Pillar Two Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

By email: pillartwoconsultation@hmtreasury.gov.uk

20 September 2022

Dear sirs

Re: BVCA comment on Pillar 2 draft legislation

We are writing on behalf of the British Private Equity and Venture Capital Association, which is the industry body and public policy advocate for the private equity (PE) and venture capital (VC) industry in the UK. With a membership of over 750 firms, we represent the vast majority of all UK-based private equity and venture capital firms, as well as their professional advisers and investors. Between 2017 and 2021, BVCA members invested over £57bn into around 3,900 UK businesses, in sectors across the UK economy. Companies backed by PE/VC currently employ over 2m people in the UK and 90% of the businesses our members invest in are SMEs.

The BVCA welcomes the opportunity to comment on the draft legislation released on July 20, 2022 (the "Draft Legislation") implementing the domestic rules of the global minimum tax envisaged by Pillar Two of the second stage of the OECD's Base Erosion and Profit Sharing ("BEPS") initiative. We note that the Draft Legislation closely follows the model rules (the "Model Rules") released by the OECD in December 2021.

As a general matter, we welcome the decision to delay the application of the UK legislation in this area to accounting periods beginning after December 31, 2023. This is a much more appropriate timetable and, it is to be hoped, will enable due consideration to be given to the extremely complicated provisions which will be required to be adopted. However, we are slightly disappointed that, despite the comments in our response dated April 4, 2022 to the consultation on potential UK rules in this area, the Draft Legislation remains almost identical to the Model Rules, even in areas where there is no clear rationale for the provisions or where they are inappropriate in a UK context.

Key point - scope

As stated in our aforementioned letter of April 4, 2022, our general "starting point" for investment funds would be that they should not be within the scope of this legislation. This is on the basis that investment funds and, in most cases, the holding entities which they directly own do not generally consolidate with their controlled portfolio companies due to specific exemptions in most generally accepted accounting principles relating to investment entities. On this basis, our view is that funds and such entities should fall outside the regime.

However, certain specific exclusions from consolidation which apply to investment funds and entities owned by such funds expressly do not apply for the purposes of Section 5 of the Draft Legislation. This means that at present they can form part of a 'consolidated group' and therefore be taken into account in considering whether the entities they own themselves form part of a consolidated group.

The definition of 'consolidated group' within Section 5 at present works on a basis that not only captures groups that actually prepare consolidated accounts (which as explained above, most investment funds and the entities they own do not), but also requires one to consider 'theoretical' consolidated groups in some circumstances.

In particular Section 5(2)(b)(ii) includes in a consolidated group certain entities, ordinarily excluded from consolidated financials, where they are not included "on the grounds that entity in question is held for sale". However, in some circumstances within the investment structures of funds, it is possible that, where (for accounting purposes) an 'investment entity' exclusion from consolidation does not apply, holding companies and portfolio companies within a fund investment structure may be relying on the fact that they are being 'held for sale' to exclude them from requirements to consolidate with the fund or certain holding companies wholly owned by the fund. Where funds do rely on this exclusion its disapplication in Section 5(2)9b)(ii) would appear to bring such entities within the scope of a 'consolidated group' for the purposes of Section 5. This risks placing an unacceptable compliance burden on funds, effectively requiring the preparation of consolidated accounts for lower tier entities in order to determine whether they are within the scope of the Draft Legislation, simply because they fall within a purely theoretical 'consolidated group' as a result of their ownership by an ultimate parent entity in a fund structure, which is itself an investment entity that is exempt under the regime,. Our view is that if an acceptable financial accounting standard does not require portfolio companies of funds or investment holding entities to be consolidated then this should not be assumed away by disapplying the entire 'held for sale' exclusion, since doing so potentially brings funds back within the regime. As it stands a portfolio company could be significantly disadvantaged if it is bought by the master holding company used underneath a fund structure, which causes it to be treated as within a consolidated group on the grounds that it meets the revenue threshold; whereas if that same portfolio investment was bought privately by an investment entity or a smaller fund, it would not suffer this disadvantage. As such we consider that this provision has the scope to distort competition within the market and should be amended to remove this exclusion. This should be clarified to ensure that, as with CbCR, the fund industry is not impacted by this regime.

We also remain concerned that the definition of "consolidated financial statements" at Clause 89 of the Draft Legislation is not as clear on this point as is desirable. As we stated in our letter of April 4, the Model Rules (see Article 10.1.1 definition of consolidated financial statements at (d) reflected in the Draft Legislation at Clause 89(d)) arguably seem to provide that, even where the relevant acceptable accounting standard would not require it, an entity is deemed to have prepared financial statements on a consolidated basis as if its acceptable accounting standard *had* required it. There is no wording to suggest you only run this rule where relevant or applicable (such as in the context of section 5 as discussed above) and so it reads as a blanket requirement to treat all entities as preparing consolidated accounts on this basis. We do not believe that this is intended and the Explanatory Notes accompanying the Draft Legislation would suggest that it is not intended. However, if it is not intended then Clause 89 is oddly drafted in that the alternative reading seems to provide that entities which prepare their accounts in compliance with an acceptable accounting standard which does not require consolidation cannot fall within Clause 89(a) but must rely on Clause 89(d). This may appear to be a minor point if the intention is as it would appear from the Explanatory Notes but, as we stated previously, it is significant for funds in that it could, inadvertently bring portfolio companies in a fund structure within the scope of the Draft Legislation. It is also inconsistent with the equivalent rules on Country-by-Country Reporting ("CbCR") which only require consolidation if actually required by relevant accounting rules and, if this point is not clarified now, we are concerned that the interpretation could alter, potentially by reference to the difference from the CbCR rules. Accordingly, we strongly urge that this is resolved.

Assuming the foregoing points are addressed, we would have relatively few comments on the Draft Legislation on the basis that we would not expect the investment fund industry to be greatly affected. However, in the unlikely event that there are residual issues we would make certain additional points (which, essentially, we made in our submission of April 4, but which do not appear to have been addressed).

We very much welcome the clarification at Section 6(3) to include within the categories of excluded entities investment funds that would be UPEs but for the fact that they do not produce consolidated accounts. However, we still do not understand why investment funds are only excluded entities if they are the ultimate parent in a structure. There does not appear to be a rationale for this and, absent such rationale, it is unhelpful to simply copy the Model Rules on this point, given that a wider range of entities (such as intermediate parent members and partially-owned parent members) may be 'responsible members' under Section 7. In our view investment funds should be included in the list in Section 6(2), not 6(3), given that it is clear that a much wider range of entities can be held responsible under the regime.

We would urge that the Qualifying Asset Holding Company ("QAHC") is specifically identified as an excluded entity. It is possible that such companies may not always fulfil the definition of "qualifying service entity" in Clause 6(4) and it is entirely intended that the QAHC is subject to a special tax regime. It has within the terms of that regime its own qualifying ownership criteria and other parameters that adequately ring fence the circumstances in which it can be used.

We do not think that partnerships are properly addressed in the rules. For example, at Clause 16(b), a partnership may not be "flow through entity" if it has a place of business in its territory of creation. It is common for limited partnerships to have such a 'place of business' where created and as such our view is that this criterion should be removed. Similarly under limb (c) investors in an English limited partnership for example may well technically have a UK permanent establishment in the form of an investment manager or general partner acting on their behalf, but the UK would not seek to tax profits attributable to the investors on that basis unless the partnership was trading (rather than carry on an investment business); as such we think this concept needs further refinement and clarification.

Furthermore, in the definition of ownership interest at Clause 95, partnerships and types of 'entity' (as defined) that are not legal persons are not well accommodated. A partnership in English law (being merely a relationship between the partners) is arguably not, in itself, entitled to a share of profits of another entity – the partners in the partnership are so entitled. It should be clear how partnerships are to be treated for the purposes of these rules and the Draft Legislation does not appear to have been considered by those with a proper understanding of how partnerships operate. This needs to be addressed.

Please do not hesitate to contact us should you have any questions or wish to discuss our feedback in more detail please contact Rachel Gauke.

Yours sincerely,

Mark Baldwin
Chairman of the BVCA Taxation Committee