BVCA *Funding the future*

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Dear Sirs

GAAR Consultation

A. Introduction

We are writing to provide the BVCA's response to the consultation document entitled "A General Anti-Abuse Rule" published by HMRC on 12 June (the ***ConDoc***) and the draft legislation set out in Annex D to the ConDoc (the ***draft GAAR***).

B. About the BVCA

This response is submitted on behalf of the Tax Committee 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 520 firms make up the BVCA membership, including more than 250 private equity, mid market and venture capital firms, together with 250 professional advisory firms. In 2010, the ongoing number of people employed by UK private-equity backed businesses was 810,000 on a full-time equivalent basis (FTEs).

The BVCA Tax Committee includes amongst its objectives the shaping of policy and the implementation of policy to ensure that it accommodates the needs of the British venture capital and private equity community.

C. Comments

Overview

1. The conclusion reached by the GAAR Study Group led by Graham Aaronson QC and set out in Mr Aaronson's Report of 11 November 2011 was that a moderate and narrowly focused GAAR, which targeted only artificial and abusive arrangements and did not affect the centre-ground of responsible tax planning, would be beneficial for the UK. The BVCA took the view at that time that the introduction

of a GAAR which met those conceptual objectives would be unlikely to impact the private equity and venture capital industry. Responsible fund managers will always be concerned to ensure that returns to investors in their funds are not eroded by multiple tax charges on the same investment return simply because the investment has - for sound commercial reasons such as obtaining the benefit of professional management, accessing asset classes where minimum investment thresholds would otherwise apply and risk diversification – been made via a fund rather than directly. Minimising tax charges in fund structures may require thoughtful structuring and, sometimes, conscious reliance on double tax treaties. Yet it will almost invariably be the case that the "tax planning" deployed is designed to avoid a tax disadvantage as opposed to creating a tax advantage[1]; and that the methodology is well-established, industry-standard and transparent.

2. With respect to the separate issue of fund manager remuneration, this has been the subject of discussion between the BVCA and HMRC over the years and the understandings reached between them, including for example those recorded in the Memorandum of Understanding of 25 July 2003 on the income tax treatment of venture capital and private equity limited partnerships and carried interest, are routinely relied on in practice.

3. In short, BVCA Members would generally expect any tax-informed arrangements implemented by them to fall fairly and squarely within the "centre-ground of responsible tax planning".

4. The BVCA is however concerned that the draft GAAR does not manifestly legislate for a narrowly targeted GAAR of the sort advocated by the GAAR Study Group (and indeed referred to in the narrative of the ConDoc), and that it would not on its terms necessarily prevent incursions into the centre-ground of responsible planning in the future, even if that is not HMRC's current intention. It is for example noted that, when the Australian GAAR was first introduced, the policy intent was to "strike down blatant, artificial or contrived arrangements, but not cast unnecessary inhibitions on normal commercial transactions"[2], but that this has not stopped the Australian tax authorities from seeking to apply it more widely in practice. Furthermore, a recent case on the Canadian GAAR serves as a warning that even relatively benign planning might end up being caught by a UK GAAR if, with time, it were to default to being a broad spectrum rule. In *Copthorne Holdings Ltd v Canada*[3], two Canadian corporations that had been parent and subsidiary became sister corporations so as to avoid a tax charge on a subsequent return of cash to a non-resident shareholder. If the group had been structured differently from the outset, there would not have been a tax charge to avoid. Nevertheless it was held that the Canadian GAAR applied.

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[1] Mr Aaronson notes at paragraph 30 of the Illustrative Draft Guidance Note appended to his Report that a reasonable response may include taking steps to avoid a wholly inappropriate tax disadvantage which might otherwise arise from carrying out an entirely commercial transaction.

[2] Explanatory Memorandum to the Tax Laws Amendment Act (No.2) 1981 which introduced Part IVA of the Income Tax Assessment Act 1936.

[3] 2011 SCC 63

5. The BVCA considers it important that any GAAR which is enacted now is framed in such a way as to minimise the risk of any "mission creep" in the future. Any perception that a UK GAAR could or might be used to attack the sort of tax efficient structures routinely relied upon by the funds industry would deter investment into the UK and damage investor confidence in UK managed funds, with knock-on consequences for the UK economy. We have set out our more detailed comments below, together with our responses to selected **questions** raised in the ConDoc, under the headings of uncertainty of scope, double tax treaties and Advisory Panel.

Uncertainty of scope (questions 3(1) and 4)

6. Paragraph 3.24 of the ConDoc makes it clear that the definition of "arrangements" used in the draft GAAR would enable its application where the wider arrangement is demonstrably commercial but a particular feature of it is consciously designed to get a better tax result than would otherwise be the case. This of itself casts the GAAR net much wider than the sort of arrangements at issue in *Mayes v Revenue & Customs Commissioners*[4]. Those arrangements were wholly contrived and without any commercial purpose and the taxpayer win in *Mayes* has been cited by supporters of the GAAR as underlining the need for a GAAR to combat those "egregious" and "wholly unacceptable" schemes which cannot be counteracted by any other means. Expanding the scope of the proposed GAAR to cover steps in or features of wider commercial arrangements which have been included to improve tax efficiency – and which are therefore by definition likely to have a main purpose of obtaining a tax advantage (the first gateway into the GAAR) – will result in the GAAR being relevant to a much broader spectrum of arrangements than the highly abusive and unmeritorious schemes at which it is claimed to be targeted, and this will in turn create uncertainty for business. A GAAR which was instead sensitive to the overall context of the tax planning and which sought to identify only those arrangements with no overarching commercial objective or where any commerciality is subordinate to the tax objectives and/or merely bolted on to assist the tax analysis would easily catch *Mayes*-style planning without raising concerns in relation to genuine business arrangements.

7. Virtually all taxpayers who have an eye to tax when structuring their transactions will therefore have to rely on their arrangements not passing through the second gateway to the GAAR, i.e. on their being filtered out by the "double reasonableness" test. In the illustrative GAAR attached to the Study Group Report, the double reasonableness test was couched as a positive test: "An arrangement does not achieve an abusive tax result if it <u>can</u> reasonably be regarded as a reasonable exercise of choices ...". In the draft GAAR, it is expressed as a negative test: "Tax arrangements are 'abusive' if they are arrangements the entering into or carrying out of which <u>cannot</u> reasonably be regarded as a reasonable course of action". If the intention is that an arrangement should not be regarded as caught by the GAAR if any person, acting reasonably, would regard it as a reasonable course of action – and it seems to us that the rules would need to be designed to work this way if they are to catch only those schemes which would widely be regarded as "egregious" or "intolerable" – then that intention emerges more clearly from the positive formulation

4 [2011] STC 1269

of the test (although determining when a person should be taken to be acting sufficiently reasonably for his or her view to count would remain a difficult area on either formulation). Overall, the BVCA believes that the inherent subjectivity involved in applying the double reasonableness test means that it will do little to reduce uncertainty as to whether a particular set of arrangements (or a particular set of arrangements-within-arrangements, where the sticking point is a tax driven feature of an overall commercial transaction) may be liable to counteraction by the GAAR.

8. The double reasonableness test is used in the draft GAAR as a means of identifying arrangements which are "abusive". In fact, the ConDoc (including David Gauke's Foreword) routinely refers to "*artificial and* abusive" schemes. There is no explicit recognition in the draft GAAR that "artificiality" is a further necessary condition for planning to be susceptible to the GAAR. Although it is appreciated that artificiality may implicitly weigh in the analysis of what is reasonable or not, it would be helpful if the terminology used in the GAAR reflected that used in the ConDoc.

9. It follows from the above that, in response to **questions 3(1) and 4**, the BVCA is not persuaded that the proposed "main purpose" rule serves as a useful filter when coupled with the concept that arrangements must also be "abusive"; nor that the "double reasonableness" test will operate as intended to counteract only artificial and abusive schemes.

10. If the draft GAAR is not to be re-framed so as to be clearly narrower in scope, then the BVCA would ask HMRC to reconsider the possibility of introducing a clearance procedure as a way of reducing uncertainty (uncertainty being of particular concern in the context of a rule intended to operate within self-assessment). A clearance procedure would not benefit those taxpayers who are deliberately "scheming" or who are aware that they are pushing the boundaries – what would be the point in asking for clearance? – but it would benefit those persons who in good conscience believe themselves to be in centre-ground territory but who cannot quite reach a comfortable landing on the words of the legislation alone. If cost and human resource constraints have played a part in HMRC's rejection of a clearance procedure, then views should perhaps be canvassed on a fee-based system, a proposal which we understand has been mooted previously. Within the private equity and venture capital industry, payment of a modest clearance application fee may well be regarded as preferable to lingering uncertainty over whether a tax-optimised element of a fund structure or remuneration arrangement might be vulnerable to counteraction by the GAAR, and the potential harmful effect that this may have on investor relations and manager recruitment.

Double tax treaties (question 2)

11. As we understand it, the GAAR is designed to prevent taxpayers achieving tax results which are contrary to the policy intent of UK tax legislation. Double tax treaties are not concerned with the policy intent of any particular state's domestic tax legislation. They are bilateral agreements negotiated between two states with different tax rules and policies and they are designed to provide a clear allocation of taxing rights between the two states in certain prescribed circumstances. The two states in question may agree that treaty benefits should be denied in certain situations

which both would recognise as abusive and, in this case, the relevant principles will be set out in a "limitation of benefits" (***LOB***) article in the treaty itself. It cannot be legitimate for one state to invoke a domestic GAAR as a unilateral override to a treaty provision: it has agreed an allocation of taxing rights with its treaty partner (possibly many years previously) and it is obliged to stick to its agreement, irrespective of its view of life or how its own tax rules may have developed in the mean time. If this were not the case, treaties would quickly become meaningless pieces of paper. On this, it is instructive that the independent Expert Committee constituted to report on the proposed Indian GAAR has recently recommended that any such GAAR should not be capable of displacing an agreed LOB article.

12. Clarity on the availability of treaty relief is key to investor confidence in making investments cross-border. Anything which risks prejudicing this clarity is potentially very damaging for cross-border investment, into or out of the UK, and may impact negatively on future fund-raisings.

13. The BVCA's response to **question 2** is therefore that it strongly disagrees with the proposal that the GAAR should be capable of counteracting UK tax advantages obtained under double tax agreements.

Advisory Panel (question 13)

14. The BVCA regards the Advisory Panel as a potentially important safeguard and believes there to be real merit in introducing a business-focused, commercial perspective into the process. We note that paragraph 6.17 of the ConDoc refers to one of the non-HMRC members ideally having experience relevant to the arrangement, with insurance business given as an example of a case where at least one of the members should have experience relevant to insurance. Clearly, should any fund structuring arrangement ever be referred to the Panel, the BVCA would regard it as critical that at least one of the Panel members dealing with the referral had a deep familiarity with the private equity and venture capital industry and a thorough understanding of general practice in this area.

15. If the Advisory Panel is primarily intended to provide an independent, industry-familiar sense check on where the boundary between ordinary responsible tax planning and unacceptable scheming lies, it is nevertheless unclear what need or justification there would ever be for the group of Panel members dealing with a particular referral to include HMRC representatives. Moreover any HMRC Panel member would be likely to share the view of his or her colleagues who have decided to pursue a GAAR argument against a taxpayer and it seems inherently unfair for HMRC to be represented on the Panel but not the taxpayer. In response to **question 13**, reassurance that the Advisory Panel will be comprised of (at least) a majority of independent and impartial members with relevant industry expertise, and more general visibility on the way that the Advisory Panel will operate in practice would be very welcome.

Please feel free to contact me if you have any queries about this letter or if you consider that a meeting with BVCA representatives would be helpful.

Yours faithfully,

David Marks
Chairman, BVCA Taxation Committee