Asset Management Reward Consultation
Specialist Policy Team, CTIS
HM Revenue & Customs
3C04 100 Parliament Street
London
SW1A 2QB

By email: fundmanager.consultation@hmrc.gsi.gov.uk

30 September 2015

Dear Sirs

Re: BVCA response to consultation on the Taxation of Performance Linked Rewards Paid to Asset Managers

The British Private Equity and Venture Capital Association (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 over 500 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 £30 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 490,000 people and almost 90% of UK investments in 2014 were directed at small and medium-sized businesses.

This letter has been produced by the BVCA's Taxation Committee, whose remit is to represent the interests of members of the industry in taxation matters. The BVCA welcomes this opportunity to make comments on the Consultation document dated 8 July 2015 on the taxation of performance linked rewards paid to asset managers (the "**Consultation Document**"). Please find our comments set out below.

In addition to providing this response, we look forward to discussing at our forthcoming meeting some of the areas of approach and difficulty in applying the methods discussed in the Consultation Document with a view to seeking to ensure that your objective, as stated in the Consultation Document, of ensuring that the treatment of performance related rewards which have historically been subject to capital gains tax, and in particular carried interest in private equity and venture capital funds, will not be changed by the new rules introduced as a result of the consultation.

1 Preliminary comments

Before getting into the details of our response, we would like to identify an area of concern with the approach in the Consultation Document and to the proposals to change the law in this area generally.

We are very concerned about the general approach that you have proposed of tackling what is identified in the Consultation Document as a problem associated with a small minority of alternative funds in the market by treating all carried interest as "trading" as a starting point and then seeking to carve out that which is acceptable to HMRC and the

Government as retaining its "investment" status. In this regard we note the statement in paragraph 1.1 of the Consultation Document that the Government is committed to maintaining the current tax treatment of carried interest in private equity funds and capital gains treatment should be retained when the fund's activities are clearly of an investing nature. In respect of the latter, while referring to seeking to identify funds which conduct trading activities and that you consider that most of the tax planning in this area is ineffective because the funds in question would be treated as trading for tax purposes under the existing general law test, there is nothing in the Consultation Document which gives any indication of what sort of activities the Government actually thinks should be treated as trading for the purpose of these new rules other than everything that is not specifically referred to. We discuss this further below.

2 Distinguishing carried interest from performance fees

The Consultation Document states that the Government is committed to maintaining the current tax treatment of some performance related rewards (for example, carried interest and private equity funds which should continue to be taxed as capital gains, as reflecting the long term performance of the funds' investments) derived from the management of alternative funds. It goes on to say that annual fund performance fees that have typically been a reward for services, and taxed as income, should continue to be charged as such.

This basic objective behind the proposal highlights the need to distinguish the fundamental difference between carried interest and a performance fee "disguised" as carried interest; the difference being that carried interest returns from funds which would be treated as carrying out investment activity applying the existing case law distinction between investment and trading activity will be dependent on the fund deploying its capital and returning that capital to its investors and will, therefore, generally not be received by investment managers holding carried interest until a number of years into the life of the fund. By contrast, funds which carry on what are fundamentally trading transactions and have historically received annual performance fees will typically continue to pay performance linked rewards at regular intervals by reference to either realised or unrealised profits in the fund and the fund will have an internal mechanism (for instance, by virtue of holding liquid assets) to realise sufficient profit to pay that regular fee, albeit that under the sort of structures referred to in the Consultation Document that you are concerned about such fees might be paid using a method that allows the recipients to claim capital rather than income treatment on the amounts that they receive.

The capital treatment of carried interest has been important to the fund management business in the UK for many years and it has been recognised that the fundamental alignment of timing of returns to investors and fund managers, the commonly lengthy period between establishment of a fund and receipt of any carried interest and the risk that a fund would not actually generate any carried interest returns have all supported the tax characterisation of carried interest as a return on an investment in the relevant fund. In addition, the stable treatment of carried interest over the past 30 years or so has added to the attractiveness of the UK as a basis for unregulated fund management activities.

We are very concerned that the approach taken by you in the Consultation Document will, at best, result in significant uncertainty as to the ultimate tax treatment of carried interest returns across the industry with the result that the UK could become a significantly less attractive jurisdiction for the establishment and operation for fund management businesses and that the effect of this might be exacerbated by the relatively mobile nature of this industry.

In addition, given the availability of existing specific anti-avoidance provisions, a number of which are targeted at taxpayers attempting to turn income into capital, we do question whether this legislation targeted at a single business sector is really warranted and are concerned that yet more legislation aimed at the fund management sector will send the wrong message about the attitude of the UK to fund management generally.

Accordingly, and on the basis that you state your objective as being to close a perceived loophole currently exploited by a small minority of the alternative funds industry, to the extent that the Government does consider that specific legislation is necessary in this area and that the damage it might cause is outweighed by its benefits, we would encourage you to reconsider the "if it's not out it's in" approach suggested in the Consultation Document for the reasons discussed in more detailed below.

3 Seek to identify the unacceptable activities

The Consultation Document identifies the issue that it is seeking to address as relating to certain asset managers who have historically received a performance fee charged to tax as income and are seeking to restructure their performance fees as performance linked interests in the underlying fund so that those fees obtain the same tax treatment as carried interest and who are reassessing the activities of the funds that they manage with a view to arguing that the funds are investing rather than trading for tax purposes. Your concern in this area arises because you consider that the activities of the alternative funds in question should be treated as a trading rather than an investment activity and so the return received by the investment manager should be treated as a share of the fund's trading profit and taxed accordingly. Notwithstanding our view that fund management specific legislation might be damaging to the sector as a whole, we do not disagree with the approach of trying to make it clearer that carried interest should be taxed as income when the activities of the fund in question do, indeed, amount to a trading activity as currently understood under the general law.

Given, however, that the purpose behind the proposal is to apply "trading" treatment to the minority of alternative funds which both conduct trading activities and have sought to restructure their performance fees as an interest in the underlying funds, we think that the approach of starting by including all performance returns received by alternative fund managers as "trading" and then seeking to define the fund activities which will allow the managers of those funds to apply capital gains tax treatment to their performance linked rewards is ill conceived and is almost certain to produce unfair and anomalous results and that such results are likely to be wholly disproportionate to the tax avoidance issue in question.

In order to achieve your overriding objective of not changing the capital gains tax treatment of performance related rewards which have historically been subject to capital

gains tax, we think that it would be much simpler and much better aligned with the current basis for determining whether a financial activity is a trading or investment activity if the new treatment of performance linked rewards as trading income applied only when the alternative fund to which the performance linked reward relates satisfied a broad definition of trading which encompassed the general mischief that you are seeking to address and still avoided the specific concern raised in the Consultation Document (that the case law and so-called "badges of trade" which were applied to determine whether an entity is trading or investing are complex and difficult to apply to modern financial markets and to the complex strategy instruments used by asset managers and that the task of distinguishing between alternative fund investment and trading activity can be a difficult one both for the fund managers involved and for HMRC's staff who are working to ensure that the "correct tax treatment" is applied).

We think that the broad alternative fund activities that are "trading" activities could be satisfactorily encompassed in a single intention-based fund investment policy statement such as the following. This test would be applied to the fund as a whole and would be based on the fund's investment policy as communicated to its investors in the marketing materials and documents governing the investors' investment in the fund. We think that a test such as the following should effectively capture those fund activities that the Consultation Document appears to be concerned about without resulting in the potential uncertainty and difficulties created by the proposals under both Option 1 and Option 2 in the Consultation Document that we discuss further below:

> "The fund investment policy and objective, as communicated to investors in the fund documentation (including, without limitation, marketing materials and the documents governing the investors' investment in the fund) is, to a significant extent, to generate profits through acquiring, holding and disposing of a range of financial instruments (including, without limitation, equity, debt and derivative contracts) or other assets through exploiting relatively short term pricing opportunities and market valuation anomalies in the underlying investments to which the fund's investment relates".

As stated, we consider that such definition would encompass those alternative funds which do, as a matter of current law, conduct trading activities without creating the undesirable effect of requiring every alternative fund to consider detailed and complicated tests in determining whether all or some of the carried interest and other performance linked rewards paid to the fund managers might be taxed as ordinary income while still placing the onus on the fund managers to critically assess the real nature of the fund's activities.

To the extent that there was concern that any terms used in this definition might be open to interpretation we think that it should be simple to clarify what you are seeking to catch as trading activity in the guidance that you will publish with the legislation.

4 Option 1 and Option 2

While we can appreciate the intention behind both of Option 1 and Option 2 as described in the Consultation Document, we are seriously concerned that the apparently straightforward methodology set out in the document would, in practice, give rise to

endless difficulties in actual implementation in the complex circumstances that make up the life cycle of an alternative investment fund (whether it is trading or investing). Hence our suggestion that we think that it would be a much more sensible approach to address the mischief highlighted in the Consultation Document by attempting to define the relatively limited activities that you think are exploiting the slightly unclear investment/trading distinction under the current law.

We discuss below in more detail our concerns with both of Option 1 and Option 2.

As a general matter, in the event that the current approach described in the Consultation Document is pursued, we consider that it would be important to retain both Option 1 and Option 2 so that funds could, depending on their particular circumstances, rely on both a general description of their activity as a starting point and then, if the activities did not fall within the general description, on the period over which they held their investments. In the latter case, we discuss below the importance of ensuring that the methodology used to determine the length of hold of an investment or investments is simple and straightforward to apply.

4.1 *Option 1*

The Consultation Document discusses setting out specific activities which are to be treated as long term investment activities by reference to the activities which a fund wholly, or substantially wholly, carries on.

While we agree that it is the actual activities carried on by a fund which determine whether the activity is an investment or trading activity, we consider that a large number of funds which would clearly be considered to be carrying out an investment activity applying the current case law tests might not satisfy the strict requirements referred to in the Consultation Document.

For instance, private equity funds might not take controlling equity stakes in trading companies or might invest alongside other investors in "club" activities to take such interests. We note that this possibility is recognised in the Consultation Document, but its existence highlights the possibility of the sort of strict tests referred to in the Consultation Document resulting in uncertainty as to whether funds which would clearly be generally considered within the sphere of "private equity" and, therefore, expected to fall outside these rules being treated as "trading" for the purposes of determining the tax treatment of carried interest.

Venture capital and development capital funds will often not take controlling interests by the very nature of the sort of investment made by them. Again, we note that the Consultation Document test does not require a controlling interest in "venture capital companies", but it also raises the concern that there might be some difficultly in defining what is a "venture capital company" for the purposes of that limb of the test to avoid the controlling interest requirement.

Other long term investment activity, such as investment by infrastructure funds and long term, senior debt investment by credit funds would be unlikely to fall within the scope of the activities referred to although we would be surprised if those activities were

considered to be of the sort that are exploiting the investment/trading divide highlighted by the Consultation Document.

In order to meet the policy objective of securing capital gains treatment for performance linked reward received by fund managers of private equity funds we would propose including a broader class of activity that referenced the fund documentation made available to investors, and by reference to which the investors determine whether to make an investment in the fund. We consider that the following description of activity should not give any concern to you that alternative funds that should be considered to be carrying on a trading activity might be able to satisfy the description but would give a simpler and more certain tests for legitimate investments funds to assess themselves on:

> "Funds with a stated investment policy (and documents including, without limitation, marketing materials and the documents governing the terms of investments in the fund) of investing (whether, without limitation, through equity, debt or other financial instruments) predominantly in unlisted companies with a view to generating capital appreciation and/or income yield for investors over a period of 3-5 years or longer."

As stated, if Option 1 is used as the desired approach or part of the desired approach in the proposal, we consider that this sort of reference to the basis on which the fund is sold to investors would protect HMRC's and the government's legitimate concern that the funds undertaking what are, as a matter of current law, trading activities are claiming investment return based on the structure of receipt of their performance linked rewards.

We note that you state in paragraph 2.19 of the Consultation Document that you do not want the forms of the test to be just on the intentions of the fund. We think, however, that referencing the fund's investor documentation protects against this risk, since the statements in these documents provide the basis on which the investors decide to invest in the fund and if the stated investment policy is not followed the fund and its manager would be open to action by the investors.

4.2 *Option 2*

While Option 2 has, on the face of it, the apparent simplicity of quantitative analysis and is aimed directly at one of the fundamental distinctions between investing and trading in financial assets of length of hold, we are seriously concerned that it would result in a complicated methodology that would be difficult to operate over the life of an alternative investment fund and which might give anomalous results dependent on the specific facts and circumstances notwithstanding the investment policy and the intentions of the fund to invest rather than trade.

In this regard, we would highlight that the activities of a particular private equity fund do not involve a simple single acquisition of a controlling equity investment in a portfolio company with that equity investment being held until disposal or IPO with no activity in between. Rather, the investment by the fund is likely to comprise of a number of distinct equity and debt investments. This range of investments will additionally be potentially complicated by the requirement to make follow on investments during the life of the fund, to participate in further capital raising requirements, potentially to refinance certain

investments either using external resources (such as, refinancing debt investments with third party bank lending) or seeking other parties' investments at some point in time to support the overall capital requirements of the portfolio company in question.

The Consultation Document refers to the intention behind Option 2 being to provide a "simple" test to determine whether a performance linked interest in the fund gives individual managers a stake in underlying long-term investments such that capital treatment is appropriate.

It then states that to be effective it envisages that the test would look at individual investments to avoid any argument that the total exposure taken by the fund through various instruments should be considered as a whole when determining the holding period. We understand that this concern might be aimed at alternative funds which carry on activities that might be considered to be the traditional remit of hedge funds, such as taking short positions in investments with a view to closing out the positions in a short period of time but do so with a number of short term instruments in the same company and argue that the individual short term instruments should be considered as a single long term investment. This is clearly not the sort of multiple investment in a single portfolio company referred to above that we are concerned that Option 2 might catch notwithstanding the overriding policy intention stated in the Consultation Document that such multiple instrument investment in the context of private equity fund should retain its capital gains treatment.

Our concern with applying this individual investment test to the activities of a typical private equity fund (or alternative funds that might not be considered to fall within the "private equity" paradigm but are clearing carrying out investment rather than trading activity) are really twofold:

(a) firstly, as stated above, the overall capital commitment to a single portfolio company might take the form of multiple instruments, some of which might be initially provided by the fund on a bridging basis and then refinanced with third party lending with the initial investment returned to the fund investors (not carried interest holders) in a relatively short time period, might involve follow on investments which are made relatively close to the fund's exit from the portfolio company or might involve transactions such as debt for equity swaps where one investment was turned into what under the rules might be considered to be a different investment notwithstanding that the same capital had been committed by the fund; and

(b) second, the approach might give rise to uncertainty about the capital/income treatment of any particular carried interest payment to the extent that the carried interest was paid during the life of the fund because of particularly successful investments and early exits meaning that average instrument by instrument holding periods at the time of the carried interest payment might be shorter than the holding period tested over the life of the fund as a whole.

Given the number and different characteristics of individual investments that might be made by an alternative investment fund in single portfolio companies and across the

whole of the fund's investments, keeping track of the length of hold of each individual investment could prove to be a considerable compliance burden. In addition, close attention would have to be paid to the methodology that was specified in the new rules to determine what the average holding period was and whether it was calculated, for instance, by reference to the amount of investment deployed by the fund, to the profit generated for the fund by the individual investment, by the internal rate of return generated on the specific investment or by some other measure. One can see that each of these methodologies might produce a significantly different result for the same fund activities.

To the extent, therefore, that the proposals did result in Option 2 being either the whole or part of the investment/trading test, we think that it would be important that the test was applied on a portfolio company by portfolio company basis so that the length of hold was, for instance, calculated by reference to the time that the fund first applied capital into the portfolio company to the time that it had received a return of, say, 90% of the capital deployed with whatever protections might be necessary to prevent the sort of "hedge fund" arguments that there was a single long term exposure through a multitude of short term financial instruments referred to above. Again, to the extent that you had concern that such a test might be exploited we think that it should be relatively easy to deal with such concern in the guidance to the rules.

5 Conclusion

We trust that the observations above are helpful in highlighting our concerns that the stated intention in the Consultation Document to retain the existing capital gains tax treatment for performance linked rewards received by managers of private equity and venture capital investment funds might be prejudiced by adopting the proposed approach to the rules and in considering the more detailed issues that would need to be addressed if the proposal does result in legislation which seeks to carve out traditional investment funds activities from the sort of "disguised" trading fund activities described in the Consultation Document using the "if it's not out it's in" approach to treating performance linked rewards as income.

As stated, we appreciate that these are complex issues and we would welcome an opportunity to meet you to discuss them in more detail with a view to trying to produce legislation that effectively tackles the practices identified as being unacceptable while retaining certainty for the UK alternative investment fund management industry and not causing significant collateral damage to activities which under the current law would clearly be treated as investment but might fall foul of prescriptive details adopting either or both of Option 1 and Option 2. For completeness we include answers to certain of the specific question appendix.

Please do contact me if any of the above warrants further discussion outside the context of a separate meeting.

Yours faithfully,

David Nicolson
Chairman of the BVCA Taxation Committee
For an on behalf of the BVCA

Appendix

Response to specific questions in the Consultative Document

Question 2

Dependent on the details of the tests adopted, particularly in the context of how to calculate the length of hold under Option 2, we do think that the proposals would prevent fund managers adopting carried interest planning in respect of funds which would be likely to be considered as carrying out trading activities under the current law trading investment test, but we are seriously concerned that they would also provide significant uncertainty as to the tax treatment of carried interest in respect of funds which clearly carry out investment activity. In this context, we note that there is nothing in the Consultation Document which clearly sets out the scope of the fund activities which the Government "considers to be trading". From the general policy intention set out in the Consultation Document, we assume that the Government does not consider any and all activity outside the scope of Option 1 as being a trading activity.

Question 3

As discussed above, while we think that the activities specified should be treated as investment rather than trading activities, we think that it would be extremely difficult to create a list of exhaustive and prescriptive activities of the sort in the four headings provided that would cover the range of alternative investment fund activity and give certainty of treatment of carried interest to such funds.

Question 4

We think that the definition in Schedule 7AD TCGA or the FCA's definition of venture capital investment could usefully be adopted or used as a starting point, omitting the requirement that the fund in question does not carry on a trade.

Question 5

We do not think that it would be a sensible approach to try to distinguish between different activities of a single fund and to put some into the investment bucket and some into the trading bucket. Rather, as discussed above, we think it would be a much more sensible approach to try to either describe the general fund activity that would be treated as trading for the purposes of the rules or to provide a broad enough description of the overall investment objective of the fund to avoid the requirement for this sort of investment by investment delineation.

Question 6

We do not consider that, as a general matter, the commercial decisions by fund managers would be affected by the specific activities described. It might, however, be that commercial decisions might be distorted by reference to the length of hold test depending on how prescriptive and complex the average length of holding methodology was in the rules.

Question 7

It is perfectly common for funds to carry on a range of activities, such as a combination of equity and debt investment or investing in debt with a view to taking an equity stake in the future. Generally these multiple activities will be managed by the same people in a typical private equity

fund, although it is possible that different people might have specific responsibilities for different areas of the investment. Whichever is the case, the carried interest received by the various individuals are likely to be the same.

Question 8

We do not think that an attempt to apportion activities would be a sensible approach.

Question 9

We think that extremely careful thought would have to be given to the methodology for determining average length of hold to give certainty and not result in inequitable and undesired treatment of carried interest as income. If there were a graduated system we consider that it should give 100% capital treatment after 2 years.

Question 10

We think that it would be extremely difficult to create a simple method of calculating length of hold that would not produce misleading result and not create significant and disproportionate compliance burdens given the minority nature of the exploitative activity that the rules are concerned with.

Question 11

It is possible that commercial decisions could be distorted depending on the complexity and "granularity" of the tests.