Sustaining growth in uncertain times

Autumn Budget 2017 – Proposals for taxation reform

September 2017

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An introduction to the Quoted Companies Alliance

We are the independent membership organisation that champions the interests of small and 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 creates impact for our members.

Small and mid-size quoted companies tend to have market capitalisations of below £1 billion. There are approximately 1,600 small and mid-size quoted companies on the Main List of the London Stock Exchange and quoted on AIM and NEX Exchange, together comprising 76% of all UK quoted companies. The total market capitalisation of the small and mid-size quoted company sector in the UK is £266 billion (as of September 2017).

Our Tax Expert Group, supported by our Share Schemes Expert Group, has prepared these proposals for taxation reform. A list of members can be found in Appendix D.

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Executive Summary

The UK's departure from the European Union will bring major changes to the structure of the economy. With much uncertainty regarding what lies ahead, it is important that the government confirms its commitment to supporting small and mid-size quoted companies – the engines of economic growth and job creation. As part of this commitment, we encourage the government to build a taxation system that is **competitive**, **simple** and **certain**.

I. Competitive

With the UK scheduled to leave the European Union in March 2019, it must build a competitive tax regime that both incentivises and enables smaller, growing companies to raise sustainable, long-term capital more cheaply and efficiently. This will be crucial to supporting long-term economic stability and demonstrating the UK is an attractive place to do business.

We call on the government to:

1. **Create a level playing field for capital raising by permitting all costs associated with raising equity to be tax deductible** through:
   - Placing a £1.5m upper limit to target the relief at smaller companies;
   - Enabling the relief to be applied to IPO and secondary fundraisings; and
   - Allowing the tax relief to be available in the year the costs were incurred.
2. Either **remove the condition that officers and employees of a company must have at least 5% of the voting rights and ordinary share capital to qualify for Capital Gains Tax Entrepreneurs' Relief** or, if that is not possible, **amend the 5% test so that it only needs to be met for a continuous 12 month period during the five year period ending with the date of sale**, as with the Substantial Shareholdings Exemption.
3. **Ensure that Entrepreneurs' Relief applies to the whole gain**, regardless of whether the selling shareholder receives consideration in the form of a cash earn-out, shares or loan notes.
4. **Encourage employee share ownership in smaller companies through Company Share Option Plans (CSOPs)** by:
   - Allowing the exercise price to be at a discount or at nil cost, while retaining income tax relief only for any increase over the market value at grant;
   - Removing the three year holding period before options can be exercised with income tax relief, as well as all leaver and other early exercise requirements; and
   - Introducing a rolling three year £30,000 limit for all subsisting options.
5. **Permit non-executive directors taking shares as part of their remuneration to pay income tax only after the sale of the shares**.
6. **Seek the state aid approval of Enterprise Management Incentives (EMIs) by the European Commission in time for April 2018**.

7.	**Allow funds to invest in AIM companies that qualify for inheritance tax relief** so that individual investors are able to fully utilise this tax relief, while spreading their investment risk.
8.	**Exempt or zero-rate from VAT any small-cap investment research that has been paid for by an institution to a broker.**

II. Simple

The UK has one of the world's most complex tax systems. New tax legislation continues to add length and complexity to the existing framework. Additional rules raise the cost of compliance for the smallest companies and create a barrier to them building their business and generating growth.

We call on the government to:

1.	**Increase the Small Companies Enterprise Centre's resources to reduce the complexity and improve timescales when using Enterprise Investment Schemes and Venture Capital Trusts.**
2.	**Continue enhancing the digital process for registering employee share plans and filing annual returns.**
3.	**Allow agents to register and self-certify employee share plans on behalf of companies.**
4.	**Introduce new rules to allow UK persons to make interest payments gross or at treaty rates where the person reasonably believes, at the time the payment is made, that the payee is entitled to relief in respect of the payment under double taxation arrangements.**
5.	**Extend degrouping charge reform to provisions relating to the intangible fixed assets, loan relationships and derivative contracts regimes.**

III. Certain

For small and mid-size quoted companies to effectively plan for their future development with confidence, they require a tax system underpinned by certainty. This will give companies the confidence to make long-term investment decisions which will help drive sustained economic growth.

We call on the government to:

1.	**Introduce a bespoke binding ruling process that can consider queries on all aspects of UK tax law.**
2.	**Confirm that medium-sized groups are not required to compile contemporaneous evidence to support transfer pricing policies, unless they wish to do so.**

I. Creating a competitive tax system

Exiting the European Union will present the UK with unprecedented economic challenges. Faced with leaving the Single Market and the Customs Union, the government will need to fully leverage all the fiscal levers at its disposal to ensure that any subsequent turbulence is temporary.

Similarly, we note the government's commitment to building an industrial strategy that supports a strong economy and delivers long-term productivity growth. It will therefore be necessary for the government to enhance the menu of sustainable, long-term funding options available to companies looking to grow and expand. Doing so will play an essential role in boosting the UK's economic competitiveness post-Brexit.

We therefore encourage the government to build a fiscal framework that rewards long-term thinking. Taking targeted and decisive action now to promote entrepreneurial activity will ensure that Britain is able to maintain a strong economic foundation in the years ahead.

Below, we set out our proposals that will allow smaller, growing companies to obtain the funding they need to grow.

A. Levelling the playing field between debt and equity

There is a distinct need to address the preferential treatment of debt over equity as a source of finance for smaller, growing companies. Companies can currently claim tax relief for costs incurred in raising debt finance, but not for equity finance. This represents a pronounced distortion in the tax system.

Yet, OECD research has highlighted the advantages equity has over debt. Indeed, empirical results "suggest that in most OECD countries more debt is typically associated with slower growth while more stock market financing generates a positive growth effect. Furthermore, recent OECD work[1] (Ahrend and Goujard, 2012) found that corporate tax systems which favour debt over equity are associated with a higher share of debt in external financing, thereby increasing financial crisis risks. The economic literature and earlier OECD work identified that the debt bias in corporate taxation generates costly economic distortions (De Mooij, 2012; Devereux et al., 2013; OECD, 2007). These findings all underline the growth benefits of reducing the debt bias in corporate taxation. Effective average tax rates on equity finance generally exceed those on debt finance, primarily because interest expenses are cost-deductible."[2]

Similarly, a UK review of the European Listings Regime indicated that making equity issuance costs deductible for corporation tax purposes would promote greater long term stability and incentivise greater use of capital markets.[3]

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[1] Ahrend, R. and A. Goujard (2012), "International Capital Mobility and Financial Fragility - Part 1. Drivers of Systemic Banking Crises: The Role of Bank-Balance-Sheet Contagion and Financial Account Structure", OECD Economics Department Working Papers, No. 902, OECD Publishing, Paris. http://dx.doi.org/10.1787/5kg3k8ksgglw-en

[2] Cournède, B., O. Denk and P. Hoeller (2015), "Finance and Inclusive Growth", *OECD Economic Policy Papers*, No. 14, OECD Publishing, Paris

[3] Capital Markets for Growing Companies – A review of the European listings regime, TheCityUK, King & Wood Mallesons, available at: https://www.thecityuk.com/assets/2015/Reports-PDF/ELR-Capital-Markets-for-Growing-Companies.pdf

Through its Capital Markets Union Action Plan[4], the European Commission is also committed to addressing the preferential tax treatment of debt in an effort to encourage more equity investments and increase financial stability in the European Union.

Reliance on debt finance is not a long-term solution for small and mid-size companies. The UK government must incentivise genuine long-term patient capital – equity finance. Providing tax relief for the costs of raising equity will level the playing field between debt and equity finance and encourage more companies to consider using public equity markets. Fully leveraging the true potential of capital markets will ensure that small and mid-size quoted companies, which play a crucial role in the UK economy, are incentivised and enabled to raise capital more cheaply and efficiently in a way that will generate employment and wealth, drive economic growth and support wider financial stability.

Furthermore, recent VAT case law[5] has confirmed that VAT on the costs of raising equity funding is deductible on input tax, if the company's activities are taxable. Hence, there is currently an inconsistency between direct and indirect taxation.

For a 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 many other European regimes (outlined in Appendix A), which provide some form of corporation tax relief for raising equity finance.

We have estimated that introducing a tax relief for the costs of raising equity would not be expensive to implement and would cost the Exchequer approximately £60.1 million over a 12 month period. We have calculated this figure based on the number of IPOs (106 of which 79 raised money) and further issues (913) on the London Stock Exchange's Main Market and AIM between 1 January 2016 and 31 December 2016, capping the relief at the £1.5 million per issue and assuming a corporate tax rate of 19%[6].

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. To provide some context, we have gathered data on fundraisings from the London Stock Exchange for both AIM and the Main Market in 2016. A summary of both data sets is outlined below in Tables 1 and 2, followed by a detailed outline on how the measure should be targeted.

[4] European Commission Action Plan on Building a Capital Markets Union, available at: http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf

[5] See Kretztechnik AG v Finanzamt Linz, CJEC case C-465/03 (2005).

[6] 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 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 issues and the following types of further issues: offer for subscription, placing and open offer, placing for cash, rights and placing. The time period examined is from 1 January 2016 to 31 December 2016, which represents a full calendar year.

Table 1 – Further Issues on the London Stock Exchange (1 January 2016 – 31 December 2016) [7]

Market	Number of Further Issues
AIM	626
UK Main Market	287
Grand Total	**913**

Table 2 – New Issues on the London Stock Exchange (1 January 2016 – 31 December 2016) [8]

Market	Type of new issue	Number of the types of new issue	Number of new issues that raised money
AIM	IPO	38	36
	Not IPO[9]	26	19
AIM Total		**64**	**55**
UK Main Market	IPO	25	21
	Not IPO	17	3
UK Main Market Total		**42**	**24**
Grand Total		**106**	**79**

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

We recommend that a limit of £1.5 million 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 European stock exchange would be deductible within the cap.

The £1.5 million 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, no issue size criteria should be attached to the relief.

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

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

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

ii. 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 £1.5 million 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.

iii. 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, public relations) should be allowed for the purposes of this measure, subject to the £1.5 million threshold mentioned above. Tables 3 and 4 outline in 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 3 – Estimated Costs of Floating on AIM[10]

Reporting accountants	£120,000
Company lawyers[11]	£90,000 - £130,000
Nominated adviser's lawyers	£25,000 - £50,000
Nominated adviser/broker corporate finance fee[12]	£30,000 - £150,000
Broker's commission[13]	4.25% - 6% of funds raised **or** 0.5% - 1% of funds not raised
Printing	£10,000
Registrars[14]	Minimum annual charge £4,000 - £5,000
Public relations	£36,000 - £72.000
London Stock Exchange AIM admission fees[15]	£8,700 - £97,500

Table 4 – Estimated Costs of Maintaining a Quotation on AIM[16]

Financial public relations	£43,000
Broker/nominated adviser annual fee (including analyst research	£25,000 - £90,000
Investor relations press cutting service	£5,400
Basic website service	£6,000
London Stock Exchange Regulatory News Service	£13,500 - £25,000
Analysis of share registrar	£1,500
Registrar	£8,500
Auditors	£10,000
Annual report design	£5,500
London Stock Exchange AIM annual fee[17]	£6,050
London Stock Exchange AIM further issues fee[18]	£0 - £49,000
Share option service	£15,500

[10] Quoted Companies Alliance research conducted between June and October 2014.

[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] AIM - Fees for companies and nominated advisers, 1 April 2017: http://www.londonstockexchange.com/companies-and-advisors/aim/publications/aim-fees.pdf

[16] Quoted Companies Alliance research conducted between June and October 2014.

[17] Varies depending on market capitalisation/size of the company.

[18] AIM - Fees for companies and nominated advisers, 1 April 2017: http://www.londonstockexchange.com/companies-and-advisors/aim/publications/aim-fees.pdf

iv. 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.

v. 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.

vi. 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.

vii. Allow equity costs to be deducted up to the limit set for debt cost deduction (£2 million)

We believe that as an alternative or transitional measure, the government should consider introducing measures to allow the cost of raising equity to be deductible but included within the £2 million *de minimis* threshold, as set out in the proposed restrictions on interest deductibility in the UK government's May 2016 consultation document.[19]

B. Reforming Entrepreneurs' Relief

Well-targeted and cost-effective capital gains tax (CGT) reliefs encourage equity investment in private and public companies. 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 welcomed the changes to Enterprise Management Incentives (EMI) implemented in Finance Act 2013 with respect to the extension of Entrepreneurs' Relief to shares acquired through EMI options, as this effectively removed the 5% shareholding requirement in this particular instance.

We also welcomed the introduction, of an investors' relief for external investors in unlisted trading companies for newly issued shares in March 2016. This is significant in encouraging investment in smaller companies, including those on AIM and NEX Exchange. We have been campaigning over the past six years for a fundamental extension to Entrepreneurs' Relief and we were pleased to see that the government agrees that incentives are needed to encourage such investment.

However, the continuing requirement for employees and directors to meet the "cliff edge" 5% requirement, in order to qualify for Entrepreneurs Relief (other than where shares are acquired under an EMI option) continue to be mentioned by our members as a critical issue.

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19 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/525923/tax_deductibility_second_consultation_v2.pdf

There are a number of related issues:

- The 5% requirement is inconsistent with the shareholding requirements that need to be met by external investors looking to obtain Investors Relief. It is unclear why employees should be treated differently to external investors, particularly where stated government policy is to encourage employee share ownership.

- Employees who hold actual equity, but fail to meet the 5% requirement, are in a materially worse after tax position than employees who acquire their shares through EMI options. Again it is unclear why this should be the case.

- The 5% requirement creates inequality between companies and LLPs (as there is no requirement for a minimum percentage interest in an LLP.

  The 5% requirement is, in any event, arbitrary in nature particularly given the focus on nominal share capital. There have been a number of cases recently, including the recent case of Castledine vs Revenue and Customs (Entrepreneurs' Relief: meaning of 'ordinary shares')[20] which highlighted the potential situation where the presence of deferred shares can reduce an entrepreneur's holding from an initial 5% to a value below that, all of which demonstrate the arbitrary (and unfair) nature of the test.

- Founding shareholders in small or mid-size quoted companies can often have their shareholding in the company diluted by the introduction of external investors to the extent that their holdings dip below the 5% threshold. It is unclear why the founding shareholders be penalised in this situation.

Furthermore, we believe that the government should continue to extend the availability of Entrepreneurs' Relief. Although the economic benefits of this measure are difficult to quantify, it is evident that the advantages for small and mid-size companies would increase. These companies would be able to attract the necessary talent and investment to grow and create more employment, which is essential to the UK's economic growth.

There are many case studies which demonstrate difficulties faced by small and mid-size quoted companies in this regard, without which there would be improved opportunities for successful growth and investment plans, greater liquidity, which would all help to generate further economic return to HM Treasury.

We divide our proposals into two parts. First, we expand below our rationale for proposing the removal of the 5% requirement. We then outline certain other measures that would ensure that Entrepreneurs' Relief operates on a fair, logical and coherent basis in the context of cash earn-outs and non-cash consideration received on a share disposal. Implementing any of these measures will help small and mid-size businesses better incentivise their employees to own shares in their companies, which will help these companies to grow.

[20] Castledine v Revenue and Customs (Entrepreneurs Relief : meaning of 'ordinary shares') [2016] http://www.bailii.org/uk/cases/UKFTT/TC/2016/TC04930.html

1. **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 stimulates growth in the UK economy by giving employees an incentive to grow the value of the business for which they work. It also helps close the "them and us" perception gap that often exists between management and employees.

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 in Entrepreneurs' Relief means that an individual must hold 5% of the voting rights and 5% of the ordinary share capital (by nominal value) in the company in which he/she holds shares to qualify for relief. This is in addition to the need to be an employee or officer of the relevant company. This means that employees who own actual shares are treated more disadvantageously than both employees who hold EMI options and external investors in the company who can benefit from Investors Relief. The former would seem to be simply unfair. The latter would seem to prioritise outside investment over encouraging employee ownership, and would seem to run against other government policy – as reflected in the Employee Ownership Trust legislation.

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. In fact, it can only occur in small companies with 20 or fewer employees.

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 or 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. As recent case law shows, the application of the relief, with its focus on ordinary share capital, can result in perverse results.

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 that small and mid-size quoted companies have faced:

1. Where shares are being passed down to the next generation of management founder shareholders are motivated to stop further dilution in order to maintain their entitlement to tax relief. This can be detrimental to the business by discouraging much needed changes in a company's capital and shareholder structure. We believe that a founding shareholder should not be penalised for having his or her shareholding in a company diluted by the introduction of either employee shareholders or new external investors where their holdings dip below the 5% threshold. The founders are still the key stakeholders to drive growth and employment.

2. 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 in negotiations considering the Entrepreneurs' Relief points.

We have collated and anonymised several examples of small and mid-size companies that have had practical difficulties with the 5% Requirement in Appendix B. They illustrate the need to address this area for growing businesses.

For those reasons, we consider that the 5% requirement is inappropriate in the modern business world and propose that it is removed for employees and officers of the business.

If the government is not prepared to remove the 5% requirement in its entirety, then it should consider introducing rules which would prevent founder shareholders from losing their entitlement to Entrepreneurs' Relief in situations where their shareholdings are diluted due to the introduction of new external investors.

For example, the 5% requirement could be amended to be more consistent with the Substantial Shareholdings Exemption (SSE), such that the test would need to be met over a 12 month period beginning within the five years ending on the date of the sale. This would encourage wider employee share ownership and align employee and management goals in driving growth. This would help mitigate situations, for instance, where a founder is diluted below 5% due to an acquisition or fundraising but otherwise has met the test for a continuous period of at least 12 months and would have qualified on a disposal in a previous two year window.

We acknowledge that HMRC might consider it necessary to introduce some form of target anti-avoidance rule (TAAR) to restrict the 'banking' of Entrepreneurs' Relief to genuine commercial circumstances rather than contrived structures.

2. 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 £10 million 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 anonymised 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

We note that any concern regarding whether an earn-out is properly to be treated as further consideration for the value of shares is effectively already addressed in HMRC guidance at ERSM110940. If the earn-out passes the tests in that guidance, HMRC accepts that the earn-out is capital and not income and that it is further consideration for the sale of the shares. If that is accepted (and the earn-out is not ‘disguised future reward’) then there is no reason why its tax treatment should be any different from the tax treatment of any upfront cash proceeds.

We also note that it is usually the buyer that insists on an earn-out rather than the seller (a seller would normally prefer all consideration up front rather than over time and uncertain as to amount) – so an earn-out is without exception a purely commercial construct based on the negotiating position and strength of the parties rather than a 'tax based tool' (and if used as a tax based tool then the principles set out in ERSM110940 already protect HMRC in this regard).

- **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 qualifying corporate bonds (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 Section 169Q or Section 169R of the Taxation of Chargeable Gains Act (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 Section 169I of the 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.

C. Encouraging employee share ownership

HMRC currently offers four types of tax-advantaged employee share scheme which qualifying companies can use to grant options or make awards over shares directly to their employees: the Company Share Option Plan (CSOP); Enterprise Management Incentives (EMIs); the Save As You Earn (SAYE) Plan; and the Share Incentive Plan (SIP).

Our comments relate to such direct employee share schemes. In recent years, following the findings of the Nuttall review, tax reliefs have been introduced for indirect ownership arrangements involving qualifying employee ownership trusts. These should continue to be available to support the employee ownership.

CSOP is a fairly simple, if inflexible, discretionary tax-advantaged share scheme. It is ideal for rewarding both managers and lower-paid employees in small companies that do not qualify to grant EMI options. However, many smaller companies find it difficult to introduce either of the tax-advantaged all-employee share plans – SAYE Plans and SIPs – because of the greater administration obligations and higher associated costs of these plans. This is because they might need to hire an additional person to deal with this or pay professional advisers, such as an administrator and savings provider for SAYE and/or a professional trustee for SIP.

CSOPs can be governed by a relatively simple set of rules and can be easily administered because there is typically little to deal with between the award (grant) of the option and the option exercise.

CSOP

Although there have been some helpful relaxations introduced by recent Finance Acts, we believe that the CSOP legislation has not been sufficiently adapted to meet modern remuneration practices. Smaller listed companies often prefer to grant Long-Term Incentive Plan (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. One of the main reasons for this is that LTIPs use fewer shares to provide the same reward. This helps smaller companies who might have issues with share availability due to lower liquidity in the shares or shareholder dilution limits.

In contrast, EMI options 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 415,000 in 2000-2001 down to only 40,000 in 2015-2016.[21] This is largely due to the flexibility of the EMI schemes designed to encourage smaller companies to grow. However, mid-size companies, in terms of employees or capital, still need support to grow and continue to recruit and retain employees. These falling numbers have not been compensated for by participation in all-employee share plans. While just over one million employees participated in each of SAYE and Profit Sharing Share Schemes (now replaced by SIPs) in 2000-2001, by 2013-2014 participation in SAYE and SIP had fallen to about 450,000 for each plan.[22] These plans are

[21] Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/623120/Table6-4.pdf

[22] Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/464153/Table6-3.pdf

predominantly operated by the largest companies due to the administration costs and need for a liquid market in the shares.

We believe that the best way to encourage employee share ownership in smaller companies that do not qualify for EMI would be to further relax the requirements of the CSOP and introduce more flexibility, in a similar way to that recommended in the report of the Office of Tax Simplification (OTS) in its Review of Tax-Advantaged Share Schemes, published in March 2012[23].

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.

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 and provide incentives to promote growth, in particular in small and mid-size companies.

The OTS report recommended (at para 2.57) that the existing £30,000 limit for all subsisting options be replaced with a rolling three year £30,000 limit. We recommend going further; the £30,000 limit should be reviewed and increased to enable CSOP to provide a meaningful incentive in today's modern workplaces.

Although the individual limits for all-employee plans and EMI have been increased significantly in recent years, the individual limit for CSOP has remained unchanged, at £30,000 per eligible employee, since 1996.

Given that the EMI individual limit is now set at £250,000 (with a maximum total value of shares which may be placed under option of £3 million), the difference between the two tax-advantaged discretionary arrangements as an effective incentive is significant for companies which do not or cease to qualify for EMI. We would suggest that the CSOP limit be increased to a figure between the current £30,000 limit and the EMI limit of £250,000, and that consideration be given to an appropriate figure for the total aggregate value of unexercised CSOP options (assuming such a maximum is considered to be necessary).

We appreciate that this would require careful analysis of the fiscal impact of such changes, but believe that, if implemented, CSOP would become more attractive to qualifying small and mid-size quoted companies as a means of incentivising their employees.

EMI

As an EU member state, the UK is currently subject to the state aid regime. In broad terms, this regime prohibits member states from granting state aid which distorts competition and trade in the EU by favouring certain undertakings.

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

EMI options offer tax reliefs to small and medium-sized enterprises. Such reliefs are viewed as aid for the purposes of the Treaty on the Functioning of the European Union (Articles 107 – 109).

The current approval of EMI by the European Commission is due to expire in April 2018. In Spring Budget 2017, the government confirmed that it will seek state aid approval to extend provision of EMI tax relief beyond 2018. This announcement was welcomed, and we would strongly advocate renewal of the state aid approval for EMI in April 2018.

Clearly, depending on the precise terms of the UK's exit from the EU, the UK may not need to observe state aid requirements for EMI schemes in the longer term. This would mean that changes to the EMI legislation could be made more easily (for example increases to the limits, including the 250 employees limit). However, as the UK is not due to formally leave the EU until 29 March 2019 at the earliest, it is important that renewal of the State Aid approval for EMI is negotiated before it expires (acknowledging that on a practical level this will be more difficult due to the on-going Brexit negotiations).

There is also a differentiation between EMI and other the option schemes. This creates a penalty for corporate growth. Typically the limits (e.g. employee numbers) mean companies outgrow EMI schemes, and the alternatives of SAYE and CSOP create a number of reduced benefits and inevitable demotivation for employees to create growth.

We propose that HM Treasury considers the alignment of the limits for EMI so that they are the same as for R&D tax relief – specifically the 500 employee limit (that is, lifting it from the current 250 employees) and the limit that can be raised (increase from £3 million to £5 million). This change creates a simplification of rules and helps businesses to avoid mistakes due to confusing limits. It will also become particularly important and relevant with the advent of IFRS16 in 2018/2019, which will require most operating lease assets to be placed on a company's balance sheet.

In our view this would:

- Address a real need in growing small and mid-size quoted companies to retain and reward their employees throughout a company's growth cycle;
- Encourage talented people to join small, but not start-up, companies, to grow to a sustainable size; and
- Concur with the government's own policy of encouraging wider employee share ownership.

Other limits also cause problems for small and mid-size quoted companies, depending on their individual circumstances and characteristics; this includes the gross assets test £30 million limit, which could be increased to reflect inflation.

D. Permitting non-executive directors taking shares as part of their remuneration to pay income tax only after the sale of the shares

Non-executive directors who wish to align their interest with those of shareholders, and subsequently agree to accept a portion of their remuneration in shares, are currently required to pay income tax upon issue of the shares. However, this comes at a time when the non-executive director will not have the cash to pay the tax.

To encourage non-executive directors to align their interests with shareholder interests, we propose that the government should allow non-executive directors to pay income tax only after the sale of the shares. We believe that this will not only help attract a higher standard of non-executive director, but also cultivate a closer relationship between the company, shareholders and the non-executive director.

E. Allowing funds to invest in AIM companies that qualify for inheritance tax relief

The current method of investing in AIM for inheritance tax purposes, where individuals have to invest directly in AIM stocks through discretionary portfolios does not match the risk with the goals of the investor. As fund managers of these portfolios tend to have to be fully invested, and inflows are regular – they have very little discretion to be able to achieve the optimum price in the market. This has meant that a number of AIM stocks which are liquid and large have become very attractive for inheritance tax purposes, making these stocks expensive.

Allowing funds to invest in AIM companies that qualify for inheritance tax relief would enable fund managers to invest in smaller and cheaper companies, spreading the allocation of capital wider than it is at the moment, thus spreading the risk for individual investors. This would create more liquidity and investment in smaller growth companies instead of maintaining the present concentration of such investments in the largest companies on AIM. We would be pleased to explore this concept with you further, involving some of our fund manager members.

F. Exempting or zero-rating from VAT any investment research on small-cap companies

Independent investment research on SMEs is essential in increasing their visibility and stimulating trading in their shares. This eases price discovery and enhances liquidity, which in turn reduces the cost of capital for companies and encouraging growth.

However, such research has experienced a significant drop since 2007 when MiFID [24] came into effect. In the UK it has become a marketing communication and the financial promotion rules means that it cannot be made generally available. This has created a considerable information inequity between the professional investment community and other investors. The economics of SMEs dictate that sponsorship of coverage is the only realistic means by which the market can be provided with quality investment research.

Recent research has indicated that most companies with a market cap of under £50 million are very scarcely covered, only being covered by their own house broker and in some cases by research that they pay for; similarly, some £500 million market cap companies struggle to get more than a handful of analysts to cover them.

Following our consistent campaigning, we welcomed the Financial Conduct Authority's decision in July 2017 to continue allowing fund managers to receive small cap research without payment where it has been commissioned and paid for by a smaller quoted company, including when issuing new shares.

However, for research that has not been commissioned and paid for by a company – that is, where an institution pays a broker to undertake investment research on a company – the institution must pay VAT in addition to the broker's fee, as the broker is deemed to be providing a service to the institution. This effectively reduces a broker's revenue yield by 20%, which in turn limits the resources it can deploy to

[24] Markets in Financial Instruments Directive (2004/39/EC)

conduct the research. This disincentivises brokers and other provider of independent investment research to undertake such activities and effectively reduces the quantity of research on SMEs.

Therefore, we propose that small-cap research that has been paid for by an institution to a broker should be liable to either a zero rate or, at least, a reduced rate. Not doing so will curtail the distribution of SME research which will damage the interests of issuers and investors alike and reducing competition in the SME funding sector.

We believe that levying VAT on investment research is an unintended consequence of the unbundling of research from execution commissions. Research has always been paid for through execution commissions which are not subject to VAT. Therefore we are not proposing a reduction in known tax revenue, rather one that has been inadvertently created.

Alternatively, if the government is unable to amend investment research's VAT rate, we propose using the new tax revenue generated to reinvest in tax incentives for small and mid-size quoted companies, such as facilitating IHT funds, outlined in item D of this section.

II. Simplifying the tax system

The UK has a reputation for having one of the world's longest and most complex tax systems. Estimates have put the length of tax handbooks at nearly 12,000 pages. Existing and new tax legislation continues to add yet more complexity and volume to the existing framework which punitively adds to the cost of compliance for UK companies.

This is particularly acute for smaller, growth companies. It is also worth noting that domestic legislation is being impacted by the OECD's BEPS framework, such as the complex proposed restrictions on interest deductibility.

We fully support the efforts being made by the Office of Tax Simplification (OTS) to explore ways to simplify it. We encourage the government to enhance and strengthen the OTS's relationship and influence with HM Treasury and HMRC so that more of its formal recommendations are implemented.

A simpler tax system would boost the growth potential of small and mid-size quoted companies by reducing compliance costs in terms of both time and money. It could also encourage companies to take advantage of the full range of tax provisions available. Such provisions would become more effective if more companies understood how they worked.

We outline our proposals for simplifying the tax system below.

A. Making it easier for small and mid-size quoted companies to utilise venture capital schemes

We believe that HMRC's guidance on the Changes to the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCT) rules introduced by Finance Act (No.2) 2015 was adequately drafted and contained much needed clarifications as to how certain rules apply. However, we still believe that the EIS and VCT rules should continue to be refined and simplified to ensure that small and mid-size quoted companies are able to fully leverage venture capital schemes and thus raise the finance they need to grow and create employment.

Whilst we appreciate the hard work provided by the inspectors within the Small Companies Enterprise Centre and their contribution in respect to venture capital schemes, the new rules have placed an additional, yet preventable, burden on many advance assurance applications. This has led to increased waiting time for responses, which have now stretched to between seven and eight weeks. This in turn has placed further constraints on companies seeking to raise financing for their businesses.

The government should increase investment into the Small Companies Enterprise Centre to reduce complexity and bring down timescales, so that the service allows the venture capital schemes to achieve their objective of supporting small, growing companies. We believe that improvements can be achieved to reduce their negative impact on small and mid-size quoted companies.

B. Enhancing electronic registration of employee share scheme plans

2015 saw the long-awaited introduction of electronic registration of employee share plans and the electronic return of annual return information. Our members supported this, seeing benefits for companies, advisors and HMRC alike.

However, experience of the new system has been mixed. Although there have been no repeats of the significant delays and difficulties from the 2015 and 2016 filings, the process of registration continues to be an obstacle for many small and mid-size quoted companies and those based outside the UK.

Our members have noted the following difficulties:

- The process to register an authorised agent is difficult and unclear;
- Smaller companies outsource PAYE and struggle to understand the PAYE portal "in-house";
- Many grouped companies will not have a relevant PAYE registration, leading them to believe they need to create one. This results in additional work;
- Low resourced financial controllers or finance directors do not have time to read all the relevant guidance;
- "Unapproved" plans are frequently registered as Company Share Option Plans (CSOPs) in error because they are "Company Share Option Plans" and the "Other" is unclear and confusing;
- More generally, the required information to be entered into the annual return templates, and the related guidance, is not always clear, in particular where tax advantaged awards are rolled over.

We propose that the relevant templates and accompanying guidance are reviewed with the objective of achieving a greater level of simplification and clarity. There should be continuing dialogue with representative bodies, as well as advance notification to changes in the schedules and questions for the online reporting and registration procedures, so that employing companies are in a position to make the appropriate reports and filings with minimal errors.

Moreover, we propose that HMRC allows agents to register and self-certify plans on behalf of companies if authorised by the company that established the plan. This would save time and resource, particularly for small and mid-size quoted companies. Likewise, agents should be able to de-register following a plan termination (e.g. takeover). ERS agents should be able to enter a plan termination date to close a plan registration (which at present can only be done by the company).

To this effect, the agent would need formal confirmation from the client that the statements in the return are true to the best of their knowledge and belief and that the agent submitting the return is merely an agent and not responsible for certifying the scheme. This would be similar to the confirmations used to authorise an adviser to deal with corporate tax issues; we believe that it should be relatively straightforward for HMRC to extend the procedure to these proposed agent arrangements.

C. Extending the withholding tax regime

We believe that further simplification benefits could also be obtained from extending the treatment set out at Section 911 of Income Tax Act 2007, which applies to withholding taxes on royalties paid by a UK person who reasonably believes, at the time the payment is made, that the payee is entitled to relief in respect of the payment under double taxation arrangements. This treatment could also be applied to interest payments made in situations where the double taxation treaty passport scheme is not in operation.

We propose the introduction of new rules which allow UK persons to make interest payments gross or at treaty rates where the person reasonably believes, at the time the payment is made, that the payee is entitled to relief in respect of the payment under double taxation arrangements.

D. Reforming the degrouping charge for intangible assets

The government made several changes to the capital gains rules for companies in Finance Act 2011. One of those changes related to the 'degrouping charge' in Section 179 of the Taxation of Chargeable Gains Act (TGCA) 1992. Under those new rules, any 'degrouping charge' is now added to the consideration for the disposal so that the charge is levied on the seller company rather than the target company.

One of the government's principal aims in introducing this change was to "simplify the capital gains rules for groups of companies as far as possible, for taxpayers undertaking commercially-driven transactions, consistent with affordability and with preserving the integrity of the regime"[25].

The changes that the government made were well received, and, in conjunction with the changes made simultaneously under the substantial shareholder exemption regime – allowing businesses to hive down assets into a new subsidiary before its onward sale and not lose entitlement to the substantial shareholdings exemption – were designed to promote the UK as an increasingly attractive jurisdiction for firms to do business.

The practical impact of a chargeable gain on the deemed disposal being added to the consideration for the disposal, and the charge falling on the vendor company, is indeed a tangible promotion of business efficacy. It reduces due diligence, disclosure of any intragroup transfers within the past six years is less onerous, and parties no longer need to spend time and cost negotiating whether there should be an election made under Section 179A TCGA.

However, while these changes have been welcomed, and are undoubtedly in line with the government's expressed goal of simplification, by only introducing changes in respect of the TCGA provisions which apply to chargeable assets, an inconsistency in regimes has arisen. There has been no contemporary change made in respect of the very similar degrouping charge provisions relating to the intangible fixed assets, loan relationships and derivative contracts regimes.

This inconsistency is significant and in practice has fundamentally undermined the benefits that the government sought to achieve with its changes in 2011. Intangible assets are becoming increasingly central to valuing companies, and their significance is not necessarily confined to small and mid-size quoted companies driven by intellectual property. In practice, the benefits that should therefore accrue under the

[25] HMRC, Simplification Review: Capital Gains Rules for Groups of Companies, a Summary of Consultation Responses, December 2010 (3.5)

TCGA revisions are stymied for many transactions, as the pre-Finance Act 2011 regime must be adhered to in respect of intangible assets created after 1 April 2002.

The government indicated in HMRC's December 2010 summary of consultation responses that it did "not currently intend to extend the degrouping proposal beyond the capital gains regime for companies"[26]. However, as referred to above, the government did not justify this position, yet noted that extending the changes beyond this regime was a "related area of work", albeit under a separate body of legislation. Specifically, the government acknowledged its awareness that by omitting at that stage to introduce similar changes to the other regimes referred to above, there was "a potential issue for future simplification work".

Moreover, in the 2016 Autumn Statement, the government restated its commitment to the Business Tax Road Map[27]. One of the fundamental principles was to "modernise and simplify the tax system [enabling] businesses that comply with tax rules fairly and consistently [to] find the tax system easy to understand and navigate"[28]. Removing this inconsistency in the degrouping provisions is aligned with this objective, and would promote the original aim of Finance Act 2011's provisions. Furthermore, the reasoning that catalysed the changes made to the TCGA under the FA 2011 equally applies to intangible assets, loan relationships and derivative contracts.

We propose the government reviews its position in respect of further degrouping charge reform. While the inconsistency is most acutely felt under the intangible assets regime, and that is our primary concern, our representation would be to also extend the successful changes that the government has made to other instances where a degrouping charge arises, including loan relationship and derivative contract regimes. Extending this reform will promote its purpose, further business efficacy and contribute to making the UK an attractive jurisdiction for businesses worldwide. We do not believe that there would be any material cost to the Exchequer in making these changes.

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[26] HMRC, Simplification Review: Capital Gains Rules for Groups of Companies, a Summary of Consultation Responses, December 2010 (3.26)

[27] Autumn Statement 2016 (4.23): https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/571559/autumn_statement_2016_web.pdf

[28] HMRC, Business Tax Road Map, March 2016 (2.43): https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/509249/business_tax_road_map_final2.pdf

III. Building certainty into the tax system

Certainty is an undervalued, yet crucial, attribute to a successful tax system. Without it, companies of all sizes are unable to effectively and confidently plan for their future development. Where uncertainty exists in a tax system, companies are far more likely to defer, or abandon altogether, plans to deploy funds to finance crucial investments that could grow their business, boost economic growth and create employment opportunities.

At the same time, increasing certainty in the tax system will decrease the number of disputes between companies and HMRC, which will remove unnecessary costs for all parties. Government will also gain from a certain tax system; one which seldom changes will ensure that HM Treasury is better able to estimate its total revenue intake in any given fiscal year and, therefore, assess its future spending plans more realistically.

We welcomed the government's decision to hold one major fiscal event per year. This move will help to promote certainty in the tax system as businesses face fewer ad hoc changes.

We outline our proposals for building certainty into the tax system below.

A. Establishing a binding ruling service

As a key cornerstone to building certainty into the tax system, we propose introducing a binding, paid-for clearance/ruling process along similar lines to those provided in the Netherlands and Luxembourg, which HMRC could also use as a small revenue-raising mechanism. At a time when the UK will want to be seen as an attractive place to do business, such a service would be a useful tool.

In the Netherlands, we understand that there is a dedicated team within the Rotterdam office of the Dutch Tax Authorities that deals with requests for binding rulings. There is no cost to the tax payer in seeking or obtaining a ruling but there is a clearly set out list of required information to enable the rulings team to fully consider the request. The team deals only in matters pertaining to international tax, including, but not limited to, application of participation exemption, permanent establishment and foreign tax payer rules. Rulings are considered by one Inspector of Taxes with another co-signing once the ruling has been granted.

In Luxembourg, an advance tax clearance mechanism is in place to allow tax payers to apply for a ruling on all aspects of Luxemburg tax law. The clearance must be submitted prior to the implementation of the proposed structure or transaction and include an accurate description of the facts as well as the anticipated tax treatment. Applications for clearance attract a fee of between €3,000 and €10,000, depending on the complexity of the matter, and are considered by a panel of six Inspectors of Tax. The panel has two months to consider the application. Where the clearance is granted, the ruling is binding on the tax authorities for a period of five tax years from the date of implementation.

It will, of course, be necessary to ensure that any proposed clearance/ruling process is not in breach of state aid regulations by virtue of being perceived to create unfair competition. It should be noted that both the Netherlands and Luxembourg have recently amended their own ruling processes (to those set out above) following challenges from the European Commission.

B. Clarifying the position of medium-sized entities with respect to transfer pricing

For medium-sized groups (as defined in the legislation), transfer pricing rules provide a partial exemption, though HMRC still has 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. This suggests that the uncertainty of the application of these rules to medium-sized entities serves little purpose. We encourage the government to clarify the position for medium-sized groups in this regard. This could be achieved by raising the threshold at which the transfer pricing rules apply.

Alternatively, 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.

Our members continuously tell us that the onerous cost of compliance outweighs any commercial benefit or any possible increase in tax revenues. We have detailed anonymised examples of companies that have experienced practical difficulties applying the transfer pricing rules in Appendix C. They illustrate the complexities and costs incurred by small and mid-size quoted companies.

Appendix A: European regimes for tax relief for the costs of raising equity[29]

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, the Belgian legislation provides for a notional interest deduction ("Déduction pour capital à risque" – "Aftrek voor risicokapitaal" or "NID) according to which companies are entitled to deduct a certain percentage ("NID rate") of their adjusted net equity from their taxable income base. The company's adjusted net equity is calculated on the basis of the capital shown on its balance sheet at the end of the preceding taxable period, adjusted by excluding certain items from the net equity amount (e.g. company's own shares, shares in other companies that qualify as financial fixed assets, capital subsidies, etc.). The applicable NID rate for tax assessment 2018 (income 2017) is 0.237% for large companies and 0.737% for small and medium sized companies. As from 2018, the qualifying net equity on which the NID rate will apply will be equal to the adjusted net equity which has accrued over the previous five taxable periods (so-called "incremental equity"). In other words, the NID regime will effectively allow

[29] Research conducted by the Quoted Companies Alliance in August 2017 (except Greece and Norway, which was conducted in October 2014).

Country	Is there any corporate tax relief for flotation costs?	Are the costs of issuing new equity generally deductible for corporation tax purposes?
		for a deduction, provided that the eligible adjusted net equity has given rise to a surplus (upon which the NID rate will apply), in comparison with the average adjusted net equity of the previous five taxable periods.
Bulgaria	Yes. Flotation costs (i.e. costs incurred by a publicly traded company with regards to issuing new securities) are not subject to a specific tax regime in Bulgaria and are generally deductible for corporate tax purposes.	Yes. The costs of issuing new equity should generally be tax deductible for corporate tax purposes.
France	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 from an accounting and tax perspective. 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. – Costs of raising new equity can also, from an accounting perspective, be offset against the share premium issued. In that case, such costs may however be deducted from as a pure tax

Country	Is there any corporate tax relief for flotation costs?	Are the costs of issuing new equity generally deductible for corporation tax purposes?
		deduction (without any P&L entry).
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. 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. 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

Country	Is there any corporate tax relief for flotation costs?	Are the costs of issuing new equity generally deductible for corporation tax purposes?
		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 Dutch jurisprudence.	Yes. Dutch corporate income tax law approves the deductibility of incorporation costs and costs related to the issue of capital.
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 costs of advisory, law services,

Country	Is there any corporate tax relief for flotation costs?	Are the costs of issuing new equity generally deductible for corporation tax purposes?
		audit, due diligence are in general 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 that 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, Sub-item 3 of the 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	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, Sub-item 3 of Russian Tax Code). All expenses recognised for Russian tax purposes should be properly documented and economically justified (Article 252, Item 1).

Country	Is there any corporate tax relief for flotation costs?	Are the costs of issuing new equity generally deductible for corporation tax purposes?
	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 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. A transitionary period was in place 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. In this regard, it is worth mentioning that the Swiss parliament recently agreed on introducing a Notional Interest Deduction on part of the equity (optional on a cantonal level and subject to certain conditions) in the context of the Corporate Tax Reform III. Depending on the outcome of a possible referendum the revision is expected to enter into force in 2019/2020.
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

Country	Is there any corporate tax relief for flotation costs?	Are the costs of issuing new equity generally deductible for corporation tax purposes?
		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.

Appendix B: The practical difficulties with the 5% Requirement experienced by small and mid-size companies

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 10 years ago by two entrepreneurs and some key managers. It floated 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

Company F'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 that 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.

Appendix C: The difficulties experienced by small and mid-size quoted companies applying transfer pricing rules

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 and 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

Appendix D: List of Expert Group members

Quoted Companies Alliance Tax Expert Group

Paul Fay (Chair)	**Crowe Clark Whitehill LLP**
Michael Bell (Deputy Chair)	Osborne Clarke
Ray Smith	Clyde & Co LLP
Sam Dames Nick Burt Mark Joscelyne	CMS
Daniel Hawthorne	Dechert
Hannah Jones	Deloitte LLP
Emma Bailey Shofiq Miah	Fox Williams LLP
Holly Edwards	Frontier Developments PLC
Neil Pamplin	Grant Thornton UK LLP
Peter Vertannes	KPMG
Matthew Rowbotham	Lewis Silkin
Catherine Hall	Mazars LLP
Tim Crosley	Memery Crystal LLP
Tom Gareze	PKF Littlejohn LLP
Emma Locken	PricewaterhouseCoopers LLP
Dan Robertson	RSM
Vijay Thakrar	Unattached
Neil Armstrong	Unattached

Quoted Companies Alliance Share Schemes Expert Group

Fiona Bell (Chair)	**RSM**
Emma Bailey (Deputy Chair)	Fox Williams LLP
Andy Goodman Philip Fisher	BDO LLP
David Daws	Blake Morgan
Graham Muir	CMS
Caroline Harwood	Crowe Clark Whitehill LLP
Juliet Halfhead	Deloitte LLP
Danny Blum	Eversheds Sutherland
Richard Sharman	FIT Remuneration Consultants
Shofiq Miah	Fox Williams LLP
Isabel Pooley	Grant Thornton UK LLP
Matthew Ward	Hewitt New Bridge Street
Sara Cohen	Lewis Silkin
Liz Hunter	Mazars LLP
Stephen Diosi	Mishcon De Reya
Stuart James	MM & K Limited
Michael Carter	Osborne Clarke
Robert Postlethwaite Stephen Chater	Postlethwaite Solicitors
Daniel Hepburn	PricewaterhouseCoopers LLP
Jennifer Rudman	Prism Cosec
Martin Benson	RSM
Dave Bareham	Smith & Williamson LLP
Barbara Allen	Stephenson Harwood
Justin McGilloway	Wedlake Bell LLP