House of Lords Finance Bill Sub-Committee - call for evidence on taxation of partnerships

About the BVCA

This response is submitted on behalf of the British Private Equity and Venture Capital Association ("BVCA").

The BVCA is the industry body and public body advocate for the private equity and venture capital industry in the UK. More than 500 firms make up the BVCA members, including over 200 private equity, mid-market and venture capital firms, together with over 200 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

The House of Lords is interested in the context in which the proposed changes would be applied and the evidence should consider whether the approach of the legislation is appropriate or whether the provisions such as those in the draft Finance Bill 2014 are a symptom of underlying problems with that approach.

Introduction

The draft Finance Bill 2014 covers four areas of partnership taxation. Of most concern for the private equity and venture capital industry are the provisions relating to the taxation of limited liability partnerships ("LLPs"), in particular the introduction of the concept of a "salaried member". The LLP is now the industry standard entity through which investment management and advisory businesses ("Managers") operate in the UK. In a private equity and venture capital context, Managers typically comprise experienced senior executives with an established investment track record (the "LLP Partners"). Although the BVCA is supportive of the aims of the anti-avoidance legislation, our members are concerned that the draft Bill and the accompanying guidance results in valid LLP Partners being reclassified as employees for tax purposes.

HMRC Consultation May 2013

The HMRC consultation document published in May 2013 'Partnerships: A review of two aspects of the tax rules' proposed two tests, a case law test and an economic test, for establishing the tax status of partners. Our preference was and remains a case law test. An approach limited to a purely economic test will not capture the 'partner' status of members of the LLP. In a private equity and venture capital context, LLP Partners have responsibility for sourcing and arranging investments, and managing and realising growth from the companies that comprise the investment fund. Investors in the funds make a long term commitment to the LLP Partners, who are entrusted to utilise investors' money over the life of the fund in order to create growth.

As far as the investors are concerned, the 'partner' status of the LLP Partners is generally best determined by a wide range of factors which might be described as 'human capital.' This will include factors such as the involvement of the individual in the management of the firm and the importance of the individual to long-term fund performance. These facts are in addition to the basis of the LLP Partners' profit allocation and exposure to risk.

Furthermore, self-employed members within an LLP structure do not have the benefit of employment law rights. Yet if they were re-classified as a salaried member, they could be liable to income tax and primary NICs as an employee, while not benefiting from employment protection. Under current tax rules LLP Partners are treated as partners and taxed as self-employed rather than as employees.

Draft Finance Bill 2014

Draft legislation was published on 10 December 2013, to be implemented in Finance Bill 2014, setting out new provisions to prevent the avoidance of employment taxes through the disguising of employment relationships using an LLP structure. It is important to note that we can see the beginnings of our concerns reflected in the legislation because consideration is given to a range of factors in the determination of 'partner' status. It is helpful that an LLP Partner has to meet all three conditions (outlined below) to be reclassified as an employee, but there remains scope for genuine partners to be reclassified incorrectly.

- <u>Condition A</u> is that the rewards received are not varied by reference to the profits or losses of the partnership. The key question here is whether the relatively predictable income flow and profits of a private equity and venture capital Manager means that individual LLP Partners' shares of profits are "fixed" or "not in practice affected by the overall amount of those profits or losses". Over a number of years the profit of a Manager will rise or fall depending on a number of factors - for example, the investment period of a fund coming to an end – but on an annual basis, with fee income largely dependent on investor commitments, profits can be reasonably predictable. Most partnership agreements effectively provide some discretion to vary profits between partners so in this context some Managers are concerned that their remuneration arrangements fall into the category of "disguised salary" as set out in the draft legislation.

- <u>Condition B</u> is that the individual does not have 'significant influence' over the affairs of the partnership. This area is causing most concern among Managers at larger private equity and venture capital houses. There are various governance groups within a typical firm that approve operational and strategic matters of the LLP and also investment committees which decide on investment matters. It is clear that individuals in these groups do exert significant influence over the partnership but if the legislation is insufficiently tailored or overly restrictive, the contribution of these individuals could be missed.

There is a further issue that even the term 'significant influence' cannot capture all of what 'partner level' contributions amount to. This is because individuals can provide essential services without which the firm could not function, that are not necessarily 'board level' functions. For example the Compliance Officer makes a contribution without which the partnership could not operate effectively (UK Managers are regulated by the Financial Conduct Authority).

Other individuals could be considered to be exercising significant influence by virtue of their investment track record: senior investment professionals are often identified as 'Keymen' in the partnership agreements that set out the terms of private equity and venture capital funds. Within our industry, simply defining 'significant influence' using a corporate governance framework could easily miss such individuals and incorrectly reclassify these LLP partners as salaried members.

- Condition C is that the individual has contributed less than 25% of any fixed profit share from the partnership in the form of a capital contribution. Private equity and venture capital is a people business and therefore, regulatory requirements aside, there is not a large amount of working capital required to be invested by the LLP Partners in the LLP itself. Very few firms will have asked LLP partners to contribute this level of capital. It is also worth noting that LLP partners in our industry bear the risk of not raising successor funds and in this sense have significant personal capital tied up in the business.

The nature of this draft legislation means that individual firms need to make their own determinations of who should remain a partner before seeking approval of their arrangements from HMRC. If this is to be feasible in practice, the accompanying guidance and sector specific examples must be thorough. As currently drafted there is not enough certainty for our industry and we would ideally seek specific examples on each of the conditions that take a nuanced approach to how LLPs in the private equity and venture capital sector work in practice.

Conclusions

With the Alternative Investment Fund Managers Directive now in force, the continued promotion of the competitive of the UK as a financial centre, is all the more important and we should not deter businesses from using the LLP structure, with its inherent flexibility and commercial advantages, as a result of any new tax legislation. Indeed as announced in the 2013 Budget, the Government is taking forward a new Asset Management Strategy designed to bolster existing competitive strengths. This is to encourage all fund managers, whether domestic or international, to keep raising their funds in the UK. To be compatible with this approach, the Finance Bill 2014 cannot be seen to be adding uncertainty as to how fund managers may be taxed.

Next steps

The BVCA is working constructively with HMRC, as these changes have a potentially wide-ranging impact on the private equity and venture capital industry. We have responded to the earlier consultation[1] and are following up with HMRC officials to see if we can provide support in drawing up industry-specific guidance that addresses our concerns.

[1] http://www.bvca.co.uk/Portals/0/library/Files/Government%20Submissions/9%20Aug%2013-BVCA%20response%20to%20partnerships%20review%20consultation.PDF