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Dear Mr Sadler

Consultation on possible changes to income tax rules on interest

We refer to the above mentioned consultation document published on 27 March 2012. Further to our meeting of 15 May 2012, we have set out our detailed comments on the proposed legislative changes in respect of the following areas:

1. Yearly interest arising in the UK
2. Quoted Eurobonds
3. Interest in kind and funding bonds
4. Disguised interest rule for income tax

As noted in our meeting, we would be very keen to be involved in discussions regarding the draft legislation at the appropriate time.

About the BVCA

The British Private Equity & Venture Capital Association (BVCA) is the industry body and public policy advocate for the private equity and venture capital industry in the UK.

The BVCA Membership comprises over 230 private equity, midmarket and venture capital firms with an accumulated total of approximately £233 billion funds under management. Private equity funds managed in the UK currently back around 4,700 companies, employing around 1.6m people on a full-time equivalent basis (FTEs) across the world. Of these, around 810,000 FTEs are employed in the UK.

General Comments

Most European countries do not operate withholding tax ('WHT') on interest and therefore any proposed changes resulting in additional withholding tax burdens could create a disincentive to investment in the UK. Additionally it is likely to result in some offshore investors investing into the UK via treaty countries (such as Luxembourg) which seems at odds with the Government's stated intention to incentivise investors to headquarter operations in the UK.

We are also concerned about the compliance burdens any changes would create. In many circumstances the recipient would be entitled to reclaim the WHT but will be subject to complex administration process to do so. In particular, this has a significant impact on the private equity ('PE') and venture capital ('VC') industry, where many funds are structured as a partnership structure, which means that even where the vast majority of investors were entitled to reclaim, there remains a withholding requirement. In many cases, this will mean that for each investment, the fund would

need to assist with a large number of treaty claims on a recurring basis. The general partners of these funds do not have the resources to deal with this, and therefore it could become a real cost to the limited partners as well as a significant resource issue for HMRC in dealing with reclaims for 100s of PE/VC funds each containing several (possibly over 100) investors seeking reclaims on a regular basis. Accordingly, it may be necessary to look for alternative ways of structuring the transaction to mitigate this potential issue.

Yearly interest arising in the UK

As noted in our discussion, PE and VC funds increasingly in the current economic environment use bridging loans to facilitate completion of a transaction, and these are typically loans with terms of less than one year. Under the current rules, such loans should be exempt from the withholding requirement. However, if the exception for yearly interest is removed, this could create a withholding requirement on those loans which are not provided by third party banks, e.g. a bridging facility from the fund. This could potentially create a significant administrative burden, and is not one which could be fixed under an existing exception such as the quoted Eurobond, given the short term nature of the loan. This could therefore have an impact on making the UK a less attractive jurisdiction in which to invest, and thus hinder growth.

We discussed in our meeting that HMRC are amenable to considering alternatives to the current proposal, e.g. a specific carve out for business transactions or drafting the legislation to cater specifically for the situations they are looking to target. In particular, we discussed that a carve out for a recipient of the interest who is a partnership or collective investment scheme could work from a PE and VC perspective. We would request that consideration is made to introducing such a carve out if the yearly interest exception will be abolished. We would be happy to assist with the drafting of any such carve out.

Quoted Eurobonds

This is a key area of concern for the PE industry as many PE transactions use the exemption to mitigate the withholding requirement. As you are aware, and as discussed in our meeting, the use of the exception is driven by the nature of PE fund structures (up to 200+ investors in each fund) and the complexities of recovering withholding tax. Historically, this has been discussed with HMRC, and it had been suggested to the PE industry that the quoted Eurobond exemption was available to mitigate WHT.

As mentioned above, a WHT requirement could cause investors to either deploy capital elsewhere or find other routes for investing into the UK (e.g. via Luxembourg). Either way, this does not appear to create a message that the UK is open for business and that it has a competitive tax system.

It seems to us that both of the proposed tests, namely that the relevant bond is not regularly traded and is owned by a member of the same group as the issuer, will attract some major practical problems:

- The "not regularly traded" test is potentially too wide. In practice, many quoted Eurobonds issued into the capital markets are not regularly traded because they are held by institutions as long term investments. Moreover, any sales which do occur frequently take place off-market, by means of private sale agreements or dealings in beneficial interests in the bonds.

- A test which depends on the ownership of quoted Eurobonds is likely to be difficult to operate in practice. Clearance systems generally base their payment arrangements (ie. whether interest is paid gross or subject to deduction of tax) on the status of the bond (ie. listed or unlisted) and would need to change their systems to investigate whether each beneficial owner of a bond has a particular legal relationship with the issuer. Many bonds are held through nominee or similar arrangements, and so it may be very difficult even to establish the identity of the ultimate beneficial owner of a bond.

Turning to the PE/VC industry in particular, as discussed, most investors within the PE/VC industry would qualify for a withholding tax reclaim. Therefore if the exemption were to be removed for PE/VC structures, the admin burden will be disproportionate to any tax which could be due to the UK Treasury. In addition, we are aware of certain investors who will not make treaty claims (even if they are entitled to it) because the costs of doing so would not make it worthwhile and therefore will be a real cost to them, thus making the UK a less attractive option for investing their money and resulting in them moving their investments elsewhere. Accordingly, the PE/VC industry would like to see an appropriate carve out for the industry.

We understand that HMRC's intention is to attack situations where Eurobond structures were being used by multinational non-treaty based corporate groups to extract cash out of the UK tax-free. Based on 5.4 of the consultation document, the Government's starting point on amending the quoted Eurobond exemption would be to deny the exemption where Eurobonds are issued to a fellow group company with the bonds subsequently being listed on a stock exchange on which there is no substantial or regular trading. We understand from our discussion that HMRC's starting point for the definition of 'group' is possibly the definition used for capital gains groups.

Whilst PE funds themselves would not fall within the capital gains group definition with their portfolio companies, and therefore the quoted Eurobond exemption should remain available on this basis, we note that the definition of 'group' could still be subject to further consideration. We would like to re-iterate that to the extent any 'connection' test or 'control' test is used to define what is considered to be intra-group, this could potentially group the PE fund and its portfolio companies if it was considered the investors in the fund are acting together to control the portfolio companies, or that the General Partner of the fund controls the portfolio companies. This could result in the PE funds no longer being able to apply the quoted Eurobond exemption.

One suggestion that we discussed with you regarding the amendment to the quoted Eurobond exemption is to allow the exemption where the recipient of the interest is a partnership or collective investment scheme (which is in line with our comments regarding the yearly interest point). We note that these exclusions have been used in the context of corporate debt although further refinement may be required in respect of situations where PE funds use investment vehicles other than partnerships. A carve-out similar to the worldwide debt cap rules could be introduced here, i.e. accounting standards are used to define group and parent, but a CIS carve out is made available for a parent which would mean that the company below the fund is the parent of the group.

Whilst we strongly argue that the exemption should remain for PE/VC structures and understand that you are currently of the same mind, notwithstanding the above, if a decision is taken to remove the quoted Eurobond exemption, it is vital that grandfathering provisions will apply to any current structures. In particular, for companies held by PE/VC investors, any cash leakage including by way of payment of WHT could result in breaching of banking covenants, with serious consequences for investors, the company, employees and economic growth. We understand from our meeting that such grandfathering provisions would be considered if required.

In any event, we would be very keen to consult with you further on this area as your thinking develops.

Funding bonds

We understand that the current arrangement in respect of funding bonds is creating an administrative burden for HMRC which is disproportionate to the tax at stake.

The key issue from a PE perspective on funding bonds is that the current banking agreements in place are unlikely to allow cash to leave the group in order to pay WHT on PIK interest. Therefore a change in this legislation would result in a potential move to using quoted Eurobonds (which has already been the preferred choice for the larger PIK instruments, but we note is also the subject of this consultation document) or other structure to avoid the cash cost.

Any changes to this area are also likely to hit the venture end of the market where portfolio businesses may have cash flow difficulties and therefore PIK pay their interest, and these deals are also too small to make the Eurobond alternative commercially feasible.

As an additional point, for the same reasons noted above in the quoted Eurobond section, any change would need, as a minimum, to include grandfathering provisions given the potential breach of banking covenants that could occur otherwise.

Disguised interest

We note that paragraph 7.5 of the consultation document refers to a future simplification of the legislation on the accrued income scheme and on deeply discounted securities. As discussed in our meeting, the accrued income scheme and deeply discounted securities legislation can be a complex area to work through, and these issues typically arise in a PE/VC context. In particular the complexity of the legislation inhibits restructuring investments which is detrimental to preserving companies in what are often difficult circumstances. Accordingly, any move to simplify these rules will be welcome.

I trust our comments are in line with our discussion during our meeting of 15 May, however, if you would like any further clarification in respect of the matters noted above, please do not hesitate to contact us. We would welcome any further opportunities to engage in discussions with you as these matters are progressed further.

Yours sincerely,

David Huff, 3i
BVCA Tax Committee Chairman