

The logo for the Quoted Companies Alliance, featuring the text "QUOTED COMPANIES ALLIANCE" in white, bold, uppercase letters on a red background with a white diagonal line.

**QUOTED
COMPANIES
ALLIANCE**

Quoted Companies Alliance
Proposals for Taxation Reform
2014 Budget

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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 £317.4 billion (as of October 2013). The total turnover of the small and mid-size quoted company sector is £174.6 billion (as of October 2013).

Small and mid-size quoted companies employ approximately 4.6 million people (as of October 2013), representing 16.6% 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.

For further information about our organisation, contact:

Tim Ward
Chief Executive
Quoted Companies Alliance
6 Kinghorn Street
London
EC1A 7HW

Telephone: 020 7600 3745
Fax: 020 7600 8288

Email: tim.ward@theqca.com
Website: www.theqca.com

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.

We welcome the Government's action in the 2012 Autumn Statement and the 2013 Budget to channel investment into small and mid-size companies through the inclusion of growth market shares in ISAs and the announcement to remove stamp duty on the trading of growth market shares from April 2014. Recent research suggests that activity and fundraising is starting to pick up on UK growth markets – with a 70% increase in the amount of money raised on AIM this year in comparison with the previous 12 months.¹

However, there is more that can be done to encourage long-term investment. Our proposals are designed to help inspire private sector growth and employment and focus on the following areas.

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**. We suggest the removal of the arbitrary 5% threshold for CGT Entrepreneurs' Relief in respect of shares held by employees/officers. This will encourage wider employee share ownership and align employee and management goals in driving growth. We believe any cost to the Exchequer will be at least partially funded by employees exercising unapproved share options – generating a large PAYE and NI receipt – as they attempt to qualify for the 12 month share holding period.

We also suggest expanding this relief to long-term, patient 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**, which invest in growth companies.

2. Creating a level playing field for equity and debt

The tax treatment of raising equity versus debt finance 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. We have included a comparison of tax treatment of raising equity across 17 European states, which highlights the UK's extreme position on this matter.

3. Creating a simple and reliable tax system

The UK 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. Nonetheless, existing and new tax legislation is still increasing in length and complexity, which is increasing the cost of compliance for UK companies. One pronounced example of this is the 2011 disguised remuneration legislation (Part 7A ITEPA 2003).

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** and **size tests** in tax legislation. We have included suggestions for how these areas could be simplified.

¹ <http://www.uhy-uk.com/resources/news/aim-grows-for-the-first-time-in-six-years-as-ipos-return-to-junior-market/>

SUMMARY OF PROPOSALS

Encouraging long-term investment and funding for growth		
<u>Issue</u>	<u>Proposals</u>	<u>Appendix</u>
Capital Gains Tax (CGT) Reform of Entrepreneurs' Relief	<p>Short-term proposals:</p> <p>Abolish the condition that the officers/employees 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').</p> <p>Have the relief applied from the date shares are acquired, or the date the option is granted (rather than exercised), under HMRC "approved" SAYE and CSOP schemes, in the same way as now applies to Enterprise Management Incentives (EMI).</p> <p>Ensure that, where a share seller qualifies for Entrepreneurs' Relief, and receives a cash earn-out consideration, the whole of the amount received under the earn-out qualifies for Entrepreneurs' Relief.</p> <p>Amend legislation to confirm that the exercise of options on the same day as the shares are sold will not cause Entrepreneurs' Relief to be lost.</p> <p>Long-term proposals:</p> <p>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.</p> <p>In addition to employees and officers, target this relief for long-term investors:</p> <ul style="list-style-type: none">• Remove the 5% Requirement and the condition that only officers and employees can qualify for CGT Entrepreneurs' Relief in respect of a company's shares.• 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.	A.i
Dividend Tax Credit for Pension Funds	<p>Reinstate the Dividend Tax Credit for pension funds, targeting this relief exclusively to investment in the SME sector.</p> <p>To encourage long-term investment, only apply the credit if shares have been held for at least three years.</p>	A.ii

Creating a level playing field for debt and equity

Cost of raising equity Allow the costs of raising equity (both during IPO and secondary fundraisings) to be tax deductible. **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. **C.i**

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. **C.ii**

Confirm that HMRC will not seek to discount the value of evidence compiled at a later date following the commencement of HMRC enquiries.

Size Tests Align size definitions for tax purposes as far as possible. **C.iii**

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.

We note that changes to Enterprise Management Incentives (EMI) implemented in the Finance Act 2013, particularly the extension of Entrepreneurs' Relief to shares acquired through EMI options, was welcomed and effectively removed the 5% shareholding requirement in this particular instance. We believe that the Government should continue to extend the availability of Entrepreneurs' Relief so that small and mid-size companies can attract the necessary talent and investment to grow and create more employment, which is essential to the UK's economic recovery.

The History of Entrepreneurs' Relief

The introduction of Entrepreneurs' Relief was a reaction to the severe criticism accompanying the abolition of business assets taper relief. Overall, that abolition has had a massively negative impact on investment in small and mid-size quoted companies.

The announcement to introduce Entrepreneurs' Relief 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"².

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

² Jane Kennedy, Public Bill Committee, 8 May 2008 (PM), column 136

We also propose over the longer term 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 'real' 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.

The personal company definition restricts businesses from incentivising most employees and is a brake on growth. 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/she 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 also penalises employee shareholders working within high-capital-requirement, high-growth businesses, as the need of those businesses 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 as much as 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 and officers of the business.

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 experiences 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 be detrimental 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 managers 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 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 - 250

Turnover - £60m

Company A restructured as part of a new investment by a third party corporate and, as part of the restructuring, certain key employees and directors also invested significant sums in Company A and purchased shares. Commercially, the relevant individuals were meant to have less than 5% of the voting rights, but the restructuring involved new holding companies so that the individuals could have more than 5% of the voting rights and ordinary share capital in the relevant holding companies and so should qualify for Entrepreneurs' Relief. New shareholders in the future could also be accommodated to qualify for Entrepreneurs' Relief, but further careful planning and negotiation with the other shareholders would be needed.

Estimated extra cost to company in management time - £30,000

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

Company B

Number of Employees - 20

Turnover- £6m

Company B 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 C

Number of Employees- 200

Turnover- £40m

Market Cap- £25m

Company C 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 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 five 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 currently continue to benefit from the relief.

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 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 those preference shares.

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, also will be classed as "ordinary share capital". The issue of these new ordinary shares would dilute all the managers' 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 share 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 the success and growth of the company. Once someone has met the conditions, he/she should retain the relief so long as he/she remains 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.

Company K

Company K had to restructure its share capital to get round the fact that B Preference Shares which had no right at all to dividends (and were effectively subordinated interest free debt rather than equity) were arguably "ordinary share capital" (and not fixed rate preference shares). The need to arguably take the B Preference Shares into account when determining whether the 5% condition meant that certain employees, who had, in practice, an equity interest of greater than 5%, would have been prevented from obtaining Entrepreneurs' Relief without the share capital restructuring. Costs of the restructuring were between £5 - 10,000 (exclusive of VAT).

Estimated extra cost to company in advisor fees - £5,000 - £10,000

c. Application of the relief

To align the treatment of employees who own shares with those companies that have HMRC "approved" SAYE and CSOP option schemes, we request that Entrepreneurs' Relief is applied from the date an option is granted (rather than exercised), in the same way as now applies to EMI options. For all other instances, the relief should be applied from the date the shares are acquired.

d. Specific adjustments to the current Entrepreneurs' Relief regime

"Marren v Ingles" rule and cash earn-outs

To ensure that Entrepreneurs' Relief operates on a logical and coherent basis, we request that the "Marren v Ingles" rule is disapplied where there is a cash earn-out.

In current law, where the sale terms include a cash earn-out element, it is necessary to value the earn-out appropriately. Where Entrepreneurs' Relief applies to the price for the shares, it will apply similarly to the value of the earn-out, which is treated as part of the consideration for the share disposal.

However, in the event that the sum received under the earn-out is higher than the estimated value of the earn-out, that excess is considered for the disposal of the earn-out, not for the disposal of the shares, and so is not eligible for Entrepreneurs' Relief. Commercially, sellers qualifying for Entrepreneurs' Relief ordinarily expect that the whole amount received under an earn-out should be eligible for the relief (subject only to the £10m lifetime cap on eligible gains). An earn-out is a legitimate, commercial method of valuing the business being acquired and there is no commercial logic as to why cash sums received under an earn-out should be treated any differently from cash sums paid on completion of the share sale. The following example illustrates the need to address this issue.

Company A

Number of Employees - 75

Turnover - £20m

Market Cap- £5m

Company A had to seek advice on the application of Entrepreneurs' Relief to different types of consideration, including a cash earn out element. Individuals related to Company J assumed that they would receive Entrepreneurs' Relief on all proceeds, including under the commercially negotiated earn-out, whereas in fact the profit on the earn-out would not qualify for Entrepreneurs' Relief and would be subject to capital gains tax at the prevailing rate.

Estimated extra cost to company in advisor fees - £15,000

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 note³ 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.

e. 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:

³ <http://www.icaew.com/~media/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide-112-er-final-at-25-jan-12.pdf>

- **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	1 year	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)

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 only on the contributions of an employee and employer. 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 have been withdrawing from equities over a sustained period. 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 2006⁴.

We also note that the Conservative Party indicated its intention to explore reinstating this relief in the Conservative Manifesto 2010⁵ and also in its document, 'A New Economic Model – Eight Benchmarks for Britain'⁶.

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 propose that the Government could initially reinstate the tax credit for investments by pension funds in growth companies, especially 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 2012, companies in the FTSE All Share and FTSE AIM All Share paid out a total of £82.4 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 2012 paid out a total of £3.1 billion in dividends. This represents only 3.7% of all dividends paid out in 2012.

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 long-term investment, the credit would only apply if the shares have been held for at least three years.

⁴ <http://www.ft.com/cms/s/0/c65e011e-28f5-11e2-9591-00144feabdc0.html#axzz2BpxbwwuF>

⁵ The Conservatives Manifesto 2010 – Invitation to join the Government of Britain, p. 12, available at: <http://www.conservatives.com/Policy/Manifesto.aspx>

⁶ 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 - Creating a level playing field for equity and debt

i. Tax relief for the costs of raising equity

There is a specific entitlement to claim a tax deduction for costs incurred in raising debt finance, whereas the costs of raising finance through the issue of equity is not tax deductible. This represents an unnecessary and pronounced distortion in the tax system, which has been referenced in the recent Mirrlees Review⁷ and raised in a number of debates surrounding the causes and consequences of the financial crisis.

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

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

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

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

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

Country	Is there any corporate tax relief for flotation costs?	Are the costs of issuing new equity generally deductible for corporation tax purposes?
United Kingdom	No	No
Austria	Yes Flotation costs are generally deductible for corporate tax purposes without any restrictions (cf. sec. 11 (1) (1) of the Austrian Corporate Income Tax Act).	Yes The costs of issuing new equity are generally deductible for corporate tax purposes without any restrictions (cf. sec. 11 (1) (1) of the Austrian Corporate Income Tax Act).
Belgium	Yes Flotation costs and, more generally, restructuring costs can be tax deductible if incurred to develop taxable income.	Yes In order to align the tax treatment of equity financing on the one hand and debt financing on the other, Belgium legislation provides for a notional interest deduction ("Dédution pour

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>

		<p>capital à risque” – “Aftrek risicokapitaal”).</p> <p>A fictitious interest calculated on the “net equity” of companies or branches can be deducted for their cost of capital. The notional interest is calculated as risk-free interest with reference to 10 year government bonds. The rate to apply in tax year 2014 (income 2013) is 2.742% for large companies and 3.342% for small companies.</p> <p>The “net equity” is determined by adjusting the equity, primarily by deducting the tax book net value of any financial fixed assets that are grouped under “participations and other shares” on the company's balance sheet.</p> <p>There are other deductible items, such as the net equity assigned to foreign permanent establishments or non-Belgian real estate property.</p>
Bulgaria	<p>Yes</p> <p>Flotation costs (i.e. costs incurred by a publicly traded company with regards to issuing new securities) are not subject to a specific tax regime in Bulgaria and are generally deductible for corporate tax purposes.</p>	<p>Yes</p> <p>The costs of issuing new equity should generally be tax deductible for corporate tax purposes.</p>
France	<p>No</p>	<p>Yes</p> <p>The costs of issuing new equity are deductible expenses for the financial year in which the costs are incurred. The taxpayer may also elect to capitalise those costs and amortise them over a maximum period of 5 years.</p> <p>However, such costs are not deductible in specific cases where they are not incurred in the interests of the company, e.g. upon capital reduction followed by a capitalisation of retained earnings (which protects only the</p>

		interests of shareholders).
Germany	Yes Flotation costs (underwriting fees, management fees, selling concessions, legal fees and registration fees) for primary offerings are deductible as business expenses. The same is true for secondary offerings if they are conducted mainly in the interests of the company (this is usually the case).	Yes In general, all costs of issuing new equity are deductible for corporate tax purposes. Only costs that are directly related to the acquisition of shares by shareholders (e.g. notarisation costs for a takeover agreement, if notarised separately) may be treated as a hidden profit distribution when paid by the company (and therefore not subject to relief).
Greece	Yes	Yes
Hungary	Yes	Yes
Italy	Yes Based on Italian accounting principles, flotation costs may generally be capitalised. In this case, they may be depreciated (and deducted) over five fiscal years.	Yes Based on Italian accounting principles, the costs of issuing new equity may generally be capitalised. In this case, they may be depreciated (and deducted) over five fiscal years.
Luxembourg	Yes Flotation costs are tax deductible as general expenses.	Yes The costs of issuing new equity are considered as operating costs. In principle, they are tax deductible for the issuer for corporation tax purposes to the extent they are booked as expenses in the Luxembourg GAAP accounts of the issuer. However, if the new equity finances assets that generate exempt income, the portion of the costs that finances the exempt income is non-tax deductible.
Netherlands	Yes Costs that do not qualify as equity (e.g. management and underwriting commission) are allowable as deductions under Dutch jurisprudence.	Yes Dutch corporate income tax law approves the deductibility of incorporation costs and costs related to the issue of capital.
Poland	No	Yes

		The law is not clear on the tax deductibility of the costs of issuing new equity. According to the most common interpretation, public and similar costs (such as court fees, administrative charges, stock exchange fees and notary fees) related to the issue of new shares on a stock exchange are not tax deductible. Other costs, such as advisory costs, are tax deductible.
Portugal	Yes Pursuant to Portuguese GAAP, which follows IAS, such costs do not meet the criteria to be treated as intangible assets and therefore should be treated as a cost in the P&L. From a corporate tax perspective, such costs are therefore tax deductible on the basis that they are necessary for the company to run its business.	Yes Any administrative and similar costs incurred are tax deductible on the basis such costs are necessary for the company to run its business.
Russia	Yes Expenses associated with affecting an issue of securities (in particular the preparation of an issue prospectus, the manufacture or acquisition of blank forms and the registration of securities) as well as expenses associated with the servicing of own securities are accounted for as non-sale expenses for Russian tax purposes (Article 265 Item 1 Subitem 3 of Russian Tax Code). The above rule applies only for the issue of securities by the taxpayer. If, however, there are costs for setting up a subsidiary, these costs may become tax deductible only after disposal (retirement) of the subsidiary shares. All expenses recognised for Russian tax purposes should be properly documented and economically justified (Article 252 Item 1).	Yes Expenses associated with affecting an issue of securities (in particular the preparation of an issue prospectus, the manufacture or acquisition of blank forms and the registration of securities) as well as expenses associated with the servicing of own securities are accounted for as non-sale expenses for Russian tax purposes (Article 265 Item 1 Subitem 3 of Russian Tax Code). All expenses recognised for Russian tax purposes should be properly documented and economically justified (Article 252 Item 1).

Serbia	Yes	Yes
Spain	Yes No restrictions on the tax deductibility of flotation costs are established in the Corporate Income Tax (“CIT”) Law, as long as they are duly recognised in the P&L.	Yes No restrictions on the tax deductibility of flotation costs are established in the Corporate Income Tax (“CIT”) Law, as long as they are duly recognised in the P&L.
Switzerland	Yes The general principles regarding costs of issuing new equity should apply to the tax deductibility of flotation costs. That is, such costs can either be capitalised and depreciated over five years or booked directly as an expense, in both cases with tax deductible effect provided that the costs are economically justified.	Yes The costs for incorporation, capital increase and general company organisation can either be capitalised and depreciated over five years or booked directly as an expense, in both cases with tax deductible effect provided that the costs are economically justified.
Ukraine	No	Yes As there are no direct restrictions in the Tax Code regarding deductibility of the costs of issuing new equity, one may assume that such costs are generally tax deductible. However, the Ukrainian tax authorities may try to challenge deductibility claiming that such costs are not directly related to the issuer’s business activity.

Proposals for reform

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

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

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

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.

Proposals for reform

We submitted representations on the operation of the debt cap rules during the HMRC consultation in September 2011 and made a number of suggestions as to how we believe these rules could be simplified⁸, 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.

Practical difficulties with the Worldwide Debt Cap Rules

Below is an 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.shtml>

Company A

Number of Employees - 500

Turnover - £120m

Market Cap - £60m

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.

Proposals for reform

We suggest the position for medium-sized groups is clarified. HMRC should 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.

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. 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.

APPENDIX D

MEMBERS OF THE QUOTED COMPANIES ALLIANCE TAX EXPERT GROUP

Neil Pamplin (Chairman)	Grant Thornton UK LLP
Paul Fay (Deputy Chairman)	Crowe Clark Whitehill LLP
Emma Bailey	Fox Williams LLP
Michael Bell	Osborne Clarke
Nick Burt	Nabarro LLP
Jason Collins/	
Kate Featherstone	Pinsent Masons LLP
Christopher Connors/Ray Smith	Clyde & Co LLP
Tim Crosley	Memery Crystal LLP
Sam Dames	CMS Cameron McKenna LLP
David Gubbay	Dechert
Richard Jones	BDO LLP
Natasha Kaye	Olswang
Joseph Litten	EY
James Mottram	K & L Gates LLP
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Sara Cohen	Lewis Silkin
Karen Cooper	Osborne Clarke
Jared Cranney	ISG plc
Rory Cray	FIT Remuneration Consultants
Vanessa Cundy Cooper	KPMG LLP
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Matthew Findley	Pinsent Masons LLP
David Firth	Penna Consulting PLC
Philip Fisher/Andy Goodman	BDO LLP
Mark Gearing	Field Fisher Waterhouse
Paula Hargaden	Burges Salmon
Colin Kendon	Bird & Bird LLP
Michael Landon	MM & K Limited
Robert Postlethwaite/Stephen Chater	Postlethwaite & Co
Andrew Quayle	Olswang
Richard Sharman/Amanda Stapleton/Amanda Flint	Grant Thornton UK LLP
Nicholas Stretch	CMS Cameron McKenna LLP
Mia Thursby-Pelham	PricewaterhouseCoopers LLP
Nick Wallis	Smith & Williamson Limited
Matthew Ward	Hewitt New Bridge Street