By email: dpt-tp-pe-reform@hmrc.gov.uk

14 August 2023

Dear HMRC

Re: Reform of UK law in relation to transfer pricing, permanent establishment and diverted profits tax

The BVCA is the industry body and public policy advocate for the private equity and venture capital ("private capital") industry in the UK. With a membership of over 750 firms, we represent the vast majority of all UK-based private capital firms, as well as their professional advisers and investors. In 2022, £27.5bn was invested by private capital into UK businesses in sectors across the UK economy, ranging from consumer products to emerging technology. There are over 12,000 UK companies backed by private capital which currently employ over 2.2 million people in the UK. Over 55% of the businesses backed are outside of London and 90% of the businesses receiving investment are small and medium-sized businesses.

This letter sets out the BVCA's response to the consultation that was published on 19 June 2023. We have limited our remarks to the proposals that are of most concern to our members, namely those relating to permanent establishments and how the proposals are relevant to the private equity and venture capital fund management industry in the UK. We have provided direct replies to the relevant consultation questions at the end of this letter, but the bulk of our response is of an overarching nature and is set out in the body of the letter below.

By way of introduction, private equity and venture capital funds are generally structured as UK or non-UK limited partnerships with a general partner which is responsible for the management of the fund. The general partner will then commonly engage an investment manager to provide discretionary investment management services to the fund. This might be an investment manager regulated as an alternative investment fund manager under the Alternative Investment Fund Managers Directive ("AIFMD") or otherwise. The fund general partner or investment manager might then engage with one or more investment advisory providers who would provide significant input into selecting and negotiating the fund's investments.

The fund will generally raise its investment capital from a range of international investors who are unconnected with the business establishing the fund and providing the investment management and/or advisory services to it (and, so, to the external investors).

The mantra for the fund investors is that, in general terms, they should be no worse off (from a tax as well as other perspective) from investing via the fund than they would be had they invested in the fund's investments directly. It is, therefore, essential that establishing a fund with an investment manager or investment adviser in the UK does not carry a risk of exposing any of the fund's investors to UK tax on their returns from the fund by reason of the fund or its investors being treated as trading through a permanent establishment in the UK.

The position in this regard has been sufficiently clear to date through a combination of:

(a) the fact that private equity and venture capital funds do not carry on a trade, a point agreed to be correct in law in respect of venture capital funds (prior to the use of the term private equity) in the 1987 statement on the tax treatment of partnerships used as funds for equity investment in unquoted companies entered into between the BVCA, the Inland Revenue and the Department of Trade and Industry; and

(b) the organisation of funds established outside the UK with a non-UK investment manager and UK investment adviser which will not have or habitually exercise authority to do business on behalf of the fund or the fund's investors.

The fund industry and the location of its service providers is an extremely competitive area with jurisdictions, including Luxembourg, Ireland and the Channel Islands, seeking to increase their share of the fund establishment, administration and management business at the expense of the UK. Coupled with the UK's departure from the EU single market and the importance to private funds of access to the AIFMD to allow them to market funds to certain international investors, this has led to many more funds being established outside the UK with non-UK AIFMs and UK investment advisers.

A number of EU jurisdictions (such as France), recognising this issue, acted to address the problem along with the implementation of AIFMD by clarifying that fund management did not create a permanent establishment to enable their domestic fund management business to continue to operate successfully. As stated, it is important that the use of UK investment advisers does not carry the risk of creating a UK permanent establishment for the funds' non-UK investors or funds would be driven to consider moving their (often significant) investment advisory businesses (or parts of them) outside the UK.

In this context, certain aspects of the permanent establishment proposal, in relation to both domestic statute and the UK's treaty negotiating position, are of concern without further clarification and/or published guidance on how any new rule might apply to private funds. These are:

(a) the change to what is an agency permanent establishment from someone who "has and habitually exercises [in the UK] authority to do business on behalf of" the fund to someone who "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without modification by" the fund; and

(b) the exclusion from being an independent agent of agents who "act exclusively or almost exclusively on behalf of one or more enterprises with which it is closely related".

As discussed above, private funds are often structured with a non-UK investment manager and a UK investment adviser. In these arrangements, the investment adviser would often be given a mandate from the investment manager to recommend investments and then to negotiate the terms of the investment with the final agreement to the terms and decision to make the investment being taken by the investment manager and/or the entities established by the fund to hold the investments. While not clear, it is possible under these arrangements that the UK investment adviser might be considered to be an agency PE under the new test in (a) above and also be excluded from being an agent of independent status under (b) depending on how one tested the investment adviser's "close relationship" by reference to the investment manager or fund(s) to which it provided advice or to the independent, unconnected non-UK investors in the fund(s).

We note that this concern was considered by the BVCA in 2017 when adoption of the new PE definition in the MLI was being considered, but that the concern was not relevant when the UK chose not to adopt the change.

In order to retain certainty for non-UK investors in funds with UK investment advisers we would, therefore, recommend retention of the current definition of permanent establishment and no change to the definition of agent of independent status.

If, however, this is not considered to be a feasible approach to the question of better aligning UK law with the OECD position then it will be very important that clear provisions or published guidance is provided (preferably in good time before any changes are implemented to avoid uncertainty in the market) that would give clear comfort to the industry that investment advisers would not create a UK permanent establishment for non-UK investors or the funds that they advise (or that they would not if they conducted their business within clear, and practical, guidelines set out in the guidance).

We note that there are a number of interlinked issues that would need dealing with:

(a) one would not expect private equity and venture capital funds to be trading, so that having a UK PE would not adversely affect the fund and its investors as a whole, although it could affect individual investors treated as holding their interest in the fund for the purpose of their own trading activities. We note in this regard, however, that there has been recent publicity in relation to carried interest questioning the general non-trading status of private equity funds. This already raises significant concerns for the many funds that are managed from the UK, but if changes to the PE definition were introduced, it would be even more important that this non-trading status was reemphasised in clear guidance;

(b) there is an issue for non-UK investors in funds which themselves might be treated as carrying on a trade to which their holding of an interest in the fund could be attributed. Historically, HMRC guidance in this area has been loosely articulated and unhelpful in not clearly allowing a conclusion that most holdings in private equity funds (by their nature generally long-term investments) should not be attributed to any trade (such as banking or insurance) carried on by a non-UK investor in the fund. So, if changes to the definition of PE were introduced, it would be important for HMRC to clarify its position and guidance in this regard and give clear comfort that non-UK investors in private equity and similar funds would generally not be treated as holding their interest in the fund as part of a trade carried on in the UK where they were investing, in line with the fund's investment policy, for the medium to long term; and

(c) as referred to in the open consultation document, a number of UK asset managers rely on the investment management exemption ("IME") as the basis of concluding that they are not dependent agents of the funds that they manage. It will, therefore, be a required consequence of any change to the definition of agency permanent establishment that changes are made to sections 1146 to 1150 CTA 2010 to include transactions carried out by investment advisers (as opposed to just fund managers) that could amount to actions of a dependent agent.

So, while we understand the desire to more closely align the UK's definition of permanent establishment with that adopted by the OECD, and developments to it, it is crucially important to the UK's private fund management industry that any change does not increase the risk that international investors might become subject to UK tax on their returns from the funds that they invest in. As has been seen with the trend since the introduction of the AIFMD for funds to be established in European jurisdictions outside the UK, much of the private fund industry is very mobile and small perceived advantages or disadvantages or risks can have significant consequences on the decision of how to establish and manage funds. Once fund managers have taken a decision to move resources outside the UK it can be very difficult to persuade them to move back.

If changes are made to the definition of permanent establishment to potentially bring UK investment advisers within the scope of dependent agent permanent establishment, it will extremely important that, in good time before any change is implemented, comfort is given to the international investor base that they will not become subject to UK tax as a result of investing in funds with a UK investment adviser through things like:

(a) updating and modernising the guidance on funds' investment status to make it clear that, on a proper application of current UK law, private funds with an investment strategy of holding investments in the medium to long term would not be considered to be trading;

(b) providing clear guidance around how much a UK investment adviser can take the lead in negotiating contracts relating to the fund's investments and not create a PE in the UK when the contracts will be finally authorised and entered into by the fund's investment manager and/or the holding company established by the fund that will acquire, hold and dispose of the investment; and

(c) providing appropriate guidance in respect of the proposed exclusion from the independent agent definition that could, for instance, follow the guidance in SP1/01 in respect of the independent capacity test such that it is clear that when investment advice (or investment management) is provided to a widely held collective fund the investment adviser will not be considered to "act exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related". It should also be made

clear that one widely held fund established by the business of which the investment adviser is part will not be considered to be "closely related" to another fund established and advised by the same business and that fund managers/advisers that provide their services to a number of different investors under bespoke arrangements such as segregated mandates and single investor funds would equally not be considered to be "closely related" to any one investor provided that the fund adviser's income was split across a number of independent mandates.

So, while our preference would be that the proposed changes are not made to the definitions of dependent and independent agents, if such changes are to be made, it will be crucially important to the UK private fund management industry that the changes are made in conjunction with the sort of guidance and industry comfort discussed above. Any perceived risk that the changes might bring international investors in funds advised from the UK into the UK tax next could have materially adverse consequences for the UK fund management industry at this time when the government is working hard to support it.

We would be happy to arrange a call or meeting with you to discuss this further if that would be helpful.

Please do not hesitate to get in touch if you have any questions or if you would like to discuss any of these issues in more detail (please contact Rachel Gauke at rgauke@bvca.co.uk).

Yours sincerely

Maria Carradice

Maria Carradice

Chair, BVCA Taxation Committee

Question 14: The government welcomes general observations from respondents regarding the perceived advantages and disadvantages of each option for amending the PE definition.

We do not have a view on whether one is better than the other and consider that the sort of guidance and industry comfort referred to above would be equally important whatever change were made.

Question 15: Do respondents foresee any issues with the UK limiting this definition to fixed place of business and dependent agent PEs?

No.

Question 16: Do respondents foresee any specific issues with the UK changing its domestic law position in terms of the definition of a dependent agent PE? Do respondents foresee any specific issues with the UK changing its domestic law position in terms of the definition of an independent agent?

Yes we think that changes to these definitions might raise concerns in the private funds industry that engaging UK investment advisers could bring the funds' international investors into the scope of UK tax on their returns from the fund and so consider it important that, if any such change were made, clear guidance and comfort along the lines suggested above is put in place in good time before any change became operative.

Question 17: Do respondents foresee any issue with the UK potentially changing its negotiating position, so that UK tax treaties might include these provisions?

Similar concerns to those above. To some degree it would not be helpful to the private funds industry if there was a different, narrower definition in treaties than in domestic law because the domestic law terms would probably still be relevant for at least some potential investors in the fund.

Question 18: Do respondents foresee any issues with the UK aligning the domestic legislation on PE attribution either directly with the relevant double taxation treaty or with Article 7 of the OECD Model supported by the Commentary and the OECD Report on the Attribution of Profits to PEs?

See above.

Question 19: Would removing any particular aspects of the legislation in Chapter 4 CTA 09 be problematic?

None obvious.

Question 20: The government welcomes respondents' views about possible unforeseen and/or unhelpful consequences or interactions with other parts of UK tax legislation which are not addressed in the above proposals.

See above as regards amending sections 1146 to 1150 CTA 2010 (the IME) to include investment advisers.

Question 22: The government welcomes comments from respondents on the potential impact of the reforms contemplated in this consultation on the UK asset management sector.

See above.