By email: robert.nott@hmrc.gsi.gov.uk 08 November 2017

Dear Robert,

Partnership Tax Reform Draft Legislation

We discussed at our meeting on 12 October how the proposed draft legislation published on 13 September might fit with standard partnership-based private investment fund structures ("IFPs") of the sort that our members use typically. We discuss the various draft provisions and their application to IFPs below.

This letter sets out the BVCA's comments on the draft legislation following our meeting. I am sorry that we have been a little delayed in sending these thoughts to you, but hope they will be useful nonetheless.

1. Partnerships: bare trusts

We discussed the scope of this provision, and you confirmed that it would not apply to assignees of the economic rights attached to an interest in an IFP made under section 31 of the Partnership Act 1890. Such assignments are common, particularly in respect of carried interest in order to maintain a degree of confidentiality between the individual carry holders' arrangements (who often don't have visibility over each other's carry percentages).

2. Allocation of firm's profits and losses between partners

As we discussed, this is probably the most important and, potentially, most problematic of the proposals for IFPs. The difficulties for IFPs to apply the proposed new terms of section 850 ITTOIA[1] relate to two aspects of the proposals:

(a) it is not clear how the terms "profits and losses" and "profits or losses" as used in section 850 should be applied to the gross income receipts and expenses of an investment business partnership; and
(b) sections 850 applies only to income, while IFPs will generate a mix of return of money invested in assets, capital gains and income along with incurring expenses in generating these items.

The press release published on 13 September alongside the draft legislation states that the new rules will make clear that partnership profits for tax purposes must be allocated in the same ratio as the commercial profits. The consultation document published on 9 August 2016 referred to some partnerships manipulating profits, loss and capital gains allocations for tax purposes, although it is not clear from the consultation document what sort of manipulative arrangements the statement is aimed at.

In the context of aligning profit allocations for tax purposes with commercial profits, IFPs operate a fixed allocation methodology which is documented in detail in their limited partnership agreements

[1] We refer in the rest of this letter to section 850 ITTOIA, but our comments apply equally to section 1262 CTA 2009.

from the establishment of the fund. This is one of the fundamental terms on which external investors invest their money as limited partners. A typical IFP structure is illustrated in Appendix 1. The IFP "waterfall" is based on the amount of cash invested and the amounts of cash distributed, irrespective of the underlying source of those amounts. This typical waterfall would operate in the following order of priority:

- general partner's share/GP management fee – a fixed percentage by reference to capital committed or capital invested
- expenses
- return of investors' capital investment
- payment of investors' agreed preferred return (e.g. 8% or their capital invested and not returned)
- possibly 100% to carried interest holders to catch up with investors' preferred return (on a fund with a 20% carry, carried interest holders would receive "catch up" distributions equal to 25% of the amounts paid to investors by way of preferred return)
- all future distributions in the agreed investor/carried interest split (e.g.80/20).

The expenses of the partnership are paid out of the fund receipts so reducing amounts available for distribution out of both the partnership's income and capital receipts.

The IFP might make more than one distribution in a given year, which might include only capital, only income or a mix of the two.

Going back to the basic term used in section 850 of "profits and losses", section 847 provides in this context that "profits of a trade" should be read as "income arising from a business"; no provision is made in respect of capital, nor is there any clarification of how "losses" should be construed for an investment business. So, it has always been, and under the proposed draft legislation remains, unclear how the term "profits and losses" should be applied to a mixed income and capital waterfall of an investment partnership.

As can be seen from the operation of the standard waterfall described above, the IFP's profit-sharing arrangement does not provide for any partner to have "a percentage or other fixed proportion" of the investment receipts for a period read narrowly, but it does very clearly fix exactly how much each partner is entitled to in the period out of the amounts received by the IFP in the period. The partnership agreement will also set out how income and capital receipts of the partnership are allocated towards the entitlement.

It is not clear to us whether profit sharing arrangement of the type seen in typical IFP agreements will fall within section 850 (1A) (a) or (b). On the basis that a typical IFP's profit-sharing arrangement would not provide for any partner to have "a percentage or other fixed proportion" of profits (because of the sequential variability described above), we suspect it would by default be (b). Given that both (a) and (b) are looking to find a percentage to be used in section 850(1) we are not sure it matters terribly which it is. A more important outcome for IFP partnerships is that there continues to be some flexibility to allocate particular items of income/capital. We give two examples below of why IFPs might need to allocate certain items of income and expense to particular partners, but this would always be within the confines of the documented profit-sharing arrangements in the IFP's limited partnership agreement. Again, these allocations will be agreed with the IFP's investors and will be put in place from commencement of the fund.

Two examples are:

(a) *Excused investors*

It is not uncommon for certain investors in investment funds to be excused from investing in certain investments (eg certain investors may not want to participate in investments involving arms, alcohol, tobacco or gambling) the fund might make. In that case, the excused investor would not pay its share of the cost of the investment and would not receive any returns from it. The excused investor's profit-sharing arrangement would be the same as the other investors' except that it would be operated as if the excused investor were invested in a fund with the other investors which had not bought the underlying investment in question.

In this case, the negotiated and documented commercial arrangement will be that the excused investor does not share in the proceeds from the investment, which might produce large amounts of income, no income or the same proportion of income and capital as the fund's other investments. It is important in such a case that income and capital from investments where there are excused investors are only allocated to those other investors and that a single percentage share of income not applied to allocate all income to all investors.

(b) *WHT administration*

One of the important aims of an IFP is to keep administrative costs down and, to the extent possible, reduce the external investors' administrative burdens.

For this reason, it is not uncommon for IFP profit-sharing arrangements terms to provide for income that is received by the partnership subject to WHT to be allocated to the general partner to the extent possible. This is so that, hopefully, the general partner can file a single WHT recovery or reduction application rather than individual investors having to file WHT recovery applications themselves.

Sometimes is possible for an IFP with a UK corporate general partner to receive income gross from foreign sources where there might otherwise have been withholding tax. This would be achieved by undertaking to the relevant foreign tax authority that the income would be allocated to the UK corporate general partner. Clearly, the IFP cannot continue to do this if UK tax law allocates the income in a different way.

Given the difficulties of applying the "profit and loss" concept to a typical IFP and the fact that the overall tax consequences for the partners in an IFP are clearly determined by the fixed terms of the IFP's limited partnership agreement, we think that it would be very helpful if it could be made clear that the terms "profit" (or "income arising from a business) and "loss" refer to individual items of income and expense and that, as long as the allocation of the items to partners follow the terms of the IFP's partnership agreement and are consistent with the ultimate receipts of the partners from the fund, allocations of income and expense will fall within the terms of new section 850(1A)(a).

3. Partnership returns: information to be included

The proposed additional wording in TMA 1970 section 12AA seeks to clarify the information to be included in a partnership tax return in two ways – specifying the information to be included where the partnership is itself a partner in another partnership, and specifying the bases on which a reporting partnership should prepare its returns where one of its partners is a partnership.

Reporting partnership is a partner in another partnership

Investment partnerships may hold interests in other partnerships for a number of reasons, for example in order to invest alongside co-investors in a particular portfolio company, or if the investment partnership is a fund of funds. New subsection 12AB(1A) requires a reporting partnership to disclose income or losses from each underlying partnership separately, and to disclose the basis on which the amounts from the underlying partnership have been included.

Where an investment partnership controls the underlying partnership, we expect this information to be readily available. However, where the investment partnership holds a minority interest in the underlying partnership, it is possible that the investment partnership will struggle to provide this disclosure as the underlying partnership may be established overseas, and therefore not be a required to provide UK tax reporting information.

For reporting partnerships that are funds of funds, the majority of the underlying partnership holdings may be established overseas and therefore not reporting partnerships. A minority interest holding in such a partnership cannot usually compel the manager of the underlying partnership to provide UK reporting, or may only be able to do so at significant cost to the investment partnership.

On this basis, we recommend that subsection (1A)(d) only applies where the underlying partnership is itself a reporting partnership. For clarification, investments in overseas non-reporting partnerships could be separately identified as such.

The reporting requirements set out in subsection (1A) will require additional disclosure schedules in the partnership return. We would be happy to work with HMRC to develop the required reporting templates.

Reporting partnership has a partner which is a partnership

Investment partnerships commonly have limited partners which are themselves transparent. The investment partnership will not receive details of all limited partners of the investing partnership as part of KYC/ AML procedures when the investment is first made. In certain circumstances an investment partnership may receive beneficial owner information for withholding tax treaty claim purposes; however this may not be complete in all instances. It is therefore highly unlikely that a reporting investment partnership would be able to provide the information on indirect limited partners as set out in subsection 12AB(1C). Even if the reporting partnership was able to obtain this information, confidentially clauses in the limited partnership agreement may restrict the partnership from reporting the information on the partnership return.

Reporting partnerships will in most cases already prepare partnership statements on both an income tax and corporation tax basis. As investment partnerships will not receive trading income, the existing partnership statements already categorise the partnership's returns between UK and non-UK source.

We therefore recommend that subsection 12AB(1B) apply only to partnerships with trading income. The partnership return could be amended to include certification that the reporting partnership is claiming an exemption from reporting on all four bases under (1B).

4. Partnership returns: overseas partners in investment partnerships

BVCA members had welcomed the introduction of the dummy UTR for overseas investors. Some members had found the previous process for obtaining UTRs to be time-consuming. Additionally, the allocation of unique reference numbers had led to some non-resident limited partners receiving penalty notices where no filing requirement existed.

The draft Clause 12AZB is a relaxation of the requirement to provide a UTR number for overseas partners in investment partnerships subject to the requirements of the Common Reporting Standard as implemented by The International Tax Compliance Regulations 2015. However, we are concerned that Clause 12AZB as currently drafted does not achieve HMRC's intended outcome. It is not clear to us whether 12AZB provides any additional benefits to our members, given the small number of overseas account holders that will be excluded from reporting.

The draft legislation states that there will be no requirement to include a declaration of tax reference where "… the partnership is required to set out information about the person in one or more relevant returns…" (12AZB (1)(c)). Many overseas partners in investment partnerships will not meet the definition of "reportable accounts" under CRS or FATCA, due to the broad nature of exemptions available. Such partners' details will not be included in any relevant return, and therefore the exemption under 12AZB will not apply.

The exemptions from reporting cover categories of accounts that represent a low risk of tax evasion. Partnership interests held by overseas individuals will always be reportable. However, overseas entity accounts will only be reportable if held by Passive Non-Financial Entities or Active Non-Financial Entities that do not meet an available exemption. Overseas entity accounts held by corporations with regularly traded stocks (and their affiliates), government entities and Central Banks are exempt from reporting, as are all financial institutions. Given the institutional investor base of many investment funds, we expect that the majority of overseas entity accounts to be non-reportable.

UK investment partnerships are reporting financial institutions under the Common Reporting Standard; their managers must undertake due diligence procedures to identify reportable accounts. We consider that 12AZB (1)(c) could alternatively be worded to read:

"(c) the whole of that period is a period in respect of which the partnership is required to file one or more relevant returns, and "

i.e., it is sufficient that the partnership will have undertaken the necessary due diligence procedures required to identify reportable accounts in order to file relevant returns. The partnership return template could be updated to include a certification that the partnership has filed the relevant returns for the period.

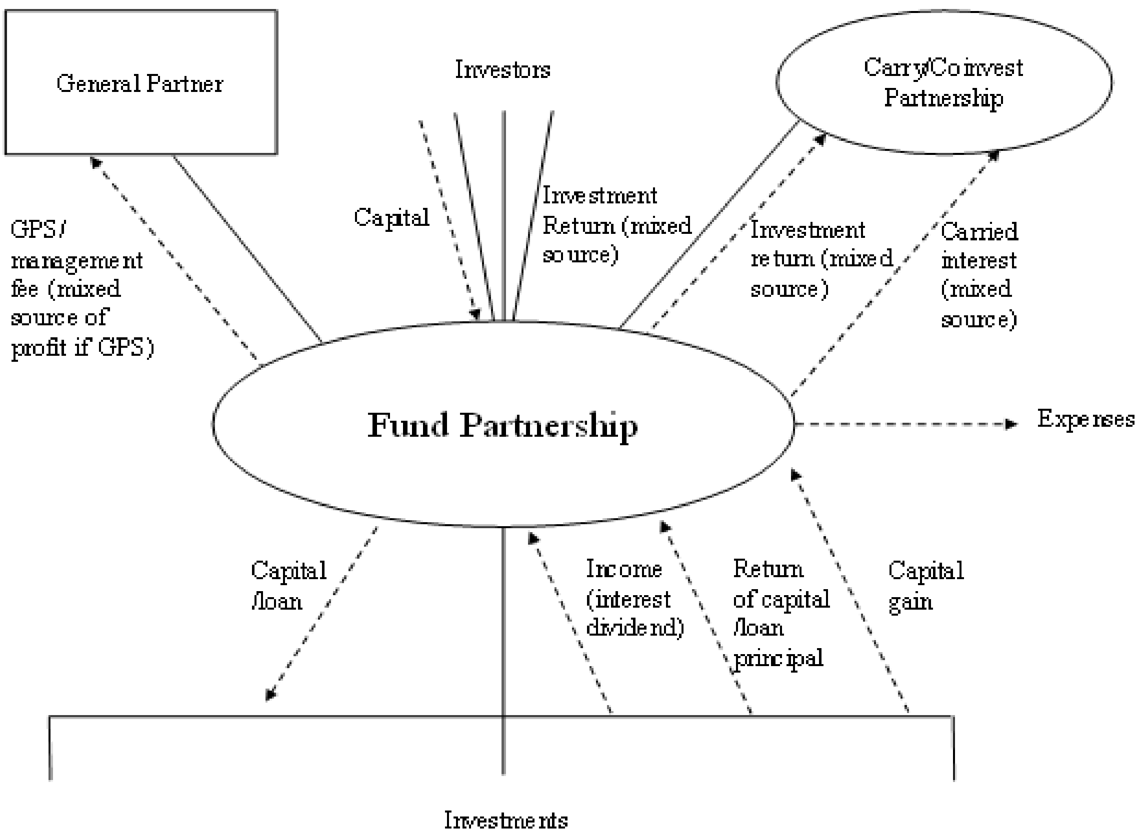
It is important that HMRC's systems are updated to allow inclusion of overseas limited partners in the partnership return without the requirement to declare their tax reference number. If the tax reference must be included, then we recommend that the dummy UTR system be retained. If the dummy UTR system is to be retained, we question whether any practical benefit arises from Clause 12AZB.

I hope that these thoughts are clear and helpful, but if you do have any comments or questions or if there is anything further you'd like to discuss with us, please do not hesitate to reach out to us.

Yours faithfully

Mark Baldwin
Chairman of the BVCA Taxation Committee

Typical Investment Fund Structure



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