VAT grouping – Establishment, Eligibility and Registration – Call for Evidence
By email: hmtvatandexcisepolicy@hmtreasury.gov.uk

19 November 2020

Dear Sirs,

Re: BVCA response to to the HM Treasury call for evidence on VAT grouping provisions

We are writing on behalf of the British Private Equity and Venture Capital Association ("**BVCA**"), which is the industry body and public policy advocate for the private equity and venture capital industry ("**PE/VC**") in the UK. With a membership of over 700 firms, the BVCA represents the vast majority of all UK based PE/VC firms, as well as their professional investors and advisers. BVCA members invested over £43bn into nearly 3,230 UK businesses in the period 2015-19, the majority being SMEs, and companies backed by PE/VC currently employ around 972,000 people in the UK.

We are writing to set out the BVCA's response to HM Treasury's Call for Evidence, published on 28 August 2020. Our response focusses on the questions raised in Chapters 2 and 3 of the Call for Evidence, concerning compulsory grouping and grouping eligibility criteria for businesses currently not in legislation, including limited partnerships.

Background to the BVCA's response

The UK hosts the most important PE/VC ecosystem outside the USA, which generates significant numbers of highly skilled jobs and adds a significant dimension to the country's global importance as a financial services hub. However, in an ever-complex operating environment the tax, legal and regulatory advantages of establishing a PE/VC fund and/or manager in the UK have been eroded as overseas jurisdictions developed more favourable regimes and the UK has not kept pace with these developments. There are plenty of jurisdictions which welcome UK fund managers with open arms and, particularly in light of Brexit, continue to evolve and strengthen their operating frameworks to ensure their country remains competitive to the PE/VC industry.

VAT grouping plays a critical role in PE/VC investment fund structures in the UK. For this reason we welcome the opportunity to provide input on HM Treasury's review of this area.

However, as you will see from our detailed responses below, we wish to register some significant concerns around any future policy change in respect of compulsory grouping and/or the VAT grouping eligibility criteria for limited partnerships.

Our concerns around compulsory VAT grouping centre on the impact this could have on long established structures adopted within the PE/VC sector (through which the investment manager is typically VAT grouped with the fund and its general partner) and also the potential impact if portfolio investments were themselves required to join VAT groups with the investment manager and/or with other portfolio investments controlled by a particular fund.

In respect of the position concerning limited partnerships, UK PE/VC fund partnerships have been structured for many years following HMRC's longstanding taxable person policy for limited partnerships, which we believe is derived from jurisprudence (rather than extra-statutory

concession). We would mention here also that this treatment was discussed recently with HMRC in the context of responses to the changes to the rules relating to the use of carried forward losses by UK companies (see attached BVCA member briefing). During our earlier discussions with HMRC it was clearly accepted that this policy is still valid and extends to cases where the fund manager is appointed by the general partner on behalf of and at the cost of the fund as well as where the manager is appointed by and at the cost of the general partner.

A fundamental change in the policy for limited partnerships resulting in VAT being charged on the management fee would cause very significant harm to the PE/VC industry, and inevitably lead to PE/VC members choosing to relocate such funds outside of the UK. There are already significant VAT advantages to basing a PE/VC fund partnership outside the UK. A change leading to VAT being charged on the management fee would make the use of UK funds unsustainable.

In his most recent Budget the Chancellor expressed his intention to review the tax, regulatory and legal regimes applicable to funds and fund managers with a view to making the UK an attractive location for the asset management industry. The current consultation on the use of UK asset holding companies is the first step in this process. It is hard to see how imposing VAT on the cost of managing UK-based PE/VC funds (and thus increasing those costs by 20%) is even remotely consistent with this objective.

We have set out our concerns in more detail below in response to the questions in Chapter 3 of the Call for Evidence.

We have also included specific comments on the implications of compulsory VAT grouping (Chapter 2) from a PE/VC industry perspective.

Response to Call for Evidence questions

Chapter 2 – Compulsory VAT grouping

Question 16: What benefits or disadvantages could a system of compulsory VAT grouping deliver for businesses? Would this vary between different sectors?
Question 20: Are there any instances where businesses are not VAT grouped for specific commercial or regulatory reasons? Please provide examples.

PE/VC businesses use fund vehicles to pool the capital of investors (such as pension funds and high net worth individuals) and invest it by acquiring shareholdings in other businesses. Further detail on the typical set-up of PE/VC structures and the use of limited partnerships is given below in our response to HMRC's questions in Chapter 3 of the Call for Evidence.

As a result of their investment PE/VC funds may hold controlling interests in investee companies. The same fund partnership could hold controlling interests in a number of different companies that operate independently, across entirely different sectors, and (other than investment by the same PE/VC fund) are unconnected.

We would therefore express concern that, if the UK introduced a system of compulsory VAT grouping, this could lead to a requirement to form VAT groups which include not just the fund entities themselves (i.e. the fund partnership, the investment manager etc), but also investee companies that might (and normally would) meet the relevant control / beneficial ownership conditions.

There does not appear to any commercial, practical or obvious policy rationale for compulsory VAT groups being created. Moreover, if implemented, this proposal would create significant issues – for example the impact on the VAT recovery position / partial exemption methodology of investee businesses operating in different sectors and with different profiles being compulsorily grouped together. The joint and several liability implications would also cause material legal and commercial concerns. For example, lenders will typically require borrowers not to join VAT groups with companies outside the security group (i.e. those companies over the assets of which the lender has security). This is for the obvious reason that a lender will not want these companies to be liable for the debts of other entities over which it has no control. At the moment this risk can be managed by choosing which companies form a particular VAT group. The risk of borrowers being liable for the VAT debts of companies outside the security group (particularly if that extends to the VAT debts of all portfolio companies of a single fund) will have a material impact on the value of the lender's security and willingness to lend.

With reference to paragraph 40 of the Call for Evidence, if an 'all in or all out' model of compulsory VAT grouping was introduced, this would mean that investee companies under common control would not be required to VAT group (if opted out), but in turn this could impact the investment manager's ability to VAT group with the fund and its general partner (discussed in detail below). An inability to VAT group could create significant VAT and commercial implications for the UK PE/VC industry, as outlined in detail in our response to question 25 below.

Chapter 3 - Eligibility criteria: partnerships

Question 21: How do limited partnerships (LPs) and Scottish limited partnerships (SLPs) currently participate in VAT groups?

Limited partnerships are regularly included by UK PE/VC managers in their VAT groups where the general partner is a UK established corporate body that is responsible for operating the partnership, and that general partner meets the normal control conditions for VAT group membership with other corporate bodies. It might be more accurate to say that supplies made by or to the fund are treated as made by or to the general partner (and so by or to the VAT group of which the general partner is a member) than to say that the limited partnership itself is in the VAT group. The same position has been adopted in respect of Scottish limited partnerships, in accordance with the BVCA's correspondence with HMRC's VAT Registration & Accounting Policy team in 2014, copies of which are enclosed.

Question 22: How do LPs and SLPs tend to be used within the structure of corporate groups and what is the commercial rationale for inserting them into VAT groups?

Limited partnerships (both English and Scottish) are used extensively by PE/VC businesses as the typical fund vehicle to pool the capital of investors, including institutional investors and high net worth individuals (i.e. the limited partners), and then invest this capital in shares in or loans to portfolio companies. Limited partnerships have been used as PE/VC (and increasingly for other asset classes such as real estate) fund vehicles in the UK since 1987 when their direct and indirect tax treatment (as well as certain legal and regulatory issues around their use and operation) was discussed by the BVCA and the UK government. The use of limited partnerships in fund structures is attractive to the PE/VC industry as investing via a partnership puts the investors in a similar position to that which would have obtained had they invested in the underlying asset(s) directly. Using partnerships as fund vehicles (outside the retail investor space) is common in many countries including the US, the Channel Islands and Luxembourg.

These fund limited partnerships typically form a part of a larger group of entities, controlled by the relevant asset manager. For example, a private equity firm may operate a number of limited partnerships for investment by different investors or for pursuing different investment strategies.

One entity may act as general partner for several limited partnerships or each may have a separate general partner. The general partner[s], which would typically meet the control criteria for VAT grouping with the investment adviser/manager, will in turn contract with the investment adviser/manager within the group for a range of investment and fund management services.

The inclusion of limited partnerships within a VAT group via their general partner[s] therefore provides administrative ease and prevents multiple VAT registrations being required. In addition, groups including limited partnerships will usually require intra-group supplies of services (i.e. the provision of investment advisory/investment management services described above) from the investment adviser/manager to the general partner/limited partnership fund.

VAT grouping helps to prevent irrecoverable VAT being suffered on such charges. The typical activities of limited partnerships in this sector (often a mixture of exempt and taxable supplies) would potentially lead to substantial irrecoverable VAT on these charges in the absence of VAT grouping.

Question 23: What, if any, commercial reasons are there for having more than one general partner in a LP that may affect VAT grouping arrangements?

No specific comments.

Question 24: In cases where a LP has more than one general partner, what commercial reasons are there to add more than one general partner to the same VAT group?

No specific comments.

Question 25: If the test for VAT grouping LPs/SLPs changed to a control and beneficial ownership test, how would this affect current VAT groups and the LPs/SLPs in question, including those that would be able to VAT group, and those that would have to be removed from existing VAT groups?

Limited partnerships are currently able to participate in UK VAT groups (with their investment adviser/manager) through their general partners.

This treatment is automatic as a matter of law, see the decision in *H Saunders & T G Sorrell* (VTD 913). HMRC's own Manual confirms this; see paragraph VATREG09350 which observes that "As a limited partner is unable to take part in the management and running of the partnership business, it has been ruled by the Tribunal that he cannot be said to be making taxable supplies in the course and furtherance of that business." As *Saunders & Sorrell* confirms, the business is being carried on only by the general partner and that is why supplies by and to the partnership are treated as made by and to the general partner. The current position is established as a matter of law; it is not an extra-statutory concession offered by HMRC.

English limited partnerships do not have separate legal personality and there is currently no means under existing UK VAT legislation to recognise them as a taxable person separate from

their general partners. As such, it is not clear how a "control and beneficial ownership" test could apply to a limited partnership's participation in VAT groups without:

- providing a legislative mechanism of registering the LP for VAT separately from its general partner(s); and/or
- excluding general partners of limited partnerships from being able to join a VAT group, despite otherwise meeting the normal conditions.

For the purpose of this response, we have assumed that the proposal we are examining is that VAT group treatment will not apply to a supply from one company ("Company A") in a VAT group to another company which is or on its own qualifies to be a member of that VAT group ("Company B") in its capacity as the general partner of a limited partnership or to a supply from Company A to a limited partnership of which Company B is the general partner unless the limited partnership in question would qualify to be a member of that VAT group if it were a company. It would be helpful to discuss with you exactly what you have in mind here, in particular if the proposal you are contemplating is narrower than we currently imagine it to be.

In the vast majority of cases (except where the manager is operating an "in house" fund for group entities) "beneficial ownership" (in the sense of where the economic value of the fund lies) will be in the hands of third party limited partners (who will have invested in the fund and be entitled to receive the returns from the fund investments except to the extent that executives have a carried interest entitling them to receive distributions in certain cases (and these individuals will clearly not be group entities) or the general partner has a priority profit share or the manager an entitlement to be paid a fee), meaning the limited partnership would cease to be eligible for VAT grouping with the fund manager. On that basis we assume that your proposal is that VAT grouping treatment would not apply to a supply between a company in the same VAT group as the general partner of that fund partnership and either the general partner company or the fund partnership.

As explained above, this could create a substantial amount of irrecoverable VAT on charges for investment advisory and investment/fund management services which are currently treated as intra-group services. In this context it is important to note that the VAT exemption for the management of special investment funds, does not normally apply to fund management services in respect of limited partnership funds.

It is expected that, if a change were introduced which results in VAT group treatment no longer applying to investment services supplied to a general partner or a fund limited partnership, then many of our members that routinely use limited partnerships within their investment structures would choose to establish and operate their funds outside the UK (e.g. in the Channel Islands or Luxembourg) going forward – particularly any new funds. Indeed, it is hard to see how they could justify using UK fund vehicles or expect to remain competitive if they did.

Another point we would highlight in respect of the possible impact of any changes on the PE/VC industry is that fund structures using limited partnerships are typically established with a view to being in place for a number of years (e.g. 5 - 10+ years). The introduction of changes to the VAT grouping rules for limited partnership funds without appropriate grandfathering provisions would inevitably lead to significant unanticipated irrecoverable VAT costs arising for existing funds unless they are migrated to a place of establishment outside the UK. Doing this will create challenges and significant costs for both the underlying investors and the fund managers and would create enormous negative publicity for the UK as a funds domicile.

In light of the UK Government's previously stated aim to enhance the ongoing competitiveness and sustainability of the UK as a jurisdiction of choice for the asset management industry, we believe it is critically important to maintain the existing position and not disturb the many PE/VC fund structures which have been established in the UK relying on UK law and HMRC policy which have been settled for over 30 years.

Question 26: When considering the normal eligibility tests for VAT grouping, what would the impact be on VAT groups if those tests were applied to LPs and Scottish partnerships as a whole rather than just general partners?

As above, in many cases limited partnerships would be unable to participate in UK VAT groups if the eligibility test applied to the whole limited partnership.

Question 27: Would it be beneficial to allow Scottish partnerships to join a VAT group subject to the same rules as other entities (i.e. where they are controlled, rather than controlling all other members of the VAT group)? Should the same treatment also apply to general partnerships?

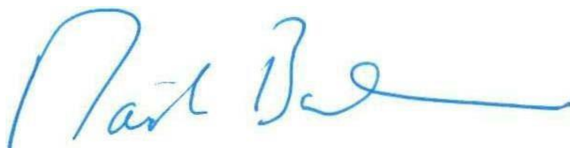
We believe that Scottish limited partnerships should continue to be treated in the same way as English limited partnerships, as previously agreed with HMRC policy in our 2014 correspondence (attached).

Question 28: Were any changes discussed in chapters one and two to be implemented, how could they impact on the inclusion of partnerships within VAT groups?

See response above in relation to possible impact of compulsory VAT grouping on the sector.

We would be grateful for an opportunity to meet and discuss the feedback provided in this letter. Please let us know if you have any comments or questions in the meanwhile.

Yours faithfully,



Mark Baldwin
Chairman of the BVCA Taxation Committee

Enclosed:

1. BVCA Technical update - carried forward losses

2.a 140924 Correspondence - HMRC to Richard Vitou

2.b 141021 Correspondence - Richard Vitou to HMRC