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By email: sovereignimmunity@hmtreasury.gov.uk

09 September 2022

Dear Jasmine

Re: Sovereign immunity from direct taxation: Consultation on policy design

We are writing on behalf of the British Private Equity and Venture Capital Association, which is the industry body and public policy advocate for the private equity (PE) and venture capital (VC) industry in the UK. With a membership of over 750 firms, we represent the vast majority of all UK-based private equity and venture capital firms, as well as their professional advisers and investors. Between 2017 and 2021, BVCA members invested over £57bn into around 3,900 UK businesses, in sectors across the UK economy. Companies backed by PE/VC currently employ over 2m people in the UK and 90% of the businesses our members invest in are SMEs.

Our interest in the proposed reforms to sovereign immunity is in how they will impact on investors in private companies and on vehicles that investors use to invest in private companies (see section on "investment regimes"). This consultation response focuses on those issues, and not on the reforms' impact on other areas of investment, such as real estate, where we defer to the appropriate industry representatives and trade bodies.

Reforming immunity

We support the government's proposal to codify sovereign immunity from taxation in statute. The current position, whereby immunity is derived from long-standing case law principles, is somewhat anomalous in the context of the modern UK tax system. Putting immunity on a statutory footing, with clear parameters as to which entities qualify and what kinds of income and gains immunity applies to, will aid taxpayer certainty and serve the interests of transparency generally.

The consultation document proposes restricting immunity to passive investment returns only. Passive returns are defined to include dividends, interest and capital gains (other than gains relating to UK property). These are the main kinds of return that PE and VC investors receive from investments in private companies. We believe it is right and consistent with international norms to regard those kinds of income and gains as passive and to then include them in the scope of the reformed sovereign immunity.

Clearly one of the most impactful aspects of the proposals would be the removal of immunity from rental income and property gains. There are arguments in favour of retaining immunity in relation to UK property activity, both on grounds of principle and the effect that removing immunity may have on the UK's relative attractiveness as a location for real estate investment. It is particularly important that care is taken not to close off avenues of investment in the UK that are available in other jurisdictions, even where they tax foreign sovereigns on real estate gains. However, we expect that those arguments will have been raised in detail by representatives of the real estate industry and we have not repeated them here.

Given that the UK does not tax dividends (other than Property Income Distributions paid by REITs) or capital gains (other than those relating to UK property) in the hands of non-residents, the reformed sovereign immunity will in effect be an immunity from interest withholding tax (WHT). We consider that relief from interest WHT tax is an important benefit to sovereign investors in private companies. In our view the process for granting WHT relief to sovereigns should be designed in a way that makes it as straightforward as possible for them to obtain gross payment of interest, which would avoid unnecessary administration and maximise the value of that benefit.

Chapter 3 of the consultation document appears to envisage a system under which each payer of UK source interest to a given sovereign investor would require separate authorisation from HMRC to pay gross. We consider that it would be better to adopt a "passport" type of approach, under which each entity that qualifies for sovereign immunity is certified by HMRC as entitled to receive interest gross, and payers are able to make gross payment based on that certification, without separate authorisation. This would entail a much lower administration burden for taxpayers and HMRC. It would also present little risk to the Exchequer: sovereigns would have an absolute entitlement to relief from interest WHT that is unlikely to change over time, so we do not believe there is any compliance benefit to be gained from re-assessing the position in relation to every lending arrangement a sovereign enters into.

Treatment of pension schemes

Some investors that are currently entitled to sovereign immunity are government pension schemes. We expect that some of those schemes will also be entitled to varying degrees of tax exemption under the UK tax regime that applies to pension schemes (albeit they are unlikely to have explicitly relied on this to date given the availability of immunity).

Chapter 3 of the consultation document asks whether such government pension schemes should be ineligible for the reformed sovereign immunity regime on the grounds that they may be entitled to other reliefs. In our view, immunity and pension scheme reliefs should not be an "either-or": if an entity separately meets the requirements for both, it should receive both. Government pension schemes which qualify as overseas pension schemes under the legislation in Finance Act 2004 may not wish to go further and become registered pension schemes. Such schemes will be exempt from UK tax on their capital gains but not on their income, in which case sovereign immunity from interest WHT will continue to be valuable.

Investment regimes

Alongside benefiting from immunity in respect of income and gains, sovereigns are also treated as qualifying investors for the purposes of several UK tax regimes that apply special tax treatments to vehicles that are used for collective investment.

We acknowledge that, as Chapter 4 of the consultation document sets out, it is necessary to consider whether it would be consistent with the policy objectives of reforming immunity to allow sovereigns to continue to access these regimes post-reform. There would be a conflict if a given regime allowed sovereigns to use an investment vehicle to escape taxation on income or gains that would be taxable if they arose to the sovereign directly.

Any changes to sovereigns' qualifying status for these investment regimes could have a consequential impact on other investors. For example, that would be the case if changing a sovereign's status took the total percentage of an investment entity owned by qualifying investors below a relevant threshold. It is therefore very important that the government considers the position for such regimes carefully and avoids disrupting existing arrangements that were established in compliance with the prevailing law.

We have set out our views on the two regimes most relevant to PE and VC investment – the Qualifying Asset Holding Company (QAHC) regime and the extended Substantial Shareholding Exemption (SSE) – below.

Qualifying Asset Holding Companies

We support the government's view, as set out in Chapter 4 of the consultation document, that sovereigns should continue to be qualifying "Category A" investors for the purposes of the QAHC regime.

The Category A definition attempts to capture genuine investors that typically use holding companies to acquire investments – that is, traditional institutional investors, including sovereigns, or vehicles that are either widely held or held by traditional institutional investors. It is not limited to investors that are tax exempt.

Moreover, the benefits of the QAHC regime are only available in relation to certain investment activities. Those do not include trading, carrying on a UK property business, or investing in the shares of a UK property rich company. Continuing to allow sovereigns to be Category A investors for QAHC purposes would not therefore present a risk of them obtaining a more favourable tax outcome in relation to UK trading income or UK property income and gains by operating through a QAHC than if they received those income and gains directly.

It is not therefore necessary to alter sovereigns' status as Category A investors. While the consultation document was reassuring on this point, it would help remove any residual uncertainty in the investment market if the government were to make a clear public statement of policy in this regard at the earliest opportunity.

Substantial Shareholding Exemption

The SSE exempts gains made by companies on disposals of shareholdings of 10% or more ("substantial shareholdings") in an investee company. Ordinarily the exemption is only available where the investee is a trading company, however this requirement is relaxed if the investor company is owned by Qualifying Institutional Investors (QIIs). In that case, depending on the percentage of the investor company owned by QIIs, a full or partial exemption applies to gains on disposals of:

- substantial shareholdings in non-trading companies; and
- sub-10% shareholdings in all companies, provided the shareholding cost at least £20 million.

Effectively this allows QIIs to realise gains on shares free of tax by investing via a UK holding company. At present only investors that are exempt from tax on capital gains (including sovereigns) are included in the definition of a QII. QIIs do not therefore gain an advantage by investing through a UK holding company as compared to investing directly.

If the final policy decision is that post-reform, sovereigns should be subject to UK tax on capital gains on disposals of UK real estate and UK property rich companies, then if sovereigns were to remain QIIs they would therefore be able to use the SSE to continue to obtain exemption in relation to indirect UK property gains, which would be at odds with the resulting immunity reforms.

If, on the other hand, sovereigns were to lose their QII status for all purposes then they would be placed at a disadvantage in relation to other investments, such as investee companies that hold non-UK property or UK non-property assets, neither of which would be taxable in the UK if they were held directly or via a non-UK holding company. This would be an arbitrary outcome and make UK investment holding companies unattractive for sovereign investors.

In our view, therefore, if the final policy decision is that sovereigns should become subject to UK tax on UK real estate-related capital gains, then the SSE should still continue to be available to sovereign-owned holding companies in respect of non-UK property rich companies. Changes should only be made in relation to disposals where (under any new rules) the underlying gain would have been taxable if it had been realised by the sovereign directly. As noted on page 1, however, we understand that representatives of the real estate industry may be making arguments in favour of retaining immunity in relation to UK property activity, and so the comments above around retaining SSE for non-property gains may ultimately not be applicable if exemption ultimately does continue to be available for property income and gains as well.

Please do not hesitate to contact us should you have any questions or wish to discuss our feedback in more detail please contact Rachel Gauke.

Yours sincerely,

Mark Baldwin
Chairman of the BVCA Taxation Committee