

## Promoting Participation in SME Boards Through Tax Incentives: A Global Overview

John Schellhase

August 2017

### Executive Summary

Over the last two decades, a large number of stock exchanges have established dedicated market segments for small and medium-sized enterprises (SMEs). This trend accelerated during the global financial crisis; as banks tightened credit, both policymakers and exchange operators saw an opportunity for equity-based finance for SMEs. In order to encourage listings, exchanges and their regulators have undertaken a number of measures, including reducing listing requirements of various kinds, reducing the various costs associated with listing, and providing enhanced support to new issuers throughout the process. Apart from and in addition to these measures, some policymakers have offered tax incentives of various kinds, both to issuers and investors, as a way to both encourage new listings and to increase trading activity.

This paper explains three common models of tax incentives for attracting investors to allocate capital to SME equity. It then looks at examples of corporate tax incentives offered to SME issuers.

In general, policymakers should consider tax incentives as only one means of encouraging market activity on SME boards, with other possible interventions including public grants or loans, subsidized technical assistance, and educational outreach.

Key takeaways are:

- Tax incentives for investors typically fall into three models: back-end exemptions on stamp duties and/or capital gains tax; tax offsets based on the value invested directly into SME equities; and tax offsets based on the value invested into SME investment vehicles.
- Although recent evidence suggests that tax incentives will motivate some investors to increase their investments in SME public equity shares, they are not the determining factor. Investors more often point to the need for market liquidity, a strong regulatory environment, and adequate information disclosure as key considerations when deciding to invest in firms listed on SME boards.
- Reductions in corporate income tax for listed SMEs are less common than incentives for investors, but a number of countries offer tax benefits to listed firms. Prominent examples are Thailand and Jamaica, where policymakers have targeted tax benefits specifically to firms listed on SME-dedicated market segments.

There are drawbacks to offering overly generous tax breaks, particularly when it comes to attracting issuers. In addition to potentially attracting companies that would otherwise be ill-prepared to access public equity financing, some policymakers and the general public may find the loss of immediate tax revenues to be a controversial bet on the future growth of firms listed on these exchanges.

## Tax Incentives for Investors

The rationale behind offering tax incentives to investors is two-fold. First, the public policy justification of foregoing government revenues is founded on the idea that expanded access to capital for SMEs can have a broad, positive impact on socioeconomic development overall, given that SMEs are essential drivers of job creation. Second, as the smaller ticket size of SME investments often makes them uneconomical in light of due diligence and other investment costs, tax incentives can defray these costs and induce otherwise-interested investors into this market segment.

### *Tax Incentives for Investors: A Global Overview*

Common models for encouraging investment in SME equities include the following (see also Table 1):

- Elimination of back-end taxes for trades of SME shares
- Tax deductions for investors as a percentage of value invested in SME shares
- Tax deductions for investors as a percentage of value invested in risk-pooling investment vehicles for SMEs

In most cases, these incentives apply equally to private angel and venture capital investments, as well as to shares listed on SME boards.

In the first model, policymakers encourage investment in shares listed on SME boards through removing so-called “back-end” taxes. These taxes are applied to profits made selling a security or as a fee for doing so. In addition to encouraging greater investor participation, these back-end incentives also

theoretically promote liquidity by removing or reducing the tax friction applied to selling shares. Poland, for example, has eliminated stamp duty taxes for trades of shares on the NewConnect platform, the Warsaw Stock Exchange's SME segment. In South Korea and India, investors benefit from reduced capital gains taxes on SME equity investments. In India, the long-term capital gains tax is eliminated altogether for shares listed on the BSE SME Platform, compared to the 20 percent rate, after indexation, applied to other equity shares. India also cuts short-term capital gains tax in half, from 30 percent to 15 percent, for shares listed on SME boards.

In the second model, as practiced in the United Kingdom and in Spain, retail investors can deduct a set percentage of the value they invest in shares of SME equity.<sup>1</sup> In both cases, the tax offsets are offered only for acquiring shares in new equity offerings. Both countries, moreover, require investors to hold the shares for an extended period—three years in the U.K. and two years in Spain—in order to claim the tax credit. As economists from Spain's National Stock Market Commission explain, "the incentive is for financing the company, not for buying on the secondary market."<sup>2</sup> This model, in other words, aims to deepen the investor base for SMEs, but also locks-in retail investors and potentially undermines the liquidity of the SME market segments. This possible outcome may not significantly affect entrepreneurs, who may be primarily interested in the capital influx from equity offerings. The consequences, however, for wider investor participation in SME boards, particularly those with very few listings, merit further study.

The U.K. example of this model is called the Enterprise Investment Scheme. Tax-deductible investments can either be private; venture capital investments; or investments in shares listed on an SME board, such as the Alternative Investment Market of the London Stock Exchange. Spain's incentives apply to investments on the Mercado Alternativo Bursátil (the Alternative Stock Market: Spanish acronym, MAB). The Spanish case, though, is unusual in that a handful of sub-national regional autonomous communities offer regional residents tax deductions for MAB investments, but only for investments in companies that are headquartered in the same region. That is, for example, a resident of Madrid could make a tax-deductible investment in a Madrid-based SME listed on the MAB, but he or she would not receive the same tax break when investing in an SME from Barcelona.

---

<sup>1</sup> Upper-limit caps apply. For example, in Spain, the maximum tax offset is 10,000 euros.

<sup>2</sup> See Arce et al., "Access of SMEs with growth potential to the capital markets," Comisión Nacional del Mercado de Valores, Working Paper No. 52, 2011.

**TABLE 1. Tax incentives for equity investments in SMEs**

Country	SME board(s)	Selected tax incentive(s) for investors
France	Alternext	Tax relief of 18% of value invested in innovation mutual funds ( <i>Fonds Commun de Placement dans l'Innovation</i> )
India	BSE SME Platform, NSE EMERGE	Long-term capital gains tax exemption; short-term capital gains tax reduction from 30% to 15%
Poland	NewConnect	Stamp duty exemption
Spain	MAB	Offset of individual income tax liabilities of 15-20% of value invested in new equity shares of SMEs listing on the Mercado Alternativo Bursátil (MAB); not a national program—the company must be domiciled in, and the investor must be a resident of, one of five regional communities: Aragón, Catalonia, Galicia, Madrid, or Murcia
United Kingdom	AIM	<i>Enterprise Investment Scheme:</i> Offset of individual income tax liabilities of 30% of value invested in new equity shares of SMEs with less than 250 employees  <i>Venture Capital Trust Structure:</i> Tax relief of 30% of value invested in authorized venture capital trusts (VCTs)

Sources: Stock exchange websites, national tax authorities

The U.K. and France offer a third model: tax incentives for special investment vehicles for SMEs. Here the theory is that pooling a large number of SME equity investments into a single investible security reduces the overall risk for investing in these early-stage companies. These vehicles also enable institutional investors to participate at larger ticket sizes while also limiting due diligence costs, as diligence is conducted for the firm managing the pooled fund, not each individual SME. In the U.K. version of this model, investors may offset their tax liabilities by 30 percent of the value invested in venture capital trusts (VCTs). These trusts are listed on the main market of the London Stock Exchange and themselves hold a portfolio of debt and equity investments in SMEs with less than 250 employees. These portfolios may also include shares of firms listed on the U.K.'s SME boards. Additional incentives for VCT investments include tax-free dividends and no capital gains tax, but investors must hold their VCT shares for five years or repayment penalties apply.

In France, investors can access a tax credit of 18 percent of the value invested in *Fonds Commun de Placement dans l'Innovation* (innovation mutual funds—French acronym, FCPI). FCPIs invest at least 60 percent of their portfolios in SME equity (including in listed shares on the Paris-based Alternext SME board). Equity investments must be in particular high-growth sectors—technology, clean-tech, and life sciences—with the remainder of the portfolio placed in money market securities. Investors also receive tax relief from capital gains and French wealth taxes. According to the Organisation for Economic Co-operation and Development (OECD), these tax incentives have encouraged over 10,000 individual investors to invest around 1.5 billion euros in French SMEs over the last two decades.<sup>3</sup>

<sup>3</sup> See the French responses from the “Equity financing and venture capital” questionnaire section of the *OECD Science, Technology, and Industry Outlook 2014*.

### ***Tax Incentives: Only a Partial Solution for Attracting Investors***

Despite these approaches, the impact of tax incentives on investor behavior has been arguably limited. According to new survey evidence from the World Federation of Exchanges, tax incentives would make slight majorities of retail and institutional investors more likely to invest in listed SMEs. At the same time, very few surveyed investors signaled interest in special investment vehicles. As Table 2 shows, these investors more frequently identified other factors, such as liquidity and transparency of financial information, as determinative of whether they would participate in SME boards.

**TABLE 2. Which of the following, if any, would persuade you to invest in listed SMEs?\***

	<b>Retail investors</b>	<b>Institutional investors</b>
Liquidity of shares	67%	84%
Regulatory framework	57%	68%
Information disclosure	67%	68%
Tax incentives	52%	53%
Research on SMEs	57%	53%
Lower transaction costs	33%	42%
Investment vehicles	29%	33%
Diversification opportunities	48%	32%

*\*Though these figures give an indication of what is most important to investors, they should be interpreted cautiously as the sample was relatively small and included survey participants from vastly different market contexts.<sup>4</sup>*

Source: "SME Financing and Equity Markets," World Federation of Exchanges, 2017

### **Tax Incentives for SMEs that Go Public**

A challenge for many stock exchanges that establish SME boards, particularly those in developing countries, is attracting enough listings to make the alternative board a sustainable enterprise. To address this issue and jumpstart new listing activity, some jurisdictions offer firms that list on SME boards breaks on their corporate income taxes. This approach is less common than tax incentives for investors, and it is practically unheard of in advanced markets. In general, policymakers are more cautious about offering tax breaks to listing firms because they do not want to entice the wrong kinds of firms to list. If firms are listing mainly to avoid paying taxes, but are otherwise unready or ill-suited for becoming public companies, investors are likely to lose confidence in the quality of listings on the exchange, with a drop-off in trading activity and lower participation in new offerings potentially to follow.

There are two main justifications for offering tax breaks to firms that list shares. First, given that SMEs play an important role in job creation and economic development, but face growth constraints due to a lack of access to finance, policymakers may see tax incentives for a public equity listing as a part of a general strategy for expanding SME access to capital. In this view, the loss of tax revenues in the short term is, in a sense, an investment in long-term economic development. Moreover, by the time the tax breaks expire, firms will have hopefully grown into larger entities that will contribute more to government revenues than they would have had they not received the financing they needed at an earlier stage in their lifecycle.

<sup>4</sup> The sample included 21 retail investors and 19 institutional investors, distributed across five countries: Canada, China, Mexico, Nigeria, and South Africa.

Second, tax breaks may correct for a common market-development dilemma. Policymakers often want SMEs to list because, by formalizing the accounting and reporting practices of key economic players, the government is likely to capture more tax revenues than it would if firms had remained closely-held operations with only informal accounting structures. For instance, a study commissioned by the Nigerian Stock Exchange found that listed companies paid 65 percent more in taxes than unlisted peers.<sup>5</sup> This reality, though, may dissuade new listings. As unlisted SMEs see that the reforms required to list lead to heavier effective tax burdens, they may prefer to simply remain private. Tax incentives could mitigate this pain point for SMEs considering a public listing.<sup>6</sup>

### ***Tax Incentives for Listed Companies: A Global Overview***

Most jurisdictions that offer tax breaks for listing firms do so by reducing the corporate income tax rate by anywhere between a third to half of the standard nominal rate. Many countries offer the same incentive structure for both SME market segments and senior boards. This is the case in Cambodia, Fiji, Kenya, Morocco, and Pakistan, as Table 3 summarizes. The experiences of Thailand and Jamaica offer two additional models where tax incentives are directed explicitly at the SME segment of the stock exchange.

**TABLE 3. Reductions in corporate income tax for listed companies (regardless of market segment)**

Country	Nominal rate*	Reduced rate*
Cambodia	20%	10%, for the three years following an initial public offering (IPO)
Fiji	18.5%	10%
Kenya	30%	27%, for the three years following an IPO for companies with at least 27% of issued share capital listed; 25%, for the five years following an IPO for companies with at least 30% of issued share capital listed; 20%, for the five years following an IPO for companies with at least 40% of issued share capital listed
Morocco	31%	15.5%, for the three years following an IPO
Pakistan	31%	26.4%, for the two years following an IPO

\*Excludes other deductions and/or additional tax liabilities

Sources: *SME Financing through Capital Markets: Final Report*, International Organization of Securities Commissions, July 2015; *SME Finance Monitor*, Asian Development Bank, 2014; stock exchange websites

From 2001 to 2009, Thailand spurred new listings on both boards of the Stock Exchange of Thailand (SET) through reduced corporate income taxes for listed firms. The rate for SMEs listing on the Mai board, though, was cut more than the discount offered larger firms on the main board—from 30 percent to 20 percent for Mai listings, compared to 25 percent for the main board (see Table 4).<sup>7</sup> Policymakers in

<sup>5</sup> Management team at the Nigerian Stock Exchange, in correspondence with the Milken Institute.

<sup>6</sup> To alleviate a fear that tax authorities will impose penalties retroactively on firms that masked their tax liability prior to going public, some financial-sector development specialists have proposed what is called a “tax amnesty” for listing firms. This provision would effectively absolve SMEs that list from past omissions or misrepresentations in tax filings. While Kenya does not offer a tax amnesty, per se, SMEs that list on the Growth and Enterprise Market Segment (GEMS) can apply for a waiver for penalties if the process of listing reveals unpaid back taxes. For more discussion on this point, see Mauro Mela et al., “Review of Growth Enterprise Market Segment (GEMS) and increasing access to Kenya’s capital market by small and medium enterprises (SMEs),” FSD Kenya, September 2015.

<sup>7</sup> From a public policy perspective, this makes good sense for three reasons: 1) larger firms should already have their books in good order, even in the kind of low information environment present in many developing countries; 2) larger firms typically have better access to finance,

Thailand saw these tax cuts as a way of encouraging a rapid increase in new listings early in the life of the alternative market, which was established in 1999 but did not have its first listing until 2001. An important feature of the Thai approach was that officials designed the incentives to become less generous over time, once the Mai board had established a track record of successful SME offerings.

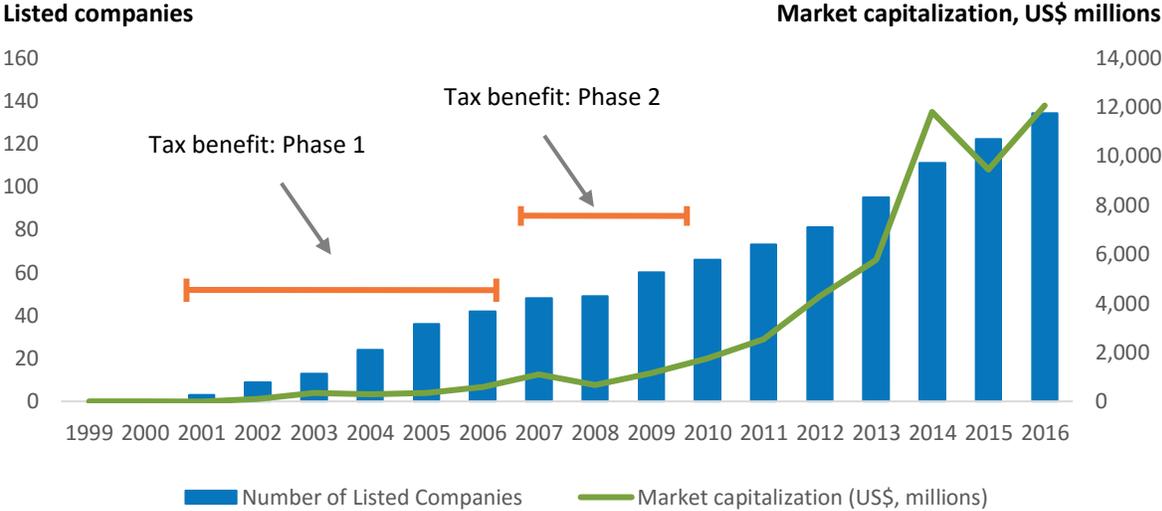
According to the SET management team, tax incentives served their intended purpose, prompting a spike in new listings during a critical moment of the development of the SME board.<sup>8</sup> During the first phase of tax breaks, as shown in Figure 1 below, the Mai board grew from 3 to 60 companies and from a market capitalization of 43 million baht to 21,809 million baht (or about US\$1 million to US\$576 million). New companies continued to list, though at less dramatic rates, during the second phase as well. The tax breaks for listed firms effectively ended when Thailand overhauled its corporate tax structure in 2009-2010, reducing the nominal rate to 20 percent for all companies. However, the Mai board has built on its early success and continues to grow.

**TABLE 4. Thailand’s approach to reductions in corporate income tax for listed firms**

	2001-2006	2007-2009	2010-present
<b>National nominal rate</b>	30%		
<b>Rate for firms listed on senior board</b>	25%, for five years following an IPO	25%, for three years following an IPO	20%
<b>Rate for firms listed on Mai board</b>	20%, for five years following an IPO	20%, for three years following an IPO	

Source: Stock Exchange of Thailand

**FIGURE 1. The growth trajectory of Thailand’s Mai board, 1999 to 2016**



Source: Stock Exchange of Thailand

particularly bank finance, than SMEs; and 3) larger firms may not have the catalytic impact on growth and job creation to the same degree as high-growth SMEs.

<sup>8</sup> Management team at the Stock Exchange of Thailand, in correspondence with the Milken Institute.

Finally, there is the case of Jamaica. Jamaica stands out for offering unusually generous tax breaks to firms that list on the SME-dedicated Junior Market. While other jurisdictions offer a reduction in corporate income taxes, Jamaica offers listing SMEs a five-year, total corporate tax holiday, followed by an additional five years of halved corporate taxes. To ensure that SMEs do not list only for these significant tax breaks, companies must remain listed for five years beyond the period of the entirety of the tax holiday. Firms that delist before completing fifteen years on the stock exchange must pay back-taxes on the remitted taxes from prior years.

Overall, tax incentives appear to have had a positive impact on attracting new listings to the Junior Market, with a steady number of new firms joining the exchange since its launch in 2009 (see Figure 2). According to survey evidence collected by the Milken Institute, at least a quarter of companies listed on Jamaican SME board were motivated to go public by tax incentives.<sup>9</sup>

Still, the introduction of tax incentives in Jamaica has not been an entirely smooth process. Originally, the Jamaican policy was to offer firms a ten-year total tax holiday on corporate income taxes, but policymakers, responding to pressure regarding the loss of revenues, reduced the full holiday to five years. They later considered removing the incentive altogether, but faced significant pushback from the stock exchange and other market participants. As might be expected, changing policies and uncertainty about the government’s commitment to maintain incentives dampened the ability of the Junior Market to recruit new listings. As the Jamaica Stock Exchange noted in its 2015 annual report, “potential listings shied away from the [Junior Market] due to uncertainties surrounding government policies on the incentives.”<sup>10</sup>

**FIGURE 2. The growth trajectory of Jamaica’s Junior Market, 2009 to 2016**



Source: Jamaica Stock Exchange

<sup>9</sup> This figure is notable because these firms selected “Other” when given a list of motivations and then wrote in a reference to “tax breaks” or “tax incentives” on their own initiative. Had “tax incentives” been one of the standard answer options, the number is likely to have been higher.  
<sup>10</sup> *Annual Report 2015*, Jamaica Stock Exchange, May 10, 2016.

## **Related Policy Tools**

Reductions in corporate income tax, of course, are not the only fiscal tool available to policymakers interested in growing the number of listed companies on SME boards. Government agencies may also work with firms to reduce the listing costs that might prevent otherwise eligible firms from pursuing a listing. These costs include both the fees to list and the costs of preparing IPO documentation, as well as the training costs required to build internal capacity to meet the exchange's regular reporting requirements.

There are a number of examples of these kinds of policies. For instance, the Polish Industrial Development Agency, which is part of the finance ministry, covers 50 percent of the listing expenses for firms joining the NewConnect SME board. In Spain, both federal and regional agencies have created initiatives to support SMEs that want to list on the MAB, including interest-free loans and grants to finance listing costs.<sup>11</sup> Policymakers may also make certain costs associated with listing tax deductible, as Kenya does for legal expenses associated with an IPO and secondary offerings.

In addition to financial support, governments and development partners may also work with firms to improve their internal book-keeping and to help firms follow corporate governance best practices. In Jamaica, for instance, the Inter-American Development Bank has implemented a US\$1.1 million project to deliver technical assistance to SMEs preparing a listing on the Junior Market. In many cases, the exchange itself will offer workshops and seminars to help firms develop the accounting and reporting practices they will need if they are to go public. The Venture Exchange of the Toronto Stock Exchange, for example, has hosted training sessions on a wide range of topics, such as filing fundamentals, fundamentals of investor relations, and how to manage a public company.<sup>12</sup> Likewise, the Bombay Stock Exchange has held around 500 seminars to build awareness about benefits of listing and the requirements to join the BSE SME Platform. While the exchanges have a business motive for these activities, policymakers could also subsidize or fund this kind of educational outreach and capacity building.

## **Conclusion**

A number of countries have used tax incentives, for both investors and listing firms, to promote activity on SME boards. Tax incentives for investors are the more common approach, particularly in advanced markets. They can take the form of reduced or eliminated back-end taxes, such as capital gains taxes, or of offsets based on the nominal value invested in SME-focused investment vehicles. In almost all cases, these investor incentives apply both to private, early-stage equity investments as well as to investments in new public equity offerings on SME boards.

Tax incentives directed at SMEs themselves typically involve a reduction in the standard corporate income tax rate. In the exceptional case of Jamaica, firms listing on the Junior Market have received a total corporate income tax holiday for several years, a policy that has enticed new listings, but not

---

<sup>11</sup> For a more detailed discussion of these initiatives, see pages 33-35 of Arce et al., "Access of SMEs with growth potential to the capital markets," Comisión Nacional del Mercado de Valores, Working Paper No. 52, 2011.

<sup>12</sup> For more, see page 66 in *SME Financing through Capital Markets*, Growth and Emerging Markets Committee, International Organization of Securities Commissions, July 2015.

without some controversy. Tax incentives for issuers, though, are not widely used because they may attract SMEs to list that are not ready to be public companies, potentially damaging the reputation of the exchange. Likewise, policymakers should carefully consider whether the loss of revenues at present will be justified by uncertain revenue gains in the future.

Whether for investors or issuers, tax incentives cannot overcome challenges to market development on their own. In general, policymakers should arguably approach tax incentives—or other subsidies—for investors and issuers as part of a holistic strategy to develop the SME sector. That is, promoting public equity listings on SME-dedicated market segments is likely best approached with complimentary policies aimed at improving financial reporting standards among SMEs overall, along with measures to encourage banks to expand their lending to the SME segment.

## Further Reading

*A Guide to AIM UK Tax Benefits*

by Chilton Taylor and Umerah Akram, London Stock Exchange, October 2015

*Can Stock Exchanges Support the Growth of Small and Medium-Sized Enterprises? Lessons from India, South Africa, and Jamaica*

by Jacqueline Irving, John Schellhase, and Jim Woodsome, Milken Institute Center for Financial Markets, July 2017

*Small and Medium-Sized Enterprises and SME Exchanges*

by Siobhan Cleary, Stefano Alderighi, Jacqueline Irving, and Jim Woodsome, a joint report from the World Federation of Exchanges and the Milken Institute, July 2017

*Access of SMEs with Growth Potential to the Capital Markets*

by Óscar Arce, Elías López, and Lucio Sanjuán, Comisión Nacional del Mercado de Valores (Spain), Working Paper No. 52, November 2011

*SME Exchanges in Emerging Market Economies: A Stocktaking of Development Practices*

by Alison Harwood and Tanya Konidaris, World Bank Group, Policy Research Working Paper No. 7160, January 2015

*SME Financing and Equity Markets*

World Federation of Exchanges, 2017

*SME Financing Through Capital Markets: Final Report*

International Organization of Securities Commissions, July 2015

## **About the Author**

John Schellhase is an associate director at the Center for Financial Markets at the Milken Institute. His work primarily focuses on financial-market development in developing countries.

## **About the Center for Financial Markets**

Based in Washington, D.C., the Milken Institute Center for Financial Markets promotes financial market understanding and works to expand access to capital, strengthen—and deepen—financial markets, and develop innovative financial solutions to the most pressing global challenges.

## **About the Milken Institute**

The Milken Institute is a nonprofit, nonpartisan think tank determined to increase global prosperity by advancing collaborative solutions that widen access to capital, create jobs and improve health. We do this through independent, data-driven research, action-oriented meetings and meaningful policy initiatives.

©2017 Milken Institute

This work is made available under the terms of the Creative Commons Attribution-NonCommercial-NoDerivs 3.0 Unported License, available at [creativecommons.org/licenses/by-nc-nd/3.0/](https://creativecommons.org/licenses/by-nc-nd/3.0/)