

The British Private Equity and
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The Clerk to the Economic Affairs Committee
House of Lords
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Dear Sirs,

“Taxing corporations in a global economy: is a new approach needed?” - Response of the British Venture Capital and Private Equity Association (“BVCA”)

On behalf of the BVCA we would like to thank you for the opportunity to present our views in response to the call for evidence issued by the House of Lords Select Committee on Economic Affairs on 27 March 2013.

The BVCA is the industry body for the UK private equity and venture capital industry. With a membership of over 500 firms, the BVCA represents the vast majority of all UK based private equity firms and their advisers. Our members have invested £40 billion in over 5,000 UK companies over the last five years. Companies backed by UK-based private equity and venture capital firms employ over half a million people and 90% of UK investments in 2011 were directed at small and medium-sized businesses.

Before addressing the specific questions raised by the Committee, we would first like to emphasise that the BVCA believes the British economy is best served by a simple, stable and predictable taxation system. To this end, we believe that the British tax regime should have the following features:

1. **Simplicity**
The current UK tax code is too complicated. This leads to increased compliance costs for business and a loss to the exchequer as result of the exploitation of inevitable loopholes.
2. **Stability and predictability**
It is essential that the UK tax system is stable and predictable to enable business to take long term investment decisions with clear tax outcomes. This is particularly important for our private equity and venture capital members when they are considering an investment as investments are invariably held for three to five years and in many cases longer.
3. **Low corporate tax rates**

We advocate low corporate tax rates in order to encourage growth in the economy.

4. **Strong incentives to promote investment in risky, early stage businesses**
The current technical requirements to access venture capital reliefs (such as the Enterprise Investment Scheme and Venture Capital Trusts) in respect of investment in high risk, early stage businesses are too restrictive. We support the extension of the existing venture capital reliefs to all types of businesses, irrespective of their ownership structure.
5. **Promotion of capital investment**
In order to stimulate growth in the UK economy we support the extension of appropriate tax incentives and reliefs (such as capital allowances) to encourage capital investment.
6. **Competitiveness**
Although headline tax rates are one of many economic factors that impact business decisions, it is vital for the competitiveness of the British economy and the British private equity industry that the corporate tax system remains competitive with equivalent economies.

We will reflect on these themes throughout our responses and we request the Committee to bear them in mind as it considers all of the evidence submitted.

Question 1: Is there a good rationale for the existing system of taxing corporate profits? What proportion of total tax receipts should come from corporation tax? Who bears the burden of corporation tax?

- 1.1 The rationale for the existing system of taxing corporate profits is perhaps a question of political and economic policy and may be better addressed by organisations other than the BVCA.
- 1.2 However, we would point out that the specific taxation of corporate profits is only one element of the total tax contribution made by companies whether directly or indirectly – for example income tax paid by employees on the salary they receive, national insurance contributions, VAT and other taxes not levied by reference to corporate profits.
- 1.3 It is therefore not appropriate to view corporation tax in isolation and, in consequence, impossible to come to a view as to the proportion of total of tax receipts that should be derived from corporation tax.
- 1.4 We note that the UK has a well-developed tax system and professionalised tax collection and advisory infrastructure. However one of its structural weaknesses is the complexity of the tax code and the continuous incremental complexity year on year. That complexity has led to the burden of corporation tax compliance increasing over time despite an on-going tax simplification project that has, based on observable results, failed to deliver any net simplification.
- 1.5 The increased complexity that any “new” tax system might introduce would be a significant concern to our members as it would undermine assumptions regarding the tax costs of the acquisition, ownership, management and eventual sale of portfolio companies as it is important for private equity investment managers to be able to forecast and price tax outcomes appropriately. In our view rather than adopting a

new basis of taxation the existing corporate tax structure should be streamlined and simplified with a view to stabilising or increasing overall corporation tax revenues.

- 1.6 We would also point out to the Committee that where investment managers make decisions regarding the territory in which to invest, any increased tax uncertainty (and the uncertainty this creates for the investment) can make a jurisdiction significantly less attractive.

Corporation tax burden

- 1.7 In our view the corporation tax burden is primarily borne by larger, established companies, i.e. those entities that have reached the stage in their development where they aim to produce a sustainable profit. For more mature businesses, therefore, the burden is more likely to fall on shareholders – largely comprised of pension funds and other institutional investors. However, we note that the cost burden of corporation tax compliance sits with all companies, irrespective of their profitability.

Question 2. How vulnerable are UK corporation tax revenues to a recession, or tax avoidance activity? To what extent has corporation tax become a voluntary tax?

- 2.1 UK corporation tax revenues are linked to all aspects of the economic climate, including whether the economy is experiencing a recession.
- 2.2 The BVCA supports Government efforts to curb abusive and artificial tax avoidance schemes. However, it is important that in targeting abusive arrangements the Government does not cause greater instability and unpredictability in the tax system, thereby reducing growth and slowing investment.
- 2.3 The BVCA is firmly of the belief that the best way to increase tax revenues is for the UK economy to grow and tax policy should, while taking legitimate steps to counter tax avoidance, do whatever is possible to foster such growth.

Question 3. How does corporation tax affect decisions by firms to incorporate, where to locate, how much to invest, how to finance activities and where to record profits?

- 3.1 The corporation tax rate and the administration of corporation tax is a factor but it is one of many considerations that a company takes into account when considering the issues you have outlined.
- 3.2 Access to markets, skilled labour, sources of investment and the legal and regulatory climate (of which tax plays a part) are all arguably of greater significance than the headline corporation tax rate. However, we would point out that many companies are sufficiently international and flexible so as to have some discretion as to where they locate their activities around the world. The UK taxation system should recognise this reality.
- 3.3 We would again emphasise that complexity or uncertainty in a tax regime is a disincentive to invest and that the tax regime in the UK is unquestionably too complex. Similarly, it is important that the overall UK tax burden applied to companies (i.e. not just corporation tax) does not tip the balance against the UK when compared to other jurisdictions.

Question 4. Is there a need to reform the UK base for corporation tax? If so, how? For example, should the preferential tax treatment of debt over equity be removed? Should reforms encourage more capital investment, particularly in UK infrastructure?

- 4.1 Without judging the wisdom of eliminating the differential tax treatment of debt over equity, we note that if the two are to be treated equally for tax purposes, capital investment will still not be on an equal footing until extraction of capital and profit is simplified to the level of debt from a company law perspective. We therefore urge the Committee to consider reforms to the legal treatment of equity investment to bring closer alignment to that of debt in the event that proposals are considered to align the tax treatment.
- 4.2 However, assuming that the UK corporation tax system is to remain predominantly based upon profits, the different tax treatment of debt and equity should be retained for the following reasons:
- a) Financing costs are as much part of a business' cost base as other revenue expenses, e.g., rent, licence fees, salaries, utilities, etc. If the differential treatment of debt over equity were removed, significant anomalies could arise in the corporation tax system, e.g., a group which borrowed against real estate assets would obtain no deduction for the interest costs on those borrowings but a group which entered into a sale and leaseback to raise capital would obtain deductions for the lease rentals.
 - b) If the differential treatment of debt over equity were removed, the net cost of borrowing for businesses would be increased at a time when it is already difficult for them to obtain open lines of credit.
 - c) The UK already has robust tax rules around interest deductibility in comparison to other countries. There are at least eight provisions within the UK tax code which limit the availability of deductions for interest costs on debt. A taxpayer needs to satisfy all of these provisions before an interest deduction is available. These include transfer pricing (quantum and interest rate), the worldwide debt cap, commercial purpose requirements, distribution rules, anti arbitrage, restrictions on timing of deductions and rules on transactions in securities.
 - d) A blanket restriction on interest costs on loans from connected parties would be artificial. If a loan could have been obtained from a third party on similar terms, why should a group be penalised because it has been able to borrow that amount from a connected party instead?
- 4.3 As mentioned above, we would emphasise that tax is far from the only factor that companies consider in their decision to use debt or equity finance. For example, the legal obligations of a company to its creditors are different to its obligations to shareholders.
- 4.4 Whilst we consider that the UK principle of an arm's length test is the fairest, and hence economically justifiable, approach we note that a number of European jurisdictions have adopted strict debt to equity ratios and caps on interest deductions which, for example, limit deductions for interest costs to a percentage of EBITDA each year – Germany, France and Spain are among them. While this has the attraction of simplicity, we would not recommend adopting a similar approach in the UK because any such limit would always be arbitrary and necessarily fail to

recognise, as HMRC has to date, that different businesses can support different levels and lines of credit, according to their underlying risk profile and cash flows: property development, pharmaceutical businesses, infrastructure, retail, etc., will all vary enormously

Capital investment

- 4.5 The capital investment incentive regime in the UK is unduly narrow and restrictive. Large sections of capital expenditure simply do not qualify for relief in the UK. A recent survey from the Said Business School estimated that in relation to infrastructure expenditure 40% of transport costs and 30% of waste management and energy and water and flood management expenditure did not qualify for any forms of tax relief. The current system of allowances for expenditure has not kept pace with business development. The UK has a very strong service sector but relief for capital expenditure is still biased towards manufacturing activity. Furthermore, the rates at which relief is given where available are less than the equivalents in other major economies. We believe that consideration should be given to allowing relief for all capital expenditure on the basis of the depreciation charge included in accounts of businesses prepared under Generally Accepted Accounting Principles. The BVCA is wholly supportive of capital investment and in our view, if capital investment is genuinely to be encouraged, the availability of investment reliefs, such as capital allowances and research and development relief, should be extended. However, we would add that the reliefs should not necessarily take the form of deductions in the calculation of profits for corporation tax purposes as many companies, particularly in the current economic climate, do not have sufficient profits to take advantage of these reliefs.

Question 5. Is the taxation of companies too narrowly focused on a complex definition of profits? Could a tax based on a broader measure of economic activity less susceptible to manipulation help to ensure that the burden is spread more fairly across the corporate sector? What would be the consequences of shifting the corporate tax base from profit to sales/turnover?

- 5.1 In our view any change to the basis of assessing corporation tax would lead to considerable uncertainty and instability in the tax system and therefore significant disruption to the normal economic activity of companies. This would clearly be highly detrimental to the Government's objective of stimulating investment and growth in the economy.
- 5.2 Shifting the corporate tax base from profit to sales/turnover may be superficially attractive because it would be one way in which the UK could potentially increase its tax take from international businesses operating in the UK. But any such change would need to be approached with caution, most importantly, because any such system could fail to take into account the different models under which businesses operate and create very different tax profiles to those which currently apply.
- 5.3 Consider, for example, a high cost / low margin business, on the one hand, and a low cost / high margin business, on the other. The first, if its turnover is greater than the second, could suffer a far greater tax bill than the second, even though its profits are much smaller. The costs paid to its suppliers would then be subject to the same turnover tax in the hands of the supplier, effectively creating multiple layers of tax on largely the same revenue stream, unless a credit system similar to the one which operates in the context of VAT were adopted, which seeks to ensure that VAT is collected only once in the supply chain to the final consumer.

- 5.4 It would therefore be illogical to move away from the taxation of the profits of a single company to a system which potentially introduces multiple layers of taxation on a single economic activity with the consequential negative impact on economic growth and investment.

Question 6. Should the taxation of SMEs be reformed? Are schemes such as the Enterprise Investment Scheme successful in leveraging additional investment in the UK and do they represent good value for money?

EIS

- 6.1 The BVCA is very much in favour of venture capital relief schemes and in our view the Enterprise Investment Scheme offers excellent value for money. Incentives to encourage growth are beneficial to the UK economy and many SMEs develop in time into healthy larger companies. However, under the current rules, Private Equity-backed SMEs usually cannot qualify for EIS. We think this is wrong. The UK tax system should encourage growth investment in companies and in our view the availability of venture capital relief to investors should be broadened across the tax base and in particular the restrictions on the permitted ownership structures of EIS companies should be relaxed. The BVCA believes that loosening of some of the restrictions placed on EIS would produce a significant benefit to the UK economy.

Reform of SME taxation

- 6.2 We are unconvinced that the additional complexity introduced by having a differential tax system for SMEs relative to large corporation tax payers is beneficial although we welcome any measures that reduce the compliance burden for SMEs within a single tax system. In our view a differential tax system would increase uncertainty for the tax payer base - in particular we would highlight that taxpayers are often uncertain which regime they will be subject to as the size of their business changes.
- 6.3 We also note that the size definitions for some incentives are different from others. This confusion adds to compliance costs and uncertainty diminishes the effect of each incentive. There are many examples of issues in this regard, including in areas such as first year capital allowances and research and development tax credits.

Question 7. Is there a need to reform the basis of the international allocation of multinational profits between countries? If so, should this be based on the existing conventions, as recently suggested by the OECD, or is there a need for more fundamental reform? What other feasible alternatives are there, consistent with international law?

- 7.1 Reform may well be needed in this area as current business practices (such as e-commerce and the rise of multinational corporations) have in some cases moved beyond the original scope of the rules. However, any reform must be consistent across jurisdictions. This is a key area in which a unilateral approach from the UK would harm British business.

Question 8. What scope is there for the UK Government to act alone in addressing concerns about the taxation of international business?

- 8.1 The UK Government should not act unilaterally in respect of the taxation of international business. A multilateral approach is needed together with clear rules and consistent enforcement across jurisdictions.

Question 9. Is there a meaningful distinction between “harmful” and “fair” tax competition? Where will future competition lead the UK corporation tax?

- 9.1 It is very important to clearly define what “harmful” means in this context. Corporation tax cannot be looked at in isolation, rather the entire economic contribution of companies, together with the broad range of the taxes to which companies are subject (directly or indirectly) must be included in the assessment.
- 9.2 The assessment of this issue also depends upon how one defines “tax competition”. If one jurisdiction provides certain tax incentives to encourage growth and another jurisdiction does not have equivalent incentives, is this tax competition?
- 9.3 While there have clearly been instances in the past where jurisdictions have had structures which have been considered to be “harmful” we would urge caution in the identification of any measures as harmful without due consideration of all relevant factors. For example, if a company trades in a jurisdiction and pays tax there on its profits and then pays a dividend to a recipient in another jurisdiction who pays tax on that dividend (with or without credit for the original tax paid by the company) no one could argue that the correct amount of tax had not been paid. Why, therefore, should it be considered harmful if the dividend paid by the company is not paid to the ultimate shareholders but paid to an entity located in a “tax haven” before being paid on to the ultimate recipients who then pay tax on it? The example, while simplistic, shows the need to bear in mind the totality of an economic transaction to assess its tax consequences properly. It can be far too easy to label individual matters as “harmful” when viewed in isolation.

Question 10. Is there a problem in the UK that foreign companies are able to gain a competitive advantage through greater tax avoidance opportunities?

- 10.1 No comment.

Question 11. How successful is the HMRC in dealing with large international business?

- 11.1 In our experience the HMRC Large Business Service is better than equivalent services in other jurisdictions. The CRM service is valuable to the companies it supports and encourages companies to maintain a low tax risk profile together with an open dialogue with HMRC. We strongly support this approach and believe that an open collaboration between taxpayers and HMRC is beneficial to all parties concerned.

Question 12. Has the use of aggressive tax avoidance schemes increased or decreased over the last decade? Why? How successful has the DOTAS scheme been? Should promoters of tax avoidance scheme be named and shamed?

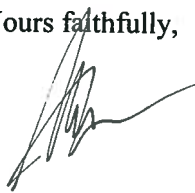
- 12.1 It is difficult for the BVCA to comment on the prevalence of tax avoidance schemes; however the boundaries of acceptable tax planning need to be very clearly defined. We are concerned that the poorly informed nature of the public debate on tax avoidance will lead to significant uncertainty for companies as to the manner in which it is acceptable for them to order their tax affairs, even as to whether claiming Government sanctioned tax reliefs (such as capital allowances) is acceptable.

- 12.2 This general public mood, together with proposals to 'name and shame' gives us significant cause for concern.
- 12.3 The most straightforward way to reduce tax avoidance is to simplify the tax system which, in our view, will naturally remove some of the more complex tax structuring opportunities.

Question 13. Is there a need for greater transparency by multinational companies in declaring taxes paid in different countries?

- 13.1 The current international financial reporting standards provide sufficient disclosure for investors in multinational companies. Any further disclosure requirement would add additional complexity and compliance costs and in our view there would be no discernible benefit to the British economy.

Yours faithfully,

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David Marks

Chairman of the Taxation Committee of the BVCA