Room 3/63
CT Losses, CTIS
HMRC
100 Parliament Street
London, SW1A 2BQ

By email: ct.lossreform@hmrc.gsi.gov.uk
cc: james.coward@hmrc.gsi.gov.uk

31 January 2017

Dear Sirs

Draft provisions for Finance Bill 2017: Clause 20 and Schedule 6 - carried forward losses

I am writing on behalf of BVCA to draw your attention to one particular difficulty, of significant and immediate concern to our members, with these draft provisions.

The BVCA is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of almost 600 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. Our members have invested over £27 billion in nearly 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 385,000 people and 84% of UK investments in 2015 were directed at small and medium-sized businesses.

In 1987 an agreed statement was issued by the BVCA, the Inland Revenue and the DTI setting out a tax and regulatory framework for the use of limited partnerships registered under the Limited Partnerships Act 1907 as venture capital fund vehicles. Although much has changed during the ensuing 30 years and there is increased competition from other jurisdictions, English limited partnerships remain a standard fund vehicle for private equity/venture capital and other classes of alternative assets. The tax regime has evolved significantly since 1987, but the basic framework of the tax treatment of investment limited partnerships remains the same as that articulated in the 1987 statement.

The model fund structure described in the 1987 statement involves a UK resident company acting as the general partner of the limited partnership. As a general rule, a new general partner company will be established for each fund (or even each partnership within a fund where the fund comprises more than one partnership investing in parallel). This is because a general partner is liable without limit for the obligations of the limited partnership and using a fresh company for each partnership avoids the risk of “cross contamination” of liabilities. General partner companies tend to have minimal capital and no assets. They will be entitled to a guaranteed priority profit share (essentially a management fee) from the fund partnership each year. The general partner is entitled to draw funds equal to its priority profit share whether or not the fund has made any profits (investment income or gains) in any particular year. The general partner will use the money drawn out of the fund to pay a management fee to an entity which acts as operator/investment manager of the fund. This is the entity in the fund manager’s group which has the (staff etc) resources to run the fund and will be fully capitalised and (usually) FCA authorised. It is, of course, insulated from the fund partnership’s liabilities by the general partner. In 1987 the manager/operator would have been a company in the same corporate group as the general partner, but now it could either be such a company or a LLP which owns the general partner. The fee paid by the general partner company is an expense of management of the general partner (which is an investment company, in 1987 language - a company with investment business in today's terminology) and trading income of the manager/operator.

Under current tax rules, the fee paid by the general partner is an expense of management and this can be carried forward by the general partner to be set off against future income and gains. As a commercial matter, in the early years of a fund partnership (when it has no investment income or capital gains out of which to pay the general partner's guaranteed profit share) the amount due to the general partner will be lent to the general partner by the fund. A partnership agreement will typically provide that this loan/advance is made on account of the general partner's priority profit share. In future years (when the partnership has income and gains) not only will the general partner's priority profit share for the later period be met out of the income/gains of that year, but the general partner will also receive an allocation of income/gains equal to the loan balance carried forward. This will eliminate the general partner's loan. The effect of this is that, during the early years of the fund partnership, the general partner will make a "loss" for tax purposes (strictly speaking, it will have a significant surplus of expenses of management over income/gains). When the general partner's share loan reverses (which will normally be the period when the fund makes its first significant disposal) there will be a "spike" in the general partner's profits for tax purposes, because income/gains equal to its guaranteed profit share for several years will all be recognised at once. The general partner will, of course, have carried forward management expenses, so that (over the life of the fund) the general partner would make neither a gain nor a loss for tax purposes, because it would have current year or carried forward management expenses with which to shelter the income/gains allocated to it over the life of the fund in respect of its priority profit shares.

From an accounting point of view, the general partner will make neither a profit nor a loss each year. This is because the fee it pays will be treated as an expense for accounting purposes and it will show the general partner's share paid (whether as an allocation of profit or a loan) as turnover in the year. Because the loan on account of the general partner's share is to be repaid out of future allocations of income/gains and is not repayable by the general partner if there are insufficient income/gains, the general partner's share is recognised as turnover each year.

This tax treatment, which equates with commercial reality and the accounting treatment, will be thrown into disarray by the proposed changes. Proposed new Section 269ZD, CTA 2010 restricts the ability of a company to reduce its total taxable profits through the use of "relevant deductions" carried forward from prior years. The definition of "relevant deductions" in new sub-section (3) includes expenses of management carried forward from prior years. You will readily see that this will disturb the tax treatment of a general partner. As I have just explained, at the moment the general partner can deduct the full amount of management fee paid in prior years against the "spike" of income/gains which arises when the general partner's share loan reverses. But the new rules will significantly restrict the ability of a general partner company to do this in the future.

I attach two slides in the appendix to this letter, which illustrate the current tax position and the position as it will be if the proposals are enacted in their current form

In our opinion these proposals will not produce a fair outcome. Each fund is a separate "project" of the fund manager with separate investors and whether that project has made a profit or loss needs to be measured over the full life of the fund. The current tax position of a general partner company over the life of a particular fund is right and accords with its accounting treatment. The tax position in any particular year is likely to be distorted. From a tax point of view, a general partner makes a "loss" in the early years (but of course it doesn't make a commercial loss at all) and this is "balanced" by a "spike" of profit in one or more years towards the end of a life of the fund when that "loss" reverses. Looking at the arrangements realistically, the general partner is no more profit making in those "spikey" years than it is loss making in the early ones. However, because the general partner can carry unused expenses of management forward without restriction, the divergence between the tax and commercial/accounting position currently does not matter.

The true measure of the fund management business's profit is to be found in the results of the manager. The general partner is effectively a cipher; it participates in the arrangements to shield the manager from exposure to the fund's liabilities.

If these proposals are introduced in their current form, they will result in a fund management group being taxed on its commercial profits in the manager and then again on an entirely artificial tax (but not commercial or accounting) measure of profit in the general partner company.

In the Treasury/HMRC response to the consultation on corporation tax loss relief (December 2016) it is noted, at paragraph 3.1, that respondents to the consultation had observed that the loss restrictions could have a significant impact on fixed investment projects. Such ventures can make large losses in early years that are recouped by profits near the end of the project. The loss relief reforms may mean these projects pay tax earlier than projected, and may not be able to relieve all their losses against profits before the cessation of the fixed term project. In response, the government observed that it "recognise[d] the impact that the loss restriction may have on fixed term investment projects. It is not the intention of the loss restriction to change the availability of relief for carried forward losses, but instead the timing of the relief." To address this concern, the government is introducing a "terminal carried forward loss relief" which will allow a company which ceases trading to use any remaining carried forward trade losses against profits arising in the final 36 months of the trade without restriction.

We welcome the introduction of terminal carried forward loss relief as evidencing an acceptance on the part of the government that the proposed changes to corporation tax loss relief can work out unfairly and unjustly in particular circumstances and a willingness to address those difficulties.

The position of a fund general partner company is (mutatis mutandis) exactly the same as a trading company engaged in a fixed or limited term project. Both make losses in early years that are recouped by profits near the end of the project.

Clearly, terminal carried forward loss relief will not of itself do anything to address the position of a general partner company and the problems we have just explained. This is because it is restricted to trading losses. Also a simple extension of terminal carried forward loss relief to cover expenses of management incurred in the final 36 months of the life of an investment company would not necessarily be of any help, because the high profit years of a general partner are more likely to be more than three years before the end of the life of a particular fund. A fund will typically have a five or six year investment period followed by a period of a number of years over which the fund investments will be managed and gradually disposed of. The high profit year(s), when the general partner's share loan reverses, are likely to be in the middle of that period, significantly more than 36 months before the end of the life of the fund.

This is a very important point for the fund management community. It cannot be right that, as a result of following a structuring approach agreed with the government many years ago, fund managers are now to be taxed on more than their commercial profits. This will be a real additional cost to fund managers, particularly managers of larger funds. There is already significant pressure on fund managers to move operations and fund structures outside the UK. We have raised this concern repeatedly in our responses to consultations on a variety of tax proposals (see, for example, our responses to recent consultations on the tax treatment of non-domiciled individuals and the wider partnership tax consultation). These proposals, if implemented, will create an incentive for fund managers not to use a UK general partner and by necessary extension to use a non-UK fund vehicle. Inevitably, that will lead to functions and employment leaving the UK. I cannot stress too strongly how important it is that this issue is addressed.

However, we are sure that, by adapting the terminal carried forward loss relief idea or in some other way, the difficulties these changes present for general partner companies can be overcome.

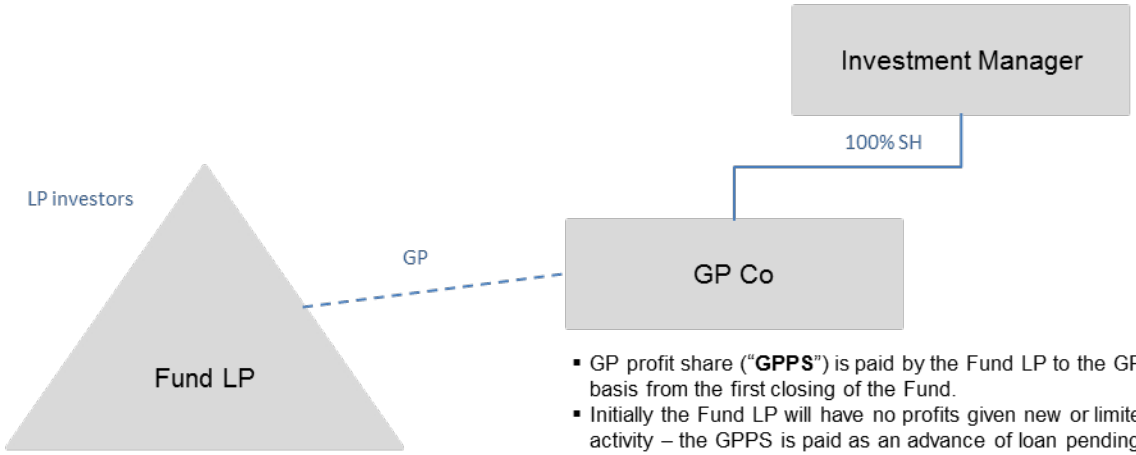
We would welcome an opportunity to discuss these concerns and ways in which they can be addressed.

Yours faithfully

David R Nicholson
Chairman of the BVCA Taxation Committee

Appendix

Typical Fund and GP/ Manager structure



- The IM is typically the vehicle to employ the investment professionals and incur corporate/ group running costs.
- The IM earns a fee from the GPCo which is accrued and paid quarterly.
- The IM has no fixed life. It may hold multiple GPCo vehicles and multiple Fund LP strategies.

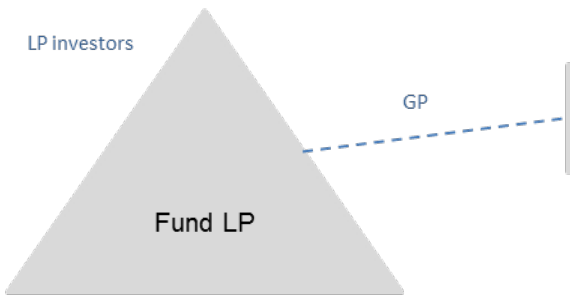
- GP profit share ("**GPPS**") is paid by the Fund LP to the GP on a quarterly basis from the first closing of the Fund.
- Initially the Fund LP will have no profits given new or limited investment activity – the GPPS is paid as an advance of loan pending future profit.
- As the Fund LP becomes profitable, the GPPS loan is reversed and a true profit share is allocated.
- The GPCo vehicle itself is typically a subsidiary of the Investment Manager ("**IM**") . The GP has limited activity itself; it appoints the IM as adviser in exchange for a fee. It is important that the GP is a separate company from the IM for legal and commercial reasons (investor request and ringfenced liability).
- The GPCo has a fixed term life according to the life of the Fund LP.

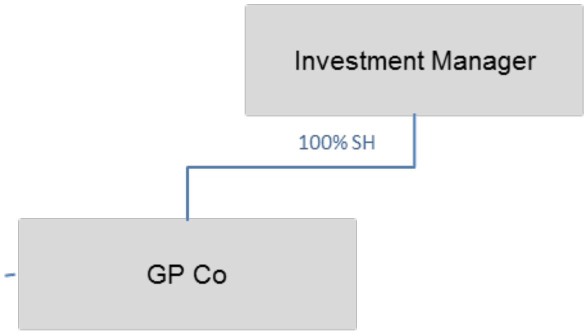
Today: Tax P&L result

	Yr1	Yr2	Yr3	Yr4	Yr5
GP profit share	-	-	-	20	5
IM fee expense	(5)	(5)	(5)	(5)	(5)
Taxable profit	-	-	-	-	-
Tax balance	(5) c/f loss	(10) c/f loss	(15) c/f loss	(15) c/f + (5) expense offset	(5) expense

Notes:
Assumed example of £250m UK Fund with 2% GPPS management fee. GPPS earned is £5m income per year. IM expense of a matching £5m.
Tax loss results in Yr1-3 where there is no profit earned by Fund LP. Loss is recorded and carried forward in full.
Investment exit by the Fund in Yr4 generates a large profit. That profit is sufficient to reverse GP loan and deliver an income result for the accrued balance to date, including Yr4 – income of £20m.
Carried forward tax loss is offset against profit recorded in Yr4 to protect against tax charge accrued.
Result over life of GPCo ensures no tax net charge at level of GPCo. All income is fully taxed at IM as net income.

Typical Fund and GP/ Manager structure





- The IM is typically the vehicle to employ the investment professionals and incur corporate/ group running costs.
- The IM earns a fee from the GPCo which is accrued and paid quarterly.
- The IM has no fixed life. It may hold multiple GPCo vehicles and multiple Fund LP strategies.

- GP profit share ("**GPPS**") is paid by the Fund LP to the GP on a quarterly basis from the first closing of the Fund.
- Initially the Fund LP will have no profits given new or limited investment activity – the GPPS is paid as an advance of loan pending future profit.
- As the Fund LP becomes profitable, the GPPS loan is reversed and a true profit share is allocated.
- The GPCo vehicle itself is typically a subsidiary of the Investment Manager ("**IM**") . The GP has limited activity itself; it appoints the IM as manager in exchange for a fee. It is important that the GP is a separate company from the IMfor legal and commercial reasons (investor request and ringfenced liability).
- The GPCo has a fixed term life according to the life of the Fund LP.

Proposal: Tax P&L result

	Yr1	Yr2	Yr3	Yr4	Yr5
GP profit share	-	-	-	20	5
IM fee expense	(5)	(5)	(5)	(5)	(5)
Taxable profit	-	-	-	5	-
Tax balance	(5) c/f loss	(10) c/f loss	(15) c/f loss	(15) c/f but use limited to (10), being [5+50%*10].	(5) expense and (5) c/f loss

Notes:
Example and results remain as "Today" scenario.
Restriction on utilisation of c/f losses prevents full offset to GP profit earned in Yr4. A tax charge arises at the level of GPCo which did not exist today.
The tax charge results in a cost to the GPCo which can never be used given the future offset of income/ IM expense after Yr4.