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03 February 2017

Dear Sirs

BVCA Response to DR Finance Bill 2017 as released on 5 December 2016

I am writing on behalf of BVCA to comment on the draft legislation as released on 5 December 2016.

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.

We support HMRCs objective of preventing the use of Disguised Remuneration Schemes which we understand from our meeting are marketed by certain Promoters and are prevalent in certain sectors of the market. However, we are concerned that both the Close Company Gateway set out in Schedule 10 and the provisions set out in Clause 33 are extremely widely drafted and may cause concerns in every day commercial situations that are very far removed from those targeted situations that the legislation intends to address. Even where the rules are ultimately found not to apply, the additional complexity that the potential application of the Disguised Remuneration rules adds to the tax analysis of a commercial situation or transaction should not be underestimated. Overall we would prefer more targeted legislation that more clearly focusses on the Disguised Remuneration Schemes that the Government is concerned about and would welcome:

a) an exclusion from the Close Company Gateway for companies that are close solely by virtue of being owned by a Collective Investment Scheme; and
b) an exemption from Clause 33 for payments that are within the scope of the Disguised Investment Management Fee rules.

Close Company Gateway ('CC Gateway')– s554AA et seq

While the amendments made to narrow the application of the CC Gateway are welcomed we still feel that such a gateway will bring numerous types of genuinely commercial transactions, that are clearly distinguishable from the Disguised Remuneration Schemes ('DR Schemes') marketed by Promoters, within the scope of the Disguised Remuneration ('DR') rules.

Of particular relevance for the Private Equity and Venture Capital ('PEVC') industry are the sales of shares and loan notes in portfolio companies or groups, which is the mainstay of a PEVC funds' business. It is commonplace for employees and management of a portfolio company to receive amounts on exit as a shareholder rather than as an employee and such arrangements are key to ensuring an alignment of interests between the portfolio company employees and the investors in the fund.

Companies that are owned by a Collective Investment Scheme fund partnership are "close" only by virtue of the fact that the rights and powers of third party investors (as partners in a partnership) are aggregated for the close company test. The third party investors usually have no connection at all to one another, other than investing in the same fund partnership, and have no right to participate in the management of the partnership. Quite unlike the DR Schemes described to us in our meeting with HMRC on 26 January, a PEVC fund and it's investee companies are absolutely dis-incentivised to enter into Disguised Remuneration Schemes, or indeed any kind of tax avoidance arrangements, as any such arrangements will undoubtedly be identified on disposal of the investment by the tax due diligence process. Latent tax liabilities hinder commercial disposal negotiations and agreements, leading to price chipping and unwelcome warranties and indemnities. Through the provisions of the Limited Partnership Agreement (that is agreed with third party investors), including the carried interest provisions, PEVC fund partnerships are incentivised to return all cash proceeds to investors as quickly as possible due to their finite life of typically 10-12 years, after which time it must be liquidated. Because of these commercial considerations, is motivated to ensure that the tax affairs of its portfolio companies and groups are straightforward and uncontroversial such that a smooth and efficient disposal process can be achieved.

Although we recognise that there are some exceptions in the existing DR rules that may apply to commercial sales of companies, the additional work that would be required on each disposal is not insignificant and so we would welcome an exception for companies that are only close by virtue of their ownership by a Collective Investment Scheme. If such an exception is not possible, we would appreciate a few clarifications as set out below.

- ***Exception for companies owned by Collective Investment Schemes***

Given these commercial factors and the extensive tax due diligence work undertaken on all disposals of portfolio companies/groups (that is a requirement the third party investors impose), we believe that there is already a very effective deterrent for companies owned by PEVC funds from undertaking any arrangement that could fall foul of the Disguised Remuneration rules. Therefore, as discussed in our meeting, we would welcome an exclusion from the CC Gateway for a company, or group of companies, that is only close by virtue of being held by a Collective Investment Scheme ('CIS').

There is precedent for including provisions specific to companies that are close only by virtue of their ownership by a CIS. For example, the late paid interest rules include special provision for close companies that would not be close but for the attribution of rights of other partners in the collective investment scheme (s375 CTA 2009). Specifically, the late paid interest rules do not apply where the debtor is a "CIS based close company" or where the debt is owed to a "CIS Limited Partnership" (a limited partnership which is a collective investment scheme or which would be a collective investment scheme if it were not a body corporate) and certain other conditions apply.

A CIS for these rules is defined by reference to s235 FSMA 2000:

(1) In this Part "collective investment scheme" means any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.

(2)The arrangements must be such that the persons who are to participate ("participants") do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.
(3)The arrangements must also have either or both of the following characteristics—
(a)the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;
(b)the property is managed as a whole by or on behalf of the operator of the scheme.
(4)If arrangements provide for such pooling as is mentioned in subsection (3)(a) in relation to separate parts of the property, the arrangements are not to be regarded as constituting a single collective investment scheme unless the participants are entitled to exchange rights in one part for rights in another.
(5)The Treasury may by order provide that arrangements do not amount to a collective investment scheme—
(a)in specified circumstances; or
(b)if the arrangements fall within a specified category of arrangement."

We understand that HMRC is concerned about a Promoter's ability to structure an arrangement so as to include a CIS in the structure of a DR Scheme. It is worth noting that although the definition of a CIS does not necessarily require regulated status, the CIS exception in the CC Gateway could include additional requirements such as 1) a de minimis CIS size such as £50 million (that would be too big for easy manipulation by Promoters but not too big to exclude legitimate funds), 2) the CIS must have a diverse ownership base or 3) the CIS must be managed by a regulated manager. Such regulated status, we feel, should discourage a Promoter from structuring into a CIS exception given the time and costs involved in obtaining regulated status, as well as the scrutiny from the relevant regulator that would undoubtedly result from any application for a regulatory licence. Further a targeted anti avoidance provision could be included so that any arrangement involving a CIS that had a tax avoidance motive could not access the CIS exclusion as an extra layer of protection. We are very happy to draft some clauses for such an exemption if that would be useful and to discuss other ideas for ways to structure such an exemption.

- ***Excluded transactions – s554AC(1)(c)***

While the inclusion of the "excluded transactions" definition, in particular, s554AC(1)(c), is welcome we note that only disposals of shares are covered and securities or loan notes are not. It is not unusual for companies to be capitalised both with equity as well as shareholder debt and where the shares and loan notes are sold as part of the same commercial transaction we think that it would be very helpful for s554AC(1)(c) to cover "securities" as well as shares.

In addition to equity and shareholder debt, funding of portfolio companies is also often provided by third party banks. It would be helpful if HMRC could confirm (perhaps in guidance) that this exclusion would still apply if the transaction the close company entered into also facilitated transactions connected to the sale of shares/securities such as third party debt repayment.

It would also be helpful if the application of this exclusion could be explained more fully in guidance as it is not absolutely clear whether other commercial transactions undertaken (e.g. those supporting the sale of investments by a fund) would fall within the scope of s554AC(1)(c) and if not whether (1)(b) could apply instead. A few examples are set out below which could be removed from the close

company gateway by amending s554AC(1)(b) so that sub-para (i) is deleted but the arm's length test is preserved or perhaps modified to a genuine commercial purpose test:

Example 1

An angel investor with a material interest in a close company of which he is also a director, sells his shares together with all other shareholders to an independent third party buyer. The close company pays it's adviser's invoice in relation to the sale.

In our view this may pass through the close company gateway. The payment by the buyer of consideration is an A-Linked Payment. The payment by the buyer of the consideration to the seller is a Relevant Step taken by a Relevant Third Party. The payment of the adviser's invoice by the close company is a Relevant Transaction.

The taxpayer would have to argue that the payment by the close company of its adviser's invoice falls within 554AC(1)(C). It is not entirely clear that this would necessarily be the case particularly, as noted above, if the buyer also acquired instruments in the close company other than shares or if the advice also related to the repayment of third party bank debt.

Example 2

A director shareholder with a material interest in a close company, sells his shares together with all other shareholders to an independent third party buyer. The close company has 'spare' cash on its balance sheet and therefore lends this cash to the buyer on arm's length terms.

In our view this may pass through the close company gateway. The loan made by the close company may comprise a Relevant Transaction. It is unclear whether such a loan (even if made on arm's length terms) would fall within s554AC(1).

In addition, it is not clear when the company is to be treated as a member of a group for the purposes of s554AD(5) and (6). For example, if the company set up to make the acquisition is close and the target being acquired takes a Relevant Step as part of the completion process e.g. lends money to the buyer, the question of whether the buyer is a Relevant Third Person is a key consideration. We should be grateful if HMRC could confirm (as for the 5% tests for Entrepreneurs Relief) whether a company can be considered to be part of a group on a particular day if it was a member of the group *at any point* in the day. This would greatly assist in the analysis where a target takes a Relevant Step on the same day as the acquisition takes place but before the acquisition has technically take place.

- ***Relevant transactions – s554AB(2)***

We are concerned that the breadth of the Employment Related Securities limb of Relevant Transaction contained in 554AB(2)(e) is very wide and may unintentionally catch, and therefore curtail, ordinary share ownership which cannot be the policy intention. It is also not clear to us how the phrase 'third person' in section 554AB(2)(e) should be applied as demonstrated in the following example:

> "A close company appoints a new CEO who acquires a material interest by way of acquiring shares from an employee benefit trust. The close company (or a company within its group)

makes a loan to the CEO to help fund the investment. The CEO uses the proceeds to pay full market value consideration to the EBT."

In our view it is unclear whether this arrangement would pass through the close company gateway. The loan from the close company would appear to be an A-Linked Payment under section 554AA(4) even though it has been made by the close company (or a member of its group).

The close company will likely have taken a step by virtue of which the CEO will have acquired his shares. In this context, it is unclear whether the CEO can be considered to a 'third person' for the purposes of 554AB(2)(e). This does not fit well with its natural meaning but as it is undefined and it leaves some room for uncertainty.

Even if the CEO in our example is not a 'third person', any other employee who is also being offered an opportunity to invest in the company at that time is likely to fall within that definition. The offer to both the CEO and other employees may comprise a single set of Relevant Arrangements or at least be connected such that the close company will have undertaken a Relevant Transaction within 554AB(2)(e).

The transfer of shares from the EBT to the CEO (and others) will likely comprise a Relevant Third Party taking a Relevant Step (within 554A(2)).

It is unclear to us why such an arrangement should be caught. It would be helpful if the term 'third party' could be clarified. Should this be a reference to a 'Relevant Third Person'? Similarly, it would be helpful (and presumably in line with the policy intention) if the definition of A-Linked Payment was clarified to say that it had to be provided by a Relevant Third Party.

- ***Other existing exemptions in the DR rules –s554Z8 and s554N(11)***

These new provisions have highlighted the fact that HMRC clarifications or guidance on the existing exceptions in the DR rules would be very useful. In particular, in s554Z8 there is some ambiguity as to the timing of the transfer of the asset and the time that the relevant step is taken. In disposal scenarios it is commonplace for an element of the consideration to be put into a commercially agreed escrow, such that the consideration will not be released until such time as agreed between the third party buyer and seller. It would be very helpful if HMRC could make clear that a genuinely commercial escrow arrangement is not a "relevant step" for the purposes of the DR rules.

Also, it would be helpful if HMRC could confirm that if s554N(11) applies to an Employment Related Security, then the disapplication of Chapter 2 applies equally to the CC Gateway as it does to the Employee Gateway.

Clause 33 – Trading income provided through third parties

As noted above we are concerned that the provisions included in Clause 33, which extend the application of the DR rules to self-employed individuals alone or in partnership, are drafted incredibly widely. As investment managers frequently provide their services via a limited liability partnership ('LLP') of which they are members, and are therefore self-employed, we are concerned that the DR legislation could apply to amounts of carried interest and co-investment returns received.

All amounts that investment managers receive, from 6 April 2015, potentially fall within the scope of the Disguised Investment Management Fee ('DIMF') rules. The DIMF rules set out a comprehensive framework within which all amounts that an investment manager receives from an investment scheme are taxed and sets out what amounts should be taxed as trading or employment income or investment returns. Overlaying the DIMF provisions with DR rules, seems unnecessarily complex and unwieldly and could potentially inadvertently override the carefully thought out consequences of the DIMF rules discussed in great detail with HMRC and HMT. We would therefore encourage HMRC to consider an exception from s23A to D for individuals who fall within the scope of the DIMF rules so far as the arrangements related to an investment scheme. It is difficult to see how such an exclusion would provide Promoters of, or users of, DR Schemes with an opportunity of structuring into the DIMF rules with a view to falling outside the DR rules.

In addition, we are concerned that the exception for loans on "ordinary commercial terms" included in the s23A et seq is too narrow. It is not uncommon for managers of PEVC funds to take out loans from third party banks to fund their co-investment. The terms offered on such loans are typically not comparable to the terms of loans that would generally be made to members of the public. For example, they usually require repayment only after a prolonged period of time (to reflect the return profile of the co-investment made by the individuals) and are secured on the co-investment which may be seen to be rather risky collateral. In addition, lenders specialising in such loans are not always in the business of making a substantial loans to members of the public. As such, the exception in s23B(4) is of limited use for investment managers that have taken out such loans and so could result in these arrangements, which have nothing whatsoever to do with disguising remuneration.

We would be very happy to discuss the points set out above with you and look forward to hearing from you as to whether you have any questions or need any further clarifications or details.

Yours faithfully

David R Nicolson
Chairman of the BVCA Taxation Committee