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Dear Sirs,

Modernising the taxation of corporate debt and derivative contracts

I am writing to you on behalf of the British Private Equity and Venture Capital Association (the "**BVCA**"), which represents the interests of members of the private equity and venture capital industry. The BVCA is the industry body and public body advocate for the private equity and venture capital industry in the UK. More than 500 firms make up the BVCA members, including over 250 private equity, mid-market, venture capital firms and angel investors, together with over 250 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

This letter has been formulated by the BVCA's Tax Committee, whose remit is to represent the interests of members of the industry in taxation matters. The BVCA welcomes the opportunity to submit formally its comments on the consultation document entitled "Modernising the taxation of corporate debt and derivative contracts" released by HMRC on 6 June 2013 (the "**Consultation Document**") and how it might affect members of our industry. Our comments in respect of the Consultation Document are set out below.

Connected party debt (Chapter 7)

1. As a general comment, there appears to be a lot of emphasis in Chapter 7 and elsewhere in the Consultation Document on ensuring symmetry between the tax treatment of the debtor and creditor. In the context of what are now international money markets and the amount of inbound capital raised by UK companies from overseas lenders and investors, we query whether this is a sensible starting point for determining how loan relationships should be taxed or a realistic premise for any more fundamental changes to the connected party rules.

2. More specifically, we are surprised at the proposal that the late paid interest rules are to be repealed (as proposed in section 7.17 of the Consultation Document). As you are no doubt aware, it is common in private equity structures for senior lenders to insist that no interest can be paid in cash on the most subordinated tranche of debt until senior debt has been discharged, but to permit the issue of "PIK" (ie. further securities) in satisfaction of the interest accruing on the junior debt. Subject to thin cap restrictions, the debt cap and other general restrictions on deductibility, the interest is deductible as and when it is satisfied by the issue of PIK. We had understood from previous discussions on this subject (particularly relating to the changes to the late paid interest rules in 2009) that HMRC did not see any significant policy issues as arising in such cases. If HMRC are concerned with the kind of arrangement described in section D.6. of Part D of the draft GAAR Guidance notes (i.e. arrangements where a lender assigns a partial equitable interest in a loan to an affiliate in a non-qualifying territory solely to ensure that the late paid interest rules apply), would it not be possible to address this concern with a mini-TAAR aimed at such arrangements?

Intra-group transfers and group continuity (Chapter 8)

3. Whilst we do not have any special interest in these proposals differentiating us from other, ordinary UK taxpayers, could we just note that any change to the current rules which produces a "dry" tax charge on an intra-group transfer will be unpopular, and we cannot see that any reasonable policy objective would be achieved by that result. We would therefore be against Options 2 and 3 described in Chapter 8.

4. In answer to question Q8.5, it would be desirable if the following aspects of the "group continuity" rules could be addressed.

   Firstly, it should be made clear that the "group continuity" rules can apply to the transfer of part of a loan relationship (and not just where the whole loan relationship is transferred). So far as we can see, there is no good policy reason why this should not be the case, and it would provide greater flexibility on intra-group debt restructurings.

   Secondly, there should be greater clarity on the application of the "group continuity" rules to relevant non-lending loan relationships in Part 6 CTA 2009.

   Thirdly, we query whether it is necessary to have three different sets of degrouping rules in the chargeable gains, intangible fixed assets and loan relationship regimes. Alignment of the rules would be helpful.

Partnerships and transparent entities (Chapter 9)

5. Private equity funds are almost exclusively structured as limited partnerships (whether as one partnership or a series of parallel partnerships). Whilst many of the limited partners are likely to be tax exempt pension funds it is also likely that some will be corporates, and some may be UK taxable corporates. Private equity funds may also hold loans or other loan relationships (such as the Preferred Equity Certificates typically issued by Luxembourg holding companies). Accordingly any proposals to change the taxation of partnerships will impact on private equity.

   Private equity limited partnerships typically do not have frequent changes in partners and, if changes do occur, this will normally be for one of a number of commercial reasons – a partner may simply decide that its invested funds can be more effectively

deployed elsewhere; a partner may no longer be able to meet its commitment to contribute further capital to the partnership; or regulatory changes may mean that the partner is no longer able to hold its investment in the partnership. The tax avoidance relating to changes in partnership shares which HMRC is seeking to counter through proposed changes in legislation is not relevant to our industry, in the sense that partnership changes occur for the above commercial reasons. If transfers of partnership interests or other changes in partnership sharing ratios were to result in a recognition of any unrealised profit or loss on the relevant partner's share of any loan relationships (or derivative contracts) held by the partnership, this change could in principle have a positive, negative or neutral UK tax impact in a typical private equity context, depending on whether the outgoing and incoming partners are within or outside the UK tax net and whether the loan relationships (or derivative contracts) are standing at an unrealised profit or loss. In any event, however, such a change would result in an increase in the already heavy compliance burden on private equity partnerships. Particularly if Option 3 and the proposal in section 9.21 of the Consultation Document were to be adopted, it would be necessary for the general partner or fund adviser to determine the fair value of each loan relationship or derivative contract held by the fund on every occasion on which there is a transfer of a partnership interest or other change in profit sharing ratios. This would be necessary in case any affected partner is a UK taxpayer and needs to determine the loan relationship or derivative contract credit or debit arising on the transfer or change; and, in any event, it is normal practice for general partners or fund advisers to prepare partnership "tax computations" on a corporation tax basis, whether or not the partners in the fund are known to be UK corporation taxpayers. Therefore Option 3 would be very unattractive in compliance terms.

6. We have noted the permutation of Option 3 described in section 9.22 of the Consultation Document, under which the loan relationship or derivative contract credits or debits arising on a transfer of a partnership interest (or other change in profit sharing ratios) would be determined by reference to the consideration passing between the relevant partners which is attributable to the loan relationships and derivatives held by the partnership (rather than to their fair values). We have a number of concerns with this proposal. Firstly, in practice, it is likely that a single price will be paid for the transfer of a partnership interest (or other change in profit sharing ratios) and it will be difficult to disaggregate that price into the constituent elements which are attributable to each loan relationship or derivative contract held by the partnership. In the absence of any express agreement on this subject between the partners concerned, it is likely that the single price would need to be "unbundled" by reference to the fair value of each loan relationship or derivative, and so the proposal in section 9.22 to use the consideration passing between the partners as the reference point would not avoid the need to determine fair values. Secondly, in many cases the general partner and the fund adviser will simply not know what price has been paid between the partners concerned. This is not always disclosed to the fund. Thirdly, the use of actual consideration may have a distortive effect. Secondary purchases of partnership interests sometimes take place at extreme prices which have little to do with the value of the underlying loan relationships or derivatives of the partnership, depending on the circumstances of the seller.

7. We also have concerns about the suggestion in sections 9.24 to 9.27 of the Consultation Document that a partner's share in a partnership might be determined for these purposes on a nebulous basis which "takes into account" a number of evidential factors. This would introduce a very uncertain test in place of a test which is currently, in our view, reasonably clear. We are pleased to see (in section 9.30)

that the changes mooted in sections 9.24 to 9.27 are not proposed for now, but we note that this will be assessed further in light of the consultation and we would like to record that we would be opposed to the uncertainty that such would follow from such a change.

Debt restructuring (Chapter 11)

8. In the current economic environment, it is not uncommon for a private equity portfolio company (like other, publicly or privately owned companies) to find itself in financially distressed circumstances. The company might be (or be on the verge of becoming) insolvent, or the directors (properly aware of the adverse consequences that can arise for the company and/or for them personally if the company becomes insolvent) might reach the view that, without a financial restructuring, it would be prudent to cease trading and to solvently wind-up the company, rather than run the risk of the company's becoming insolvent. Financial restructurings, including debt-for-equity swaps, often occur in these circumstances and are of course intended to reduce the liabilities of the company and thereby increase its chances of trading out of its financial difficulties. To let the company go into liquidation would achieve nothing for the private equity fund or the employees or other stakeholders in the portfolio company. Since the whole point of the restructuring is to reduce the company's liabilities, it is critical that the restructuring does not have the effect of increasing the company's tax liabilities, and therefore it is important that the accounting credit arising on the debt-for-equity swap does not result in an additional tax charge. Since the company does not have enough cash to pay its other creditors (a fact recognised by those creditors, which is why they are reluctantly prepared to accept equity instead of cash in discharge of some or all of their debts), it is extremely unlikely that the company will be able to meet an additional cash tax liability.

We therefore have strong concerns about Option 1 discussed in Chapter 11 of the Consultation Document. It is proposed there that the exemption in section 322(4) CTA 2009 would be broadly remodelled along the lines of the exemption in section 361A CTA 2009. It is not clear to us whether this would extend to a requirement that there must be a change in ownership of the debtor company within a prescribed period (as in s.361A(1)(b) CTA 2009) - we can see no adequate reason for such a requirement in this context. More fundamentally, we are opposed to the proposed requirement that it must be reasonable to suppose that the company would, but for the release, be the subject of an insolvent liquidation (or otherwise meet one of the strict "insolvency conditions" in sections 322(6) and 323 CTA 2009) within a specified period of time. This may be very difficult to demonstrate as a factual matter, at a time when certainty in the company's affairs is at a premium (and may be something which the directors are very uncomfortable about confirming when this could have a real impact on whether the company should properly continue to trade or not). Indeed, as discussed above, financial restructurings frequently occur precisely because the directors of a company are concerned about any realistic prospect of insolvency. If the directors, shareholders and creditors of a company act prudently to agree a restructuring of the company's balance sheet at a time when insolvency is a real risk, albeit not an inevitable outcome, we can see no reason why the company should suffer a worse tax result than a company whose directors, shareholders and creditors act less prudently and wait until insolvency is otherwise bound to follow before embarking on a restructuring.

In short, we believe that the issues associated with Option 1 are:

- factual uncertainty over whether a company meets the "insolvency conditions";
- significant distortion between companies meeting the "insolvency conditions" and those close to meeting them; and
- the risk that tax charges arising on a capital restructuring may prevent a company which would otherwise be able to continue to trade following the restructuring from doing so.

9. We can see why HMRC would object in policy terms to cases where the current rules are exploited by groups to achieve debt buy-backs at a discount, in circumstances where a tax charge on the discount would not in any way cast doubt on the group's ability to keep trading. However, we think that the proposals in Option 1 go far beyond what is required to deal with such cases. We would be happy to work with HMRC in trying to reach a solution that would address such cases, without removing the ability to restructure financially distressed companies on a prudent basis, before insolvency becomes inevitable.

10. If the proposals in the Consultation Document do ultimately make it significantly more likely that debt restructurings will rise to taxable releases for debtors, thought will need to be given to the interaction of these rules with other parts of the corporation tax code. For example, to the extent that interest on a debt has been disallowed under the transfer pricing rules, it should be made clear that the fiction created by the transfer pricing rules (ie. that part of the debt is disregarded or treated as equity) is carried through into the debt release rules, such that a corresponding part of the debt is not taxed when released.

11. In answer to question Q11.3, we would mention two aspects of the current rules where change is desirable.

Firstly, some alignment of sections 361 and 362 CTA 2009 is required, particularly where, in distressed scenarios, third parties may be acquiring both debt and shares in the borrower company. The exact order of acquisition will determine whether section 361 or 362 applies and, if section 362 applies, none of the exceptions in sections 361A to C can apply, even though the commercial transactions are essentially the same. We cannot see the reason for this difference from a policy point of view.

Secondly, the "consideration... consists only" condition in section 361C(3) CTA 2009 can create problems in perfectly bona fide circumstances where the equity-for-debt exception should apply in principle, in particular where certain fees are paid in cash to participants or where participants are given the opportunity to subscribe, on arm's length terms, for further securities in the restructured group which do not meet the ordinary share capital test.

Anti-avoidance measures (Chapter 14)

12. We are unconvinced that the proposed "regime TAAR" described in sections 14.10 to 14.20 of the Consultation Document is really necessary, given the proposed changes to the "unallowable purpose" rules described in sections 14.22 to 14.32 of the Consultation Document and the recent enactment of the GAAR. It can be difficult and expensive to perform definitive due diligence on the application of such

provisions when purchasing investee companies, or to obtain opinions providing the required high level of comfort when sponsoring an IPO or selling an investee company, even when the facts indicate that there should be no meaningful risk. Given the potential costs involved here, we would like to understand better why the proposed "regime TAAR" is believed to be necessary. At a minimum, given the broad scope of the proposed "regime TAAR", the guidance or examples referred to in section 14.17 of the Consultation Document would need to set out a broad range of "safe harbours".

We would welcome the opportunity to comment on any draft legislation and to attend further meetings with HMRC in respect of the Consultation Document. If you have any questions in relation to our responses set out in this letter, please do not hesitate to contact me on 02070905053 or at graham.iversen@slaughterandmay.com.

Yours sincerely,

P.P.

Graham Iversen

Member of the BVCA Taxation Committee