bvca The voice of long-term investment

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Mr Wayne Strangwood
HM Revenue and Customs
Room 3C06
100 Parliament Street
London SW1A 2BQ

Dear Mr Strangwood

Modernisation of the tax rules for investment trust companies and Modernisation of company law rules on distributions by investment companies

We write in response to the above named Consultation Document dated 27 July 2010.

We welcome the opportunity to participate in this consultation to modernise the Investment Trust Company ("ITC") tax rules in sections 1158-1162 CTA 2010 (formally section 842 of ICTA 1988).

We respond in our capacity as a representative body for the British Private Equity and Venture Capital industry ("BVCA"). The BVCA has more than 430 members. This includes over 230 private equity, mid-market and venture capital firms (10 of which are Private Equity Investment Trusts[1]) with an accumulated total of approximately £32 billion funds under management, as well as over 220 professional advisory firms.

The Consultation's detailed aims of allowing the ITC sector to undertake a wider range of investment strategies, providing certainty on what transactions can be undertaken and reducing administrative costs, are all to be applauded.

Our concerns, as set out below, focus on ensuring these aims are achieved and that the Government avoids a situation where the current well understood, but somewhat mechanical tests, are replaced with other tests which give rise to new uncertainties as to their correct application.

Point 1 – Comment on the proposed approach to defining a closed-ended investment fund for tax purposes

[1] See http://www.bvca.co.uk/assets/features/show/PEInvestmentTrusts for a full list of our members that are Private Equity Investment Trusts ie: ITCs investing directly or indirectly in Private Equity assets.

The proposed wording (in paragraph 4.6 of the consultation document) is "a closed-ended investment fund means an investment company whose **sole** object is investing and managing pooled funds **contributed by holders of its listed securities**:

(i) in property of any description
(ii) with a view to spreading risk"

We note the stated intention was to use a definition similar to that used in chapter 15 of the Financial Services Authority ("FSA") listing rules. However, the proposed wording is more restrictive than the FSA chapter 15 definition because:

1. It requires that the "sole" object of the fund to be investing and managing pooled funds whereas the FSA definition only requires that to be the fund's "primary" object.

2. It refers only to investing and managing pooled funds contributed by holders of the ITCs listed securities, rather than the FSA definition which requires the funds to manage their "assets", which are then defined to include pooled funds contributed by holders of its listed securities.

The proposed wording would have the effect of excluding a number of existing ITCs under the new regime, which is presumably not the intent of the new regime.

We recommend the tax and FSA definitions are fully aligned. By having a different tax definition to the general FSA definition adds unnecessary complexity to the new rules. It also opens the door to potential situations where a fund meets the FSA chapter 15 definition, but does not meet the stricter tax test.

Whilst we agree investing and managing the pooled funds contributed by holders of the ITCs listed securities must be the significant part of the ITCs activities, as a practical matter there will be situations where the ITC is:

1. Also managing assets funded through other means (eg through gearing from bank debt or similar). The proposed definition does not appear to include funds that ITCs borrow from institutions who are not shareholders of that ITC, to leverage their investments. The ability to leverage assets is a key requirement for an ITC, and not including this within the proposed definition of an ITC would restrict the ability for an ITC to operate effectively, and may exclude many existing ITCs from continuing to qualify; or

2. Carrying on any non-core activities (e.g. underwriting activities or providing investment management services to other third parties) could prevent an ITC from being regarded as "solely" focused on investing and managing the pooled funds of the holders of the ITCs listed securities.

Point 1 – Exclusion of the holding company of a trading group from the definition of an ITC

We understand the desire to limit the benefits of the ITC tax regime to close-ended investment funds. Given that Substantial Shareholdings Exemption ("SSE") is already available to trading groups on share sales, the concern here is presumably

focused on property investment groups or other trading groups with material levels of property or other assets not qualifying for SSE.

Our concern is to ensure that any holding company exclusion does not inadvertently stop ITCs from benefiting from the new regime where they hold some of their investments through holding companies, i.e. this exclusion could have the effect of turning the current investment test holding of 15% into a "50%" test, with the result of creating additional requirements under the new regime.

These intermediate holding structures are typically used to minimise overseas tax leakage (e.g. withholding taxes costs which the ultimate investor may not easily be able to re-claim or involves significant administrative effort to do so) and also to simplify administration (for example claims for withholding tax etc).

This is a particular issue for Private Equity Investment Trusts, as they make investments into Private Equity funds, often via intermediate holding structures. A widely drafted holding company exclusion could inhibit the ability of Private Equity Investment Trusts to invest in an unfettered way going forward. We understand a number of group structures have already been provided by particular ITCs illustrating the issue. An example of such a problematic structure is provided in Appendix 1.

Given this is a key area for the BVCA, we would welcome the opportunity to comment specifically on the detailed proposals around this exclusion.

It may be that, in fact, the basic wording proposed in paragraph 4.6 is already sufficiently robust to deal with the problem because it is unlikely the holding company of a listed trading or property development group (for example), could be argued to be investing and managing its funds "with a view to spreading risk" as it will not have an appropriate investment policy to meet this test and this could be used as the necessary filter.

This message could be reinforced by formally excluding holding companies from the benefit of the ITC regime "***unless*** they are held by an ITC as part of or in accordance with its investment policy".

Point 2 – (a) Proposal to move to an up-front application process

Removing the need to obtain an annual confirmation from HMRC at the end of each accounting period that the ITC conditions have been met should give a reduction in the administrative burden, provided the new regime gives sufficient certainty that the ITC continues to qualify for the special ITC tax regime.

Practically, this administrative saving is probably smaller than it initially appears because ITCs would still need to monitor compliance with the new regime internally, provide evidence to their auditors that the exemption from corporation tax on capital gains applies each year and possibly provide confirmation to existing and potential investors that it remains a qualifying ITC (see also below regarding breaches). The main benefit would therefore be for HMRC in terms of not having to process the annual confirmations.

Applications for new ITCs

We would particularly urge that there is an initial up-front clearance procedure prior to the listing of a new ITC. It would be helpful for HMRC approval to be granted for a new ITC on the basis of the information provided in a draft prospectus so that the final prospectus could confirm approval to enter the ITC tax regime had been obtained.

Ongoing information requirements

It is attractive that the ongoing information requirement (other than notifying HMRC of any breach etc) is limited to the requirement to submit the ITCs current investment policy. An ITC is required to meet FSA requirements set out in chapter 15 of the FSA handbook as part of its regulatory obligations, including ensuring that the investment policy is kept current.

It would be helpful to have confirmation that investment policy documents prepared and submitted by ITCs to the FSA should also be acceptable for HMRC purposes. It would also be helpful to have examples of the (presumably) limited circumstances in which an investment policy could be challenged by HMRC.

In addition a clearance procedure for proposed changes in investment policy (ie: when the published investment policy is changed) would be sensible.

Point 2 – (b) Provisions that should enable a smooth transition to the new regime

We note your comments in paragraph 5.20 in relation to transitional arrangements for existing ITCs moving to the new regime.

Given there are currently over 200 ITCs in the UK we suggest that these ITCs are automatically transferred into the new regime (unless, exceptionally, ITCs specifically notify HMRC they want to opt-out of this "grandfathering").

This would allow HMRC to manage the switch-over efficiently. It would be unhelpful if all 200 ITCs are required to formally apply for admission at much the same time, giving rise to potentially long delays for individual ITCs in receiving confirmation they had been admitted to the new regime.

We have no specific comments on SI 2009/2034, other than to welcome the simplification and the abolition of the "prospective investment trust" test (presumably no longer required because ITCs will be Investment Trusts ab initio).

The proposal to adopt a similar model used by AIFs in setting out a 'white list' of transactions which will be treated as non-trading activities is very useful. The broad categories proposed in paragraph 5.10 could also include revenue earned from overseas investments.

It would also be helpful if examples of transactions under each category are provided as well as a more detailed list of activities which will not be regarded as relating to trading activities. Furthermore, this list of non-trading activities should apply in all situations, not just ITCs, to avoid cases where an activity would be non-trading for

one type of entity (say an ITC) but would be considered trading for another type of entity.

Given the rapid evolution of investment assets, we also suggest that HMRC consider a clearance process for new financial products developed in the future, and for newly approved transactions to be added to an updated white list. This would be helpful in providing clear guidance to the ITC industry and also in minimising the number of queries that HMRC could receive from a number of funds seeking clarification.

We would hope that the changes being proposed would provide an opportunity to revisit the need for section 1160(4) CTA 2010, which can, in some circumstances, treat income from certain overseas investments as non-qualifying. This rule can create difficulties for an ITC if it is forced to distribute income that has been regarded as non-qualifying in order to meet the conditions for approval of its ITC status.

General comments on the proposed new compliance regime

Whilst there is no specific consultation question asking for comments on the proposed new compliance regime in general we have two areas of concern.

Firstly we believe ITCs need clear guidance as to what will constitute the various types of "breach" under the new rules and secondly - and from a practical perspective most importantly - guidance and assistance from HMRC in giving individual ITCs comfort their procedures to monitor compliance with the new regime are sufficiently robust to be acceptable to HMRC.

It seems to us this second point is critical if a self assessment regime is to give investors sufficient confidence in an individual ITC's tax status.

Definition of a "breach" and associated terms in the new regime

We note an ITC would be asked to leave the new regime if it made repeated deliberate breaches or was "non-compliant" (paragraph 5.15).

Will minor and inadvertent breaches be counted in cases of non-compliance?

We assume non-compliance means making repeated "minor" and/or "inadvertent" breaches (it is not clear if you would count breaches "remedied without delay" in the proposed totals) or if this only counts breaches which are more than minor or inadvertent (or not remedied without delay) but are not deliberate.

It would be helpful if these terms could be clarified with examples of the sort of situations which would give rise to the various types of breaches and what actions HMRC would take.

How will events outside the ITCs control be treated?

A key issue will be to understand to what extent HMRC will seek to penalise breaches which are outside the direct control of the ITC, particularly where the ITC has no means of controlling or minimising that risk.

For example, if an ITC is unable to control who owns its listed shares at any particular time (because they can be freely traded) it could move between being

close and not-close through transactions completely outside its knowledge and control.

Or to give another example a Private Equity Investment Trust may invest into a Private Equity fund (which it does not control). That Private Equity fund could then do something at an underlying level which makes the Private Equity Investment Trust fail the detailed rules.

Other points include:

1. Whether the ten year period would have a fixed start and end date, considering whole accounting periods or be a rolling ten year window.

2. Where the same breach occurs a number of times before the issue is identified, would this be counted as one or several breaches.

Leaving the ITC regime through expulsion

Where an ITC is required to leave the regime we believe there should be a right to appeal.

It may also be appropriate to allow certain ITCs to re-join the regime at a later date if and once they can demonstrate that their processes have been revised to address previous compliance failures.

It will also be important to understand when the CGT exemption is removed on expulsion from the regime. We understand current the proposal is that it would be the end of the previous accounting period. This would presumably mean that capital gains could retrospectively arise on transactions occurring in the same Accounting Period as, but before, the final default event causing expulsion from the regime?

Reporting of breaches

Will ITCs be required to report breaches to HMRC as they occur or will it only be a requirement to notify on the third/fourth breach?

It would seem to us helpful for HMRC to require notification of breaches so they can review systems in problem areas etc rather than only becoming aware of the problem when the ITC is in an expulsion situation.

Penalties for non-compliance and length of the monitoring period

We appreciate HMRC have a right to expect taxpayers to take compliance issues seriously, particularly where they wish to benefit from a special regime, and rules must have punitive measures in place for those who break the rules. However, the consequences of a breach must be proportionate to the transgression.

Whilst we are pleased that the Revenue are not proposing severe penalties for initial breaches, it must be the case that the Revenue's concern is to prevent the tax on capital gains exemption being abused and we would expect the most severe penalties to be restricted to those cases. It would be helpful to understand to what extent an ITC would be open to the usual tax penalty regime for process weaknesses.

Provided suitable clarity can be provided upon exactly what qualifies as a breach (and in particular that minor and inadvertent breaches do not have to be counted) we feel the proposal of exclusion on three or four breaches in a ten year period sets an appropriate hurdle in terms of compliance.

Determining whether the policies an ITC has in place to monitor its compliance are sufficiently robust

A key issue for many ITCs will be to ensure its procedures for monitoring the new ITC tests are sufficiently robust. It would be helpful if HMRC could give guidance on these matters for example how often they expect tests to be carried out - on every transaction, daily, weekly, what level of review is required, etc.

It would also be helpful if HMRC would:

1. Discuss proposed monitoring policies with ITCs so they could be agreed as reasonable and any ITC specific issues discussed and procedures to address these points agreed.

2. Put in place a process whereby if an ITC is concerned that it could be in a breach position or that a potential transaction could be a breach, that the ITC could consult with HMRC and obtain a clearance on the point in question in a timely manner.

Point 3 – Close Company condition

We appreciate the Government's desire to block abusive structures however the issue with the close company test is that:

1. The ITC may not be aware of all of the relationships between its shareholders and as a listed entity cannot control who buys its listed shares or securities.

2. The problem is made more complex by the partnership attribution rules which can attribute an entire partnership's holding to any single partner (in section 448 CTA 2010, previously s417(3)(a) ICTA 1988)

As such an ITC could be a close company without realising it, since it would have no means of fully identifying the associates of every potential combination of participators.

This problem will be made even more acute if the listed company carve-out in s 446 CTA 2010 (previously s415 ICTA) is removed, as this provided a safe-harbour to show an ITC was not close. This is particularly important where an ITC has more than one class of shares.

One unintended consequence of this proposed change (together with the relaxation of the need to be on the UK main list) is that ITCs may consider moving off-shore, on the basis that there is no advantage in remaining in the UK and their investors need certainty regarding their status.

More generally we question, given the costs and obligations of listing and running an ITC, whether ITCs are really likely to be used for material levels of avoidance in real life situations. It appears to us there are many other cheaper tax free wrappers, such

as partnerships, small groups of individuals could use at much lower cost to hold investments.

Therefore we wonder if another test could be found which is more definite and easier for ITCs to apply in practice than the close company test. Otherwise we feel the Consultation's aim of increasing certainty may be lost.

Alternatively, if the close company test is felt to be the only option by Government, we recommend that the rules be relaxed so that:

1. An ITC need not consider attributions where it is not aware of personal or other relationship between investors in its close company calculations. And

2. The partnership attribution rules should be turned-off for the purposes of determining if the ITC is close for these purposes in a similar way to that done in the loan relationship rules when considering collective investment schemes in sections 493 to 496 CTA 2009.

Another alternative would be for an ITC to have an obligation to inform HMRC if and when it is becomes aware it is a close company so HMRC can then examine whether there is some over-arching tax avoidance motive of the ITC itself and only take action against abusive ITCs.

Point 4 – Purposive approach and removal of 15% holding test

The removal of the 15% holding test and its replacement with a more purposive approach is to be welcomed.

For funds which are FSA regulated under chapter 15, we note that there is already a requirement for a published investment policy to be maintained and followed by the fund.

If the approach of following the FSA rules as far as possible is adopted, where a fund has an investment policy in place which it believes is sufficient to meet the ongoing obligations in the listing rules (and no FSA challenge has been made):

1. Will HMRC typically accept that generally such a policy will meet this new "spread of risk" test or would HMRC reserve the right to review policies in detail and potentially require amendments to be made, even where policies are already believed to be compliant with the listing rule requirements?

2. Once a policy has been agreed as appropriate what steps will HMRC expect to be put in place to show the policy is actually being followed in practice and remains up to date? Again, will it be sufficient to argue the listing rule conditions are met or will HMRC potentially require additional work to be done around ongoing compliance?

Going forward where an ITC acts as a feeder fund to a Private Equity fund would the Private Equity fund itself be required to prepare an investment policy/prospectus document? The Private Equity fund, typically a limited partnership, may well be located outside the UK (for example in the Channel Islands and subject to their regulation, rather than the FSA). What proposals are there regarding the published investment policy in these circumstances?

Also if, for example, an ITC invests into just one or two Private Equity funds is this diversification of risk on the basis that each of these funds themselves has a spread of investments?

Point 5 – The listing rule

We note the proposal to widen the listing rule definition to include securities admitted for trading on a regulated market (as defined under the Markets on Financial Instruments Directive).

If these proposals are adopted, would HMRC approve that an investment policy created for a market in another European Union member state would be acceptable for the purposes of addressing the spread of risk requirement?

Point 6 – Distribution of capital profits

We note historically structures have been arrived at to allow ITCs to return capital (eg: share buy-backs etc) and ensure that the discount reflected in an ITCs share price relative to its net asset value does not become excessive. It would be helpful for HMRC to confirm that it has no underlying objection to these structures either historically or going forward.

Indeed it would be useful to understand from a policy perspective why a tax rule blocking capital distributions is needed in addition to the general Companies Act restrictions already in place?

The only issue we are aware of with the Companies Act is where you have ITCs which are not investment companies under company law (and have reserves which are capital in nature, but which did not arise from the realisation of investments). Under the current regime, these reserves should be available for distribution as a dividend payment. However under the proposed regime, presumably ITCs would be prevented from making any distributions from all capital profits so could no longer distribute these reserves.

Point 7 – Distribution of income

In addition to our comments noted in point 2(b) above on re-visiting section 1160(4) CTA 2010, it is helpful to remove the requirement for an ITC's income to be "wholly or mainly" derived from shares and securities and this should allow ITCs scope to invest more widely without tax distorting investment decisions.

However we do not agree that a reduction in the level of retained income is acceptable as a "quid pro quo" for this proposed change.

There are two very good reasons why an ITC needs a considerable amount of flexibility not to distribute all of its accounting income in a particular period:

1. An Investment Trust will typically want to "smooth" its distributions so that it shows a general upward trajectory in its dividend payments. Being able to hold back some cash from earlier periods allows for this. An ITC is a long term investment vehicle that needs to consider future periods and as such is fundamentally different to an Open

Ended Investment Company (which is essentially treated as it if were ceasing on each accounting reference date).

2. The other key issue is around dealing with situations where there are large levels of accrued income. This is a particular issue for Private Equity Investment Trusts as the underlying Private Equity funds often invest in payment-in-kind ("PIK") notes or discount securities which generate large levels of accrued income but no realised cash to pay the corresponding dividend until an exit or redemption event for the underlying security. It is possible that income may be accrued for several years but may ultimately have to be written of in one year if the company underperforms. It is a significant cash exposure if the previous accrued profits have had to be paid out as dividend.

Again the ITC needs the ability to both carry forward cash from earlier periods to allow cash distributions to be made in years where large levels of income are accrued and also for the total required distribution to be less than 100% of the accrued income in those periods.

We have no objection to using tests based on figures in the audited accounts provided adjustments are made for accrued income in particular or sufficient headroom is allowed in the distribution test as at present.

Where the size of a required distribution is not based on the accounts distributable reserves figure, it is important that rules are retained so that an ITC is not required to make an illegal distribution under the Companies Act in order to meet the HMRC 'retention test'.

Point 8 – Method of measuring "Revenue Income"

As a general observation where figures can be taken directly from audited accounts this reduces the scope for inadvertent errors which is helpful. However in the context of arriving at "Revenue Income" from the ITCs accounts it is necessary to determine what is correctly on revenue account as opposed to capital.

As such some level of adjustment from the pure accounting figures will remain necessary and we don't see an obvious better alternative to the current approach.

We hope that points above are helpful and would be delighted to discuss this response in more detail with you and your colleagues in which case please contact me.

Yours sincerely

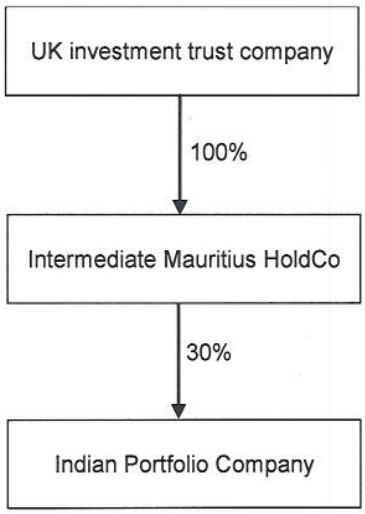
David Huff
Chairman
BVCA Tax Committee

Appendix 1

Point 1: Example of a Private Equity Investment Trust holding structure

This below diagram illustrates a typical ITC investment structure into a number of Indian portfolio companies via an intermediate Mauritian holding company structure.

(Please note that the holding of an intermediate 100% Mauritius subsidiary that holds an investment in an Indian trading company could potentially be over 50% so it is a subsidiary of the ITC).



(ii) requirement to aggregate subsidiaries causes separate minority investments to be treated as a single holding for purposes of the investment diversification test.