Quoted Companies Alliance

Proposals for Taxation Reform

2015 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 £351 billion (as of October 2014). The total turnover of the small and mid-size quoted company sector is £180 billion (as of October 2014).

Small and mid-size quoted companies employ approximately 1.6 million people (as of October 2014), representing 6.3% 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 D.

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

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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.

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 removal of stamp duty on the trading of growth market shares.

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 that 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.

Further employee share ownership could be encouraged **by relaxing some of the requirements of the Company Share Option Plan** (CSOP), as suggested by the Office of Tax Simplification.

We believe that long-term investment could be incentivised 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 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 detailed proposals of how this relief could work, as well as a comparison of the tax treatment of raising equity across 19 European states, which highlights the UK's extreme position on this matter. We estimate the cost to the Exchequer in any year to be approximately £60m.

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, as well as proposals so that **EIS companies can be assisted in coming to market**.

SUMMARY OF PROPOSALS

Encouraging long-term investment and funding for growth

Issue	Proposals	Appendix
Capital Gains Tax (CGT) Reform of Entrepreneurs' Relief	**Short-term proposals:** Abolish the condition that the officers/employees of a company must have at least 5% of the voting rights and 5% of ordinary share capital in the company in order to qualify for the relief ('5% Requirement'). Commence the 12 month period during which the qualifying tests must be met from the earlier of the date shares are acquired or the date the relevant 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). Ensure that, where a share seller qualifies for Entrepreneurs' Relief and receives an earn-out, shares or loan notes as consideration, the whole of the amount qualifies for Entrepreneurs' Relief. 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. **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 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**
Relaxation of the CSOP requirements	Encourage employee share ownership in smaller companies by relaxing the requirements of the Company Share Option Plan (CSOP): • Allow the exercise price to be at a discount or at nil cost (while keeping the income tax relief only for any increase over the market value at grant). • Remove the three year holding period before which options can be exercised with income tax relief.	**A.ii**

	• Consequentially remove all leaver and other early exercise requirements. • Replace the existing £30,000 limit for all subsisting options with a rolling three year £30,000 limit.	
Dividend Tax Credit for Pension Funds	Reinstate the Dividend Tax Credit for pension funds, targeting this relief exclusively to investment in the SME sector. To encourage long-term investment, only apply the credit if shares have been held for at least three years.	**A.iii**
Creating a level playing field for debt and equity		
Cost of raising equity	Allow the costs of raising equity to be tax deductible. Introduce a £1.5m upper limit in order to target the relief appropriately to SMEs. Allow the relief to be applicable for both IPO and secondary fundraisings. Allow all types of fundraising costs associated with raising equity to be tax deductible. Allow tax relief for the costs of raising funds to be available in the year these were incurred. Allow the relief to be available once the implementing legislation comes into effect. Allow the relief to apply to costs incurred as a result of an aborted fundraising.	**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**
Size Tests	Align size definitions for tax purposes as far as possible.	**C.iii**

Assisting EIS companies in coming to market	Change the EIS legislation (ITA 2007 s 247) or stamp duty legislation (FA 1986 s 77) to facilitate the insertion of a new holding company on top of an EIS company.	**C.iv**

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 growth.

The History of Entrepreneurs' Relief

The introduction of Entrepreneurs' Relief was a reaction to the severe criticism accompanying the abolition of Business Asset Taper Relief. Overall, that abolition has had a 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"[1].

Proposals for Reform

Our initial proposals (sections a. to d.) 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.

We also propose (section e.) 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-

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

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 owners 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.

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 can 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 example

We have collated and anonymised 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, while 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

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

Company D 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 the business, 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 E

Company E is currently considering how 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 has arisen to protect those existing shareholders' holdings for Entrepreneurs' Relief.

Company F

Number of Employees - 200
Turnover - £20m

The company's 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 would have been commercially acceptable and accounted for/disclosed as shareholder funds would have been classed as "ordinary share capital". The issue of these new ordinary shares would have diluted 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 G

Company G, 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 H

Company H 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.

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

Company I

At exit, the CEO of Company I had share options but did not have the required 5% of fully paid up shares. Upon a successful exit, Company I's start-up CEO was penalised at a tax rate more than twice the 10% tax rate applied to the company founders, despite being involved very early on and having worked full-time with the company for nine years.

b. Alignment of treatment of EMI, SAYE and CSOP share option schemes

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.

c. Entrepreneurs' Relief treatment of non-cash consideration

"Marren v Ingles" rule and cash earn-outs

To ensure that Entrepreneurs' Relief operates on a logical and coherent basis, we request that a further category of qualifying business disposal is included within Entrepreneurs' Relief – the disposal of an earn out which has arisen from the disposal of shares which, had the consideration not consisted of an earn-out, would itself have qualified for the relief.

In current law, where shares are sold and the consideration consists of or includes a cash earn-out, the net present value of the earn-out is treated as consideration received on the sale. Where the disposal meets the conditions for Entrepreneurs' Relief, the earn-out portion of the consideration, along with any cash received upfront, will form part of the consideration for the share disposal which qualifies for the relief.

However, in the event that a sum is subsequently received under the earn-out which is higher than the value estimated at time of the share disposal, that excess is treated as arising on the disposal of the earn-

out, not on the disposal of the shares, and so is not eligible for Entrepreneurs' Relief. Sellers qualifying for Entrepreneurs' Relief ordinarily expect that the whole amount received under an earn-out will 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 a 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. We therefore propose that disposals of earn-outs in cases such as this are treated as qualifying business disposals for Entrepreneurs' Relief purposes.

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 A 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

Shares and loan notes received as consideration

We are also aware of problems which arise when individuals, receive shares or loan notes as consideration for the sale of their private companies and who do not own at least 5% of the ordinary share capital in and/or are not employees of the company that acquired the shares ('the acquiring company') at the time that those subsequent shares or loan notes are sold or redeemed.

Where shares or non-qualifying corporate bonds (non-QCBs) are received, the portion of the gain from the original sale related to this consideration is 'rolled-over' into the base cost of the new shares/loan notes. When those shares or loan notes are subsequently disposed of, the rolled-over gain then falls into charge as part of the overall gain/loss arising on their disposal.

A similar effect arises where QCBs are received, except that in that case the gain is held-over until such time as the QCB is disposed of.

Due to the way that the Entrepreneurs' Relief rules are drafted, whether or not any resulting gain qualifies for relief depends on whether the individual holds 5% or more of the ordinary share capital in the acquiring company and is an employee of that company throughout the 12 months up to the date of the subsequent disposal or redemption. Hence, if the individual does not meet these tests, he/she will not qualify for the relief, even if he/she met the tests in relation to the original company at the time of the original disposal.

It is possible to elect under s169Q or S169R TCGA 1992 to disapply the roll-over or holdover treatment respectively (and pretend that cash had been received as consideration instead). The effect is that Entrepreneurs' Relief is available on the full consideration received (provided the qualifying tests are met) but the gain is deemed to arise at the time of the original disposal and cannot then be rolled over into the new shares or loan notes acquired. However, unless sufficient cash has been received as part of the deal, individuals often do not have the resources to pay the resulting additional tax liability.

We believe that the way these rules work is having a distorting effect on share deal negotiations and, in some cases, is prohibiting sales from being agreed where the purchaser does not have sufficient cash to pay

for the shares without issuing shares or loan notes and the vendor is unwilling to accept the tax consequences. A change in the rules would help to encourage further share sales which would feed growth in the 'real economy', given that it is only shares in qualifying trading companies that qualify for the relief.

Therefore, we propose that the Entrepreneurs' Relief rules are amended so that, where an individual meets all the qualifying conditions for the relief to apply on the disposal of shares, the whole of the gain arising on the disposal should qualify, whether or not an element of that gain is rolled-over into new shares or non-QCB loan notes or held over into QCBs. This could be achieved by amending s169I TCGA 1992 to provide for an alternative new condition (condition E) under which the disposal of shares or securities in a company could qualify for relief (i.e. where an earlier qualifying gain had been rolled over or held over into the shares or securities concerned). Sections 169Q and 169R could also then be repealed.

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

The legislation on Entrepreneurs' 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.

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

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

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 as suggested by the introduction of 'SME Growth Markets' in the new Markets in Financial Instruments Directive (MiFID II); **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 earlier of the date shares are acquired or the date the relevant option is granted (rather than exercised), under HMRC "approved" SAYE and CSOP schemes	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. Relaxation of the CSOP requirements

The Company Share Option Plan (CSOP) is a simple and flexible tax-advantaged share scheme, which is ideal for rewarding both managers and lower-paid employees in small companies that do not qualify for granting Enterprise Management Incentive (EMI) options.

Many smaller companies find it difficult to introduce either of the tax-advantaged all-employee share plans – SAYE and SIP – because of the complexity of the legislation for these plans and the high administration costs. CSOPs have far fewer requirements and so can be governed by a very simple set of rules and can be easily administered.

Unfortunately, the CSOP legislation, first introduced in 1984, has not been adapted to meet modern remuneration practice. Most companies nowadays prefer to grant "LTIP" awards over the full value of shares, while the exercise price of a CSOP option must not be less than the market value of a share at the date of grant.

In contrast, EMI options, first introduced in 2000, allow options to be granted with a discounted – or even zero – exercise price. As for CSOPs, income tax relief is only given in respect of any increase in the value of the shares over their market value on the date of grant.

HMRC statistics show that the number of participants granted CSOP options has fallen from a peak of 415,000 in 2000-01 down to only 25,000 in 2012-13. This is largely due to the trend in practice away from market-value share options.

These numbers have not been compensated for by participation in all-employee share plans. While roughly one million employees participated in each of SAYE and Profit Sharing Share Schemes (now replaced by SIP) in 2000-01, by 2012-13 participation in SAYE and SIP had fallen to about 400,000 for each plan. These plans are predominantly operated by the largest companies.

We consider that the best way to encourage employee share ownership in smaller companies (which do not qualify for EMI) would be to relax the requirements of the CSOP in a similar way to that recommended in the report of the Office of Tax Simplification ("OTS") of its Review of Tax-Advantaged Share Schemes, published in March 2012[3].

In particular, the OTS report recommended (effectively for CSOP):

- Para 2.45: Allow the exercise price to be at a discount or at nil cost (while keeping the income tax relief only for any increase over the market value at grant).
- Para 2.55: Remove the three year holding period before which options can be exercised with income tax relief.
- Para 2.56: Consequentially remove all leaver and other early exercise requirements.
- Para 2.57: Replace the existing £30,000 limit for all subsisting options with a rolling three year £30,000 limit.

The additional cost to the Exchequer of these measures would be relatively low. However, the extra flexibility for design of CSOPs could substantially boost the levels of employee share participation, in particular in smaller companies.

[3] Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/198444/ots_share_schemes_060312.pdf

iii. 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% in gilts and fixed interest compared with 38.5% in equities. This is the highest allocation of gilts and fixed interest since the Pensions Regulator started compiling data in 2006[4].

We also note that the Conservative Party indicated its intention to explore reinstating this relief in the Conservative Manifesto 2010[5] 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, such as the transfer pricing test) or based on market capitalisation at the time of investment. 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 as suggested by the introduction of 'SME Growth Markets' in the new Markets in Financial Instruments Directive (MiFID II).

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 at 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 3.8% 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] See 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 are 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.

Raising debt is not a long-term solution for 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 consider public equity.

For small and mid-size company, the costs of raising equity represent a disproportionately large percentage of funds being raised and are, 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, Luxembourg, the Netherlands, Norway, 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 has confirmed that VAT on the costs of raising equity funding are deductible on input tax, if the company's activities are taxable. Hence, there is currently an inconsistency between direct and indirect tax in terms of the ways of raising equity finance.

Growth companies primarily would benefit in practice from a tax relief on the costs of raising equity. As noted in a recent LexisNexis report:

> *During the first quarter of 2014 a fifth of the IPOs on AIM were carried out by companies in the pharmaceuticals & biotechnology and healthcare (pharma & biotech and healthcare) industry sector (3 IPOs), with the retail industry sector (2 IPOs) and the media & telecommunications industry sector (2 IPOs) together representing just over a fifth of the IPOs on AIM.*[8]

This analysis illustrates that recent market activity on AIM has been driven by real economy companies.

We have estimated that this measure would not be expensive to implement and would cost the Exchequer approximately £60m over a 12-month period. We have calculated this figure based on the number of IPOs (132 of which 102 raised money) and further issues (1258) on AIM and the London Stock Exchange's Main Market between 1 January 2013 and 31 December 2013, capping the relief at the £1.5m per issue and assuming a corporate tax rate of 20%[9]. We have provided a detailed analysis of these figures and our proposals for reform below.

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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

[8] Source: LexisNexis Report: Tracking the market: Trends in IPOs on AIM Q1 2014

[9] Our cost calculations assume that the costs of an IPO are 7.5% of the total amount of money raised and that the costs of a further issue are 5%. We have excluded companies on the International Main Market from the cost calculations in order to capture only UK companies raising funds on UK public equity markets. However, no sectors were excluded from the analysis. The source of the data is the London Stock Exchange's New and Further Issues Statistics (available at: http://www.londonstockexchange.com/statistics/new-issues-further-issues/new-issues-further-issues.htm). The data analysed includes all new and further issues from 1 January 2013 to 31 December 2013. This time period represents a full calendar year and also a time when there was an active IPO and further issues market.

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

Country	Is there any corporate tax relief for flotation costs?	Are the costs of issuing new equity generally deductible for corporation tax purposes?
United Kingdom	No	No
Austria	Yes Flotation costs are generally deductible for corporate tax purposes without any restrictions (cf. sec. 11 (1) (1) of the Austrian Corporate Income Tax Act).	Yes The costs of issuing new equity are generally deductible for corporate tax purposes without any restrictions (cf. sec. 11 (1) (1) of the Austrian Corporate Income Tax Act).
Belgium	Yes Flotation costs and, more generally, restructuring costs can be tax deductible if incurred to develop taxable income.	Yes In order to align the tax treatment of equity financing on the one hand and debt financing on the other, Belgium legislation provides for a notional interest deduction ("Déduction pour capital à risque" – "Aftrek risicokapitaal"). A fictious 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 2015 (income 2014) is 2.63 % for large companies and 3.13 % for small companies. The "net equity" is determined by adjusting the equity, primarily by deducting the tax book net value of any financial fixed assets that are grouped under "participations and other shares" on the company's balance sheet. There are other deductible items, such as the net equity assigned to foreign permanent establishments or non-Belgian real estate property.
Bulgaria	Yes Flotation costs (i.e. costs incurred	Yes The costs of issuing new equity

	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.	should generally be tax deductible for corporate tax purposes.
France	Yes	Yes The costs of issuing new equity are deductible expenses for the financial year in which the costs are incurred. The taxpayer may also elect to capitalise those costs and amortise them over a maximum period of 5 years. Generally there is no cap on the amount of the deduction that can be obtained. However, such costs are not deductible in specific cases where they are not incurred in the interests of the company, e.g. upon capital reduction followed by a capitalisation of retained earnings (which protects only the interests of shareholders). The deduction works as follows. The costs of raising equity are considered as general expenses and are included in the P&L of the company. In France, taxable income is equal to the difference between the annual profits and losses of the company. Also, there are 6 limitations to the deductibility of interests on debt paid by French Companies (but there is no limitation to the deductibility of the costs of raising debt financing): - Related party interest rate must, in any case, be at arm's length; - Thin-cap rules; - General cap to the deductibility of financial expenses; - M&A context;

		- Specific limitation applies in case of debt-financed transactions between a member of a tax group ("intégration fiscale") and its shareholder / a company controlled by the shareholder (that is not a member of the tax group); and - Anti-hybrid provisions : The 2014 French tax bill provides that the deductibility of interest paid to an affiliate would be subject to tax at least at 8,33% at the level of the Lender. The measure aims at avoiding the use of hybrid instruments and low-tax jurisdiction.
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. Generally, there is no financial cap on the availability of the deduction. 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). If the costs are not directly linked to the respective shareholders then the costs are deductible business expenses.
Greece	Yes	Yes
Hungary	Yes Such costs are deductible as general expenses.	Yes Such costs are deductible as general expenses.
Italy	Yes	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.	Generally, there is no financial cap on the availability of the deduction. There is only a limit on the availability of the deduction of interest charges (net of interest income) which is a cap equal to 30% of EBITDA. The deduction operates as follows: - Under Italian accounting principles, the Italian company should capitalise costs incurred to increase the share capital and then depreciate these costs over a five year period. Such depreciation is deductible for corporate income tax purposes; - Under Italian accounting principles, the Italian company should capitalise costs incurred to increase the debts and then depreciate these costs over the duration of the loan. Such depreciation is deductible for corporate income tax purpose; - Interest charge deduction is subject to a cap (30% of EBITDA).
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	Yes Dutch corporate income tax law approves the deductibility of incorporation costs and costs related to the issue of capital.

	Dutch jurisprudence.	
Norway	Yes Listing costs are deductible in the year the costs are incurred.	Yes The cost of raising new equity is deductible in the year the cost is incurred. There is no cap on the amount of costs for which a deduction may be claimed.
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 effecting 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 the Russian Tax Code). The above rule applies only for the issue of securities by the taxpayer. If, however, there are	Yes Expenses associated with effecting 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

	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).	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 for the tax deductibility of issuing new equity are established in the CIT Law, as long as they are duly recognised in the P&L. Generally, there is no financial cap on the availability of the deduction.
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. On 1 January 2013, the accounting rules of the Swiss Code of Obligations were revised. There is a transitionary period until 1 January 2015. As of this date, it will no longer be admitted to capitalise incorporation, capital increase and organisation costs, but rather such costs have to be treated immediately as an expense.
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 of the UK economy.

To provide some context, we have gathered data on fundraisings from the London Stock Exchange for both AIM and the Main Market in 2013. A summary of both data sets is outlined below in Tables 3 and 4, followed by a detailed outline on how the measure should be targeted.

Table 3 – New Issues on the London Stock Exchange (1 January 2013 – 31 December 2013)

Market	Type of New Issue	Count of the Types of New Issue	Count of New Issues that Raised Money
AIM	IPO	61	61
	Not IPO[10]	38	11
AIM Total		**99**	**72**
Main Market	IPO	30	30
	Not IPO	3	0
Main Market Total		**33**	**30**
Grand Total		**132**	**102**

Source: The London Stock Exchange – New Issues (www.londonstockexchange.com/statistics/new-issues-further-issues/new-issues-further-issues.htm)

Table 4 – Further Issues on the London Stock Exchange (1 January 2013 – 31 December 2013)

Market	Count of Further Issues
AIM	939
Main Market	319
Grand Total	**1258**

Source: The London Stock Exchange – Further Issues (www.londonstockexchange.com/statistics/new-issues-further-issues/new-issues-further-issues.htm)

a. Introduce a £1.5m upper limit in order to target the relief appropriately to SMEs

We recommend that a limit of £1.5m is placed on the costs incurred by a company for raising equity finance which would be eligible for corporate tax relief. The cost of raising equity finance by a UK company on any of the European Bourses would be deductible within the cap.

[10] For example, re-admission to the market or transfer with a fundraising

The £1.5m cap will direct corporate tax relief to mainly small and mid-size quoted companies far more than large listed entities, as these companies tend to raise higher sums of money which results in greater fees associated with the fundraising. In our opinion, for sake of simplicity therefore, no issue size criteria should be attached to the relief.

b. Allow the relief to be applicable for both IPO and secondary fundraisings

We note that a number of small and mid-size companies raise funds through public equity markets as bank finance and bond markets are not available or are too expensive. In addition, some small and mid-size companies are looking to access investors who invest in quoted companies at a more attractive valuation than might be available through private equity. Primarily, companies usually decide to float to accelerate growth or development capital.

We believe the measure should, for that reason, target costs arising from any fundraising/issuance event, thus including both new (IPOs) and further issues (secondary fundraisings) (subject to the £1.5m threshold mentioned above).

For policy reasons, we consider that it will be important to target the relief to issuances where funds will be employed in the business. We suggest no corporate tax relief should be available where funds raised are received solely/mainly by existing shareholders. This would allow companies to seek and access recapitalisation that allows them to grow their business without the process being overly onerous. It should be noted, however, that the costs of raising debt are allowable even if this is for the purpose of repaying existing debt.

c. Allow all types of fundraising costs associated with raising equity to be deductible

We believe that it is relatively straightforward to make the distinction between expenses incurred as a direct result of fundraising and other fees (e.g. ongoing fees for maintaining a listing), especially as quoted companies have robust accounting records and controls to clearly identify the costs incurred as a result of a fundraising.

We believe that all types of fundraising costs associated with raising equity (e.g. underwriting fees, professional advisors' fees, direct listing costs, marketing costs, PR) should be allowed for the purposes of this measure, subject to the £1.5m threshold mentioned above. Outlined in the table on the next page is an example of professional costs associated with a company seeking an AIM quotation and the annual costs associated with maintaining that quotation.

We understand that HM Treasury could be concerned with the possible risk that a tax relief measure for the costs of raising equity would lead to higher professional fees in the markets (e.g. for advice or underwriting). The same question could be asked for the professional costs associated with debt financing, as these are already tax deductible, but we are not aware of costs increasing or being inflated as a result of tax deductibility. Professional fees fluctuate in line with factors such as competition, market conditions and risks. Given the competitive nature of the market for professional services, we do not anticipate a rise in costs as a result of such a measure.

Table 5 – Estimated Costs of Floating on AIM

Reporting Accountants	£120,000
Company's Lawyers[11]	£90,000 - £130,000
NOMAD's Lawyers	£25,000 - 50,000
NOMAD/Broker Corporate Finance Fee[12]	£30,000 - £150,000
Broker's Commission[13]	4.25% - 6% of funds raised **or** 0.5% -1% for funds not raised
Printing	£10,000
Registrars[14]	Minimum annual charge £4,000 - £5,000
Public Relations	£36,000 - £72,000
LSE AIM Admission Fees	£7,600 - £85,750

Table 6 – Estimated Costs of Maintaining a Quotation on AIM

Financial PR	£43,000
Broker/NOMAD annual fee (including analyst research)	£25,000 - £90,000
IR Press Cutting Service	£5,400
Basic Website Service	£6000
LSE Regulatory News Service	£13,500 - 25,000
Analysis of Share Registrar	£1,500
Registrar	£8,500
Auditors	£10,000
Annual Report Design	£5,500
LSE AIM Annual Fee	£6,050
LSE AIM Further Issues Fee[15]	0- £42,875
Share Option Service	£15,500

d. Allow tax relief for the costs of raising equity to be available in the year these were incurred

In terms of the time scale for claiming these deductions, we believe that, to avoid excessive complication, tax relief for the costs of raising equity should be available in the year these were incurred.

e. Allow the relief to be available once the implementing legislation comes into effect

We also recommend that the relief should be available immediately (i.e. once legislation comes into effect) to avoid any perceived market distortion.

f. Allow the relief to apply to costs incurred as a result of an aborted fundraising

In the event of an aborted fundraising, we believe that professional costs incurred prior to an incomplete issuance should be allowed for tax relief in line with and in similar terms to costs which would be allowable if an equivalent debt financing process failed. There are a limited number of issuances that are aborted. We believe allowing all costs related to successful and cancelled issuances will reduce the level of complexity when drafting the measure.

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[11] These costs are associated with producing the admission/placing document and exclude other costs, such as due diligence/corrective agreements.
[12] Varies depending on market capitalisation/size of the company
[13] Varies depending on market capitalisation/size of the company
[14] Excludes other charges such as the AGM
[15] Varies depending on market capitalisation/size of the company

APPENDIX C

DETAILED PROPOSALS - Creating a simple and reliable tax system

We remain 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 certain 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.

We also set out below suggestions for reforms to assist EIS companies coming to market.

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 have previously submitted representations on the operation of the debt cap rules and made a number of suggestions as to how we believe these rules could be simplified[16], 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 the 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.

[16] 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 - £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 that 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 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 UK transfer pricing purposes 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.

iv. Assisting EIS companies in coming to market

The insertion of a plc holding company is often required in order for a limited company to list on a public equity market. Shareholders of the limited company will exchange their shares for shares in the new plc holding company. We propose that changes are made to the EIS legislation (ITA 2007 s 247) or stamp duty legislation (FA 1986 s 77) to facilitate the insertion of a new holding company on top of limited company in respect of which EIS relief has been claimed in a tax neutral manner. It is clearly intended by the relevant legislation that a holding company should be able to be inserted without detrimental tax consequences, but the highly prescriptive requirements of the two sets of tax legislation unfortunately conflict such that this is often not possible.

Proposals for reform

It is common for a company that is proposing to list on a recognised stock exchange or regulated growth market to insert a new plc holding company (by the shareholders of the existing company exchanging their shares for shares in a newly formed holding company), as it is an onerous procedure for a limited company to convert to a plc before listing. Given that it is common for companies to insert holding companies for this and a variety other reasons, there are reliefs throughout the tax legislation to seek to ensure that this can

be done without any adverse tax consequences provided tax avoidance is not a motive. Such provisions are included within both the EIS and stamp duty legislation.

However, the relevant provisions are highly prescriptive and directly conflict such that in most circumstances it is not possible to insert a holding company on a tax neutral basis for both stamp duty and EIS. We propose changes are made to the EIS legislation (ITA 2007 s 247) or stamp duty legislation (FA 1986 s 77) to facilitate the insertion of a new holding company on top of an EIS company.

Where the conditions of ITA 2007 s 247 are met, an exchange of shares is not regarded as involving a disposal of the EIS shares in the target company (TargetCo) and the EIS relief will become attributable to the consideration shares in the newly formed company (Newco). Consequently, EIS income tax relief will not be withdrawn and EIS capital gains tax relief will be available on the disposal of the consideration shares (TCGA 1992 s150A(8D)). FA 1986 s 77 provides an exemption from stamp duty where a Newco is inserted between TargetCo and its shareholders by way of a share for share exchange.

It is a requirement of ITA 2007 s 247 that the Newco shares are issued to holders of the shares in TargetCo in proportion to their holdings, whereas FA 1986 s 77 requires that, after the consideration shares have been issued, the shareholdings in Newco are in the same proportions as those in TargetCo (i.e. they are a mirror image). Accordingly, if one less consideration share is issued by Newco to take into account the subscriber share, ITA 2007 s 247(1)(d) will not be satisfied as the consideration shares have not been issued in proportion to shareholdings in TargetCo. Equally, if consideration shares are issued in identical proportions to the shareholdings in TargetCo, immediately following the transaction the shareholder which held the subscriber share will have an increased shareholding in the Newco and so stamp duty relief will be unavailable. The use of the words “or as nearly as may be the same proportion” in the legislation does not assist based on HMRC’s stated interpretation (even with the slight relaxation recently announced by HMRC).

Both reliefs have the same purpose of enabling the insertion of a holding company without tax consequences and so it should not be the case that the conditions conflict.

APPENDIX D

MEMBERS OF THE QUOTED COMPANIES ALLIANCE TAX EXPERT GROUP

Name	Organisation
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
Tim Crosley	Memery Crystal LLP
Sam Dames	CMS Cameron McKenna LLP
Tim Davies	Mazars LLP
Claire Harrington-Greenwood	Clyde & Co LLP
Richard Jones	BDO LLP
Natasha Kaye	Olswang
Angela Savin	Norton Rose Fulbright LLP
Adam Singer	Bird & Bird LLP
Ray Smith	Clyde & Co LLP
Aidan Sutton	PricewaterhouseCoopers LLP
Vijay Thakrar	Deloitte LLP
Emma Tuppen	K&L Gates LLP
Amy Underwood	EY

MEMBERS OF THE QUOTED COMPANIES ALLIANCE SHARE SCHEMES EXPERT GROUP

Name	Organisation
Fiona Bell (Chairman)	RM2 Partnership Limited
Jared Cranney (Deputy Chairman)	ISG plc
Michael Landon (Deputy Chairman)	MM & K Limited
Isabel Pooley / Nicholas Stretch	CMS Cameron McKenna LLP
Barbara Allen / Anika Chandra	Stephenson Harwood
Emma Bailey	Fox Williams LLP
Martin Benson	Baker Tilly
Danny Blum	Eversheds LLP
Stephen Chater	Postlethwaite & Co
Sara Cohen	Lewis Silkin
Karen Cooper	Osborne Clarke
Rory Cray	FIT Remuneration Consultants
David Firth	Penna Consulting PLC
Philip Fisher	BDO LLP
Amanda Flint / Richard Sharman / Amanda Stapleton	Grant Thornton UK LLP
David Fuller	CLS Holdings PLC
Andy Goodman	BDO LLP
Liz Hunter	Mazars LLP
Marcus Kealey/ Justin McGilloway	Wedlake Bell LLP
Colin Kendon	Bird & Bird LLP
Robert Postlethwaite	Postlethwaite & Co
Andrew Quayle	Olswang
Jennifer Rudman	Equiniti
Mia Thursby-Pelham	PricewaterhouseCoopers LLP
Nick Wallis	Smith & Williamson LLP
Matthew Ward	Hewitt New Bridge Street