>Short-term proposals:

Abolish the condition that the shareholder 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 all 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 two 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 three to 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.
Specific adjustments to the current regime:

For Enterprise Management Incentives options qualifying for Entrepreneurs' Relief, have the 12 month holding period run from the date of grant rather than exercise.

Amend legislation to confirm that the exercise of options on the same day would not cause the Entrepreneurs' Relief to be lost.</td><td>A.i</td></tr>
<tr><td>Dividend Tax Credit for Pension Funds</td><td>Reinstate the Dividend Tax Credit for pension funds, targeting this relief to investment in the SME sector.</td><td>A.ii</td></tr>
</table>

	To encourage long-term investment, only apply the credit if shares have been held for at least three years	
ISAs	Allow investments quoted on exchange regulated markets (e.g. AIM and ISDX) to qualify for inclusion in ISAs.	**A.iii**
Creating a level playing field for debt and equity		
Cost of raising equity	Allow listing costs to be tax deductible for small and mid-size companies and/or subject to an upper limit.	**B.i**
Creating a simple and reliable tax system		
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. 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.	**C.i**
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.	**C.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 group's overall position.	**C.iii**
Size Tests	Align size definitions for tax purposes as far as possible.	**C.iv**
Enterprise Investment Scheme and Permanent Establishment	Extend the UK PE requirement so that the issuing company or a subsidiary it owns can satisfy the test.	**C.v**
Increasing investment and liquidity		
Stamp Duty	Eliminate Stamp Duty on shares quoted on exchange regulated markets (e.g. AIM and ISDX) and announce the intention to eliminate Stamp Duty for all shares over a three year period.	**D.i**

APPENDIX A

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

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

Introduction

We believe 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 promotes 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 mid-size companies to attract the necessary talent and investment to grow and create more employment, which is essential to the UK's economic recovery.

We note that the London Stock Exchange also supports the proposal to reduce CGT for investment in small and mid-size quoted companies, and have included research in their Autumn Statement submission which shows the positive economic impact this change would have.

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.

The History of Entrepreneurs' Relief

The introduction of Entrepreneurs' Relief was a reaction to the severe criticism accompanying the abolition of taper relief. Overall, it has had a massively negative impact on investment in small and mid-size quoted companies and was the wrong signal from Government in terms of supporting smaller growing companies.

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].

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

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 mid-size businesses better incentivise their employees to own shares in their companies, which will help these companies grow.

We also propose that the Exchequer rebrand Entrepreneurs' Relief as 'Stakeholders' Relief' and create 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. This would make a clear distinction between investors and traders.

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. Such awards are ever more important in an environment where the employer's ability to increase salaries is restricted.

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' interests. 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. Very few employees will hold 5% of their employing company's share capital.

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 that 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 two to 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 two 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 to when the CGT Business Asset Taper Relief was abolished in 2008. There is 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 mid-size 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 our Tax and Share Schemes Expert Groups, 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 mid-size 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 its 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.

Furthermore, soon after this transaction, an incoming new Chairman wished to also be included within the planning. This aim (to qualify for Entrepreneurs' Relief) was felt to be uncommercial by existing management and created tension within the management team.

Estimated extra cost to company in management time - £20,000
Estimated extra cost to company in advisor fees - £25,000

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 - £10,000

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 - £15,000

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 - £15,000

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.

Estimated extra cost to company in management time - £20,000
Estimated extra cost to company in advisor fees - £20,000

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.

Company H

Company H has individual and venture capital shareholders. It is a medical technology company. It has shares of two classes, which its articles of association call ordinary shares and preference shares.

Its founders believed that because they each held at least 5% of the ordinary shares, they would qualify for Entrepreneurs' Relief on an eventual sale.

However, they have recently found that this is not the case. To qualify, they must hold at least 5% of ordinary share capital as that term is defined in the tax legislation (section 989 Income Tax Act 2007). That definition includes any share which has any kind of variable dividend right. The ordinary shares in this company do have only a variable dividend right, but the preference shares also potentially have a right to a variable dividend as well as a fixed one. The effect is that the company's preference shares are also treated as part of the company's "ordinary share capital" within the statutory definition. The 5% calculation must therefore include them.

As there are many more preference shares than ordinary shares (as the company calls them), the individual founders thus do not hold 5% of the total ordinary share capital within the statutory definition, and so are now unable to qualify for Entrepreneurs' Relief.

Company I

Number of Employees - 200
Turnover - £20m

The company balance sheet was not attractive to lenders as there was a large shareholder debt present. The shareholder proposed to capitalise debt; however the form of share which is both commercially acceptable and be accounted for/disclosed as shareholder funds will also fall to be "ordinary share capital". The issue of these new ordinary shares would dilute all the management's holdings below 5%. There was an enormous amount of time and effort, and not inconsiderable professional cost expended, in debating and solving an issue which was far removed from the very laudable commercial aim of trying to attract new funding to the business.

Estimated extra cost to company in management time - very significant
Estimated extra cost to company in advisor fees - in excess of £20,000

Company J

Company J, which operates option schemes, is highly acquisitive - issuing shares to buy businesses. It has one executive with a 5% shareholding and he has had to top up his interest from time to time to keep the 5% holding as further shares are issued. In the meantime, the worry of getting numbers right gives the company secretary extra work.

The company concerned would say it is wrong that this executive is penalised for a successful and growing company and argues that once someone has met the conditions they should retain the relief so long as they remain an employee/director - however small his/her shareholding becomes. EMI options do not lose their relief because a company grows in size; neither should Entrepreneurs' Relief be lost in the same way.

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 mid-size 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 three to 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:

- **Market Capitalisation and Market Segment** – Qualifying companies would be those whose shares are publicly traded on a regulated market below £200 million at the time of investment and

'unlisted' companies (with no such limit). We consider £200 million to be in line with the definition of a SME under the proposals for a 'SME Growth Market' in the ongoing review of the Markets in Financial Instruments Directive (MiFID); **OR**

- **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 ISDX). This would be similar to the current qualifying criteria of the Inheritance Tax 100% Business Property Relief, which only applies to 'unlisted' companies.

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	2-3 years	Applied from the date shares are acquired, or if an "approved" option, date that option granted.	None
Long-term investors	No	No	3-5 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/ISDX and private companies)

Specific adjustments to the current regime:

a. Enterprise management incentive options qualifying for Entrepreneurs' Relief

We welcome the changes to the EMI scheme announced in the 2012 Budget and particularly the move towards the ability to access Entrepreneurs' Relief through approved schemes.

As a practical measure, however, in the great majority of cases, small and mid-size quoted companies are not able to take advantage of the reduced rate of CGT. This is due to the need to hold the (EMI) shares for 12 months before disposal. Employees are, in the main, unwilling or unable to finance the purchase of the shares under option.

We suggest that the 12 month time period runs from the date of grant rather than exercise. We are confident that this would result in a far higher take up of EMI option schemes and they would fulfil the aim for which they were designed.

We also suggest extending the relief to other approved schemes, such as CSOP and SAYE options.

b. The 5% limit and dilution on the day of sale

The legislation on Entrepreneur's Relief (as set out in Section 169I(6) TCGA 1992) provides the conditions which must be satisfied where employees are selling shares:

> *Condition A is that, throughout the period of 1 year ending with the date of the disposal—*
>
> *(a) the company is the individual's personal company and is either a trading company or the holding company of a trading group, and*
>
> *(b) the individual is an officer or employee of the company or (if the company is a member of a trading group) of one or more companies which are members of the trading group'*

'Personal Company' is defined in section 169S(3) TCGA 1992 in the following terms:

> *(3) For the purposes of this Chapter "personal company", in relation to an individual, means a company-*
> *(a) at least 5% of the ordinary share capital of which is held by the individual, and*
>
> *(b) at least 5% of the voting rights in which are exercisable by the individual by virtue of that holding.*

On a direct application of these conditions, it would seem that if holders of share options exercise their rights and acquire shares on the date of sale (which would be considered to be the date of disposal) the percentage of share capital held by existing shareholders will be diluted. If this falls below 5% the individuals will no longer be eligible for Entrepreneurs' Relief.

In response to the ICAEW's question on this issue, HMRC responded by confirming that the exercise of options on the same day would not cause the Entrepreneurs' Relief to be lost. As a result, the ICAEW guidance note[2] on Entrepreneurs' Relief and the legislation do not match up in terms of how this situation should be treated. We believe that legislation in this area should be clarified.

[2] http://www.icaew.com/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide-112-er-final-at-25-jan-12.pdf

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.

Furthermore, pension funds are fleeing from equities. The Pensions Regulator has said that UK funds hold 43.2 per cent in gilts and fixed interest compared with 38.5 per cent in equities. This is the highest allocation of gilts and fixed interest since the Pensions Regulator started compiling data in 2006[3].

We also note that the Conservative Party has already indicated its intention to explore reinstating this relief in the Conservative Manifesto 2010[4] and also its document, 'A New Economic Model – Eight Benchmarks for Britain'[5].

a. Proposals for reform

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 SMEs.

Qualifying companies ('SMEs') could either be defined using an existing tax legislation size test (i.e. a 2 out of 3 test like the transfer pricing test) or based on market capitalisation. For example, qualifying companies ('SMEs') could be defined as UK companies whose shares are publicly traded on a regulated market below £200 million at the time of investment and 'unlisted' companies (with no such limit). We consider £200 million to be in line with the definition of a SME under the proposals for a 'SME Growth Market' in the ongoing review of the Markets in Financial Instruments Directive (MiFID).

Targeted to the SME sector, this measure would not cost the Exchequer a significant amount of tax revenue. In 2011, companies in the FTSE All Share and FTSE AIM All Share paid out at total of £70.7 billion in dividends. Small and mid-size quoted companies in the FTSE All Share and in the FTSE AIM All Share (defined as those with a market capitalisation below £1 billion) in 2011 paid out a total of £3.2 billion in dividends. This represents only 4.5% of all dividends paid out in 2011.

Reinstating the dividend tax credit would have the dual effect of increasing pension certainty and increasing long-term investment in the small and mid-size 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 three years.

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[3] http://www.ft.com/cms/s/0/c65e011e-28f5-11e2-9591-00144feabdc0.html#axzz2BpxbwwuF

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

[5] *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

iii. Inclusion of investments on exchange regulated markets in ISAs

The tax status of AIM and ISDX 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 ISDX 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 ISDX 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-size 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 ISDX shares should qualify for ISA relief.

The overwhelming view of small and mid-size quoted companies and their advisors is that allowing AIM and ISDX shares into ISAs would provide the greatest positive impact on growth of the sector. When surveyed in our QCA/BDO Small and Mid-Cap Sentiment Index in February 2012 and again in September 2012, including AIM and ISDX companies in ISAs was the most popular measure amongst respondents[6].

In February 2012, 28% of companies and 25% of advisory firms noted that this policy would have the greatest positive impact on small and mid-cap quoted companies if it were announced in the 2012 Budget. When surveyed again in September 2012, the sector confirmed their support of this measure again, with 34% of companies and 37% of advisory firms stating that the inclusion of AIM and ISDX shares into ISAs would have the greatest positive impact on their business if it were announced in the 2013 Budget. Companies noted in the surveys that:

- "This would open up our possible investor pool tremendously to those who can't currently invest in us." (February 2012)
- "[This measure would] lead to long-term shareholders." (February 2012)
- "We have around 2,000 private shareholders, but minimal institutional investors. These institutions are reluctant to invest in small growing companies because the amount of equity available is too small to make research worthwhile for them and make trading easy for them. Many private investors invest through ISAs, so small growing companies are closed to them. Allowing the natural investor base for these companies to invest in them would give a more efficient allocation of capital and faster growth in the economy as a whole." (September 2012)
- "It would substantially increase the interest in our shares, boosting the share price and making it easier for us to raise equity." (September 2012)

[6] The survey figures are based on a quarterly online survey across the small and mid-cap quoted sector, with members and associates of the QCA and contacts of BDO. The responding sample is weighted by industry to be representative of small and mid-cap UK quoted companies, as derived by the London Stock Exchange. Fieldwork was undertaken by research company YouGov. Fieldwork for the February Index was undertaken between 19/01/12 and 31/01/12, and the sample size was 237 adults. Fieldwork for the September Index was undertaken between 12/09/12 and 03/10/12, and the sample size was 200 adults.

- “We would find more of our employees and private investors investing in us. It would reward further for the risk of owning an AIM share. It could encourage greater dividend distribution.” (September 2012)

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/ISDX shares and therefore stimulate investment and economic growth in the sector.

APPENDIX B

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[7] 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.

a. Proposals for reform

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 or restricted to those companies that fall within the European Union or medium-sized enterprise definition. This would target the relief and reduce the costs to the Treasury.

The costs could be written off over say a five year period, which would spread the tax cost. This would help increase the flow of equity funds into the SME sector, which will create jobs, growth and tax revenues within the UK and thereby supporting the Government's drive to stimulate growth UK economy.

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 and mid-size companies and/or subject to an upper limit.

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[7] 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 C

DETAILED PROPOSALS - Creating a simple and reliable tax system

We have become increasingly concerned that some areas of the tax legislation impose a disproportionate compliance burden on small and mid-size quoted companies. In this section, 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-size 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 mid-size 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 HMRC consultation last year and made a number of suggestions as to how we believe these rules could be simplified[8], including:

- We suggest that consideration is given to a means of avoiding the gateway test being failed unnecessarily whilst respecting EC requirements. This could be achieved 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. For example, perhaps in certain circumstances for groups below a certain size threshold, they could 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 experienced practical difficulties applying the worldwide debt cap rules, which illustrates the complexities and costs for small and mid-size quoted companies.

[8] 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

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

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 - £20,000
Estimated extra cost to company in advisor fees - £20,000

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 rules

Below are anonymised examples of companies that have experienced practical difficulties applying the transfer pricing rules, which illustrate the complexities and costs for small and mid-size 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 - £20,000
Estimated extra cost to company in advisor fees - £20,000

Company B

Company B is a UK sub group of a German parent, which operates in a number of territories globally, manufacturing and distributing video camera equipment. The other territories in which it operates have tax rates equal to or higher than the UK. The group is classed as medium for UK transfer pricing purposes. The UK sub group was recently reorganised and had to rework its UK transfer pricing support documentation at a cost of some £40,000 (management time & professional fees), with future annual costs anticipated to refresh the documentation.

Estimated extra cost to company in management time - £20,000
Estimated extra cost to company in advisor fees - £20,000

Company C

Company C, a UK aviation group, is medium for transfer pricing and has annual costs (management time and professional fees) of some £25,000 to maintain/refresh transfer pricing documentation. This documentation has never been requested or queried by HMRC since the introduction of the new transfer pricing regime.

Estimated extra cost to company in management time - £12,500
Estimated extra cost to company in advisor fees - £12,500

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-size quoted companies with relatively low entity values are caught.

a. Proposals for reform

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-size quoted 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.

b. Practical difficulties with the Senior Accounting Officer Requirements

Company A

Company A, a UK group, has large, historic intercompany balances. As the SAO test only looks at the debt side and ignores the payable side, the group is very near the SAO limits and is likely to breach it shortly. To avoid the requirement to deal with SAO procedures, the group has undertaken a reorganisation to net out the various balances to clearly stay under the SAO limits.

Estimated extra cost to company in management time and advisor fees -£60,000

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. Enterprise Investment Scheme and Permanent Establishment

We welcome the relaxation of the requirements to qualify for the Enterprise Investment Scheme (EIS). However, we are concerned that the recently introduced requirement for the EIS issuing company to have a UK Permanent Establishment (PE) is causing unnecessary complications. The same issue applies for SEIS relief.

F(no 3)A 2010 replaced the previous requirement for a qualifying trade to be carried out wholly or mainly in the UK with the requirement that the issuing company must have a UK PE. Where the issuing company is not UK tax resident, HMRC manuals (VCM17025) state that:

> *an overseas-registered parent company will not be regarded as having a permanent establishment in the UK merely by virtue of the fact that it has a subsidiary which is resident in the UK, or which carries on its business there. An overseas parent company must itself have a permanent establishment in the UK for it to qualify.*

A non UK resident parent of a group, which has extensive UK trading operations, may not therefore qualify for EIS. We have seen a number of examples where non UK companies have had to take the otherwise unnecessary step of creating a UK PE in order to qualify for EIS, incurring unnecessary costs to do so.

We suggest the UK PE requirement is extended so that the issuing company or a subsidiary it owns can satisfy the test.

APPENDIX D

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 volume of trading. 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 ISDX 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 to medium-sized quoted companies.

We support the London Stock Exchange’s proposal to remove Stamp Duty on AIM shares and note their research which shows that Stamp Duty on AIM shares accounts for less than 3% of the overall revenue from Stamp Duty (approximately £72 billion).

APPENDIX E

MEMBERS OF THE QUOTED COMPANIES ALLIANCE TAX EXPERT GROUP

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Chris Bond	PKF (UK) LLP
David Boyd	Mazars LLP
Nick Burt	Nabarro LLP
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Christopher Connors	Charles Russell LLP
Karen Cooper	Osborne Clarke
Jared Cranney	Interior Services Group plc
John Daughtrey	Equiniti
Michael Deeks	Olswang
David Firth	Penna Consulting PLC
Philip Fisher	PKF (UK) LLP
Amanda Flint	Grant Thornton UK LLP
David Fuller	CLS Holdings PLC
Andy Goodman	BDO LLP
Paula Hargaden	Burges Salmon
Daniel Harris	Ernst & Young LLP
Colin Kendon	Bird & Bird LLP
Michael Landon/Nigel Mills	MM & K Limited
Peter Mossop/Colum Spillane	Sanne Group
Paul Twist	KPMG LLP
Nick Wallis	Smith & Williamson Limited