HM Treasury
HM Revenue & Customs

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

15 February 2018

Dear Sirs,

BVCA response to consultation on taxing gains made by non-residents on UK immovable property

I am writing to you on behalf of the British Private Equity and Venture Capital Association ("the BVCA") in response to the consultation document published on 22 November 2017 regarding the taxation of gains made by non-residents on UK immovable property.

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 600 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 £27 billion in nearly 3,800 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 448,000 people and 87% of UK investments in 2016 were directed at small and medium-sized businesses.

BVCA members raise funds to invest in a wide variety of businesses some of which will hold significant amounts of UK real estate as fixed assets used in their business. A small number of BVCA members also raise pure real estate funds (i.e. funds which invest in real estate rather than an operating business which utilises real estate in its operations). Pure real estate funds are better represented by bodies such as AREF (the Association of Real Estate Funds) and the BPF (the British Property Federation), and we have confined our comments to issues of concern to our members as operators of private equity and venture capital funds.

We warmly welcome the statement (at paragraph 6.1 of the consultation document) that "the impact of the rules on non-residents investing through …. funds as well as on the funds industry as a whole needs to be carefully considered" and it is in that spirit that we are responding to the consultation.

In summary, our comments on the proposals set out in the consultation document are:

1. In deciding, for the purposes of the charge on indirect disposals, whether the requirement for a 25% interest in a property rich vehicle is met, persons are not to be treated as connected, acting together or otherwise have their interests aggregated by virtue of their participation in a collective investment scheme as defined in the Financial Services and Markets Act 2000;

2. Gains arising to a non-resident on a disposal of an interest in a property rich vehicle should be exempt from tax if that vehicle is a trading company or the holding company of a trading group, regardless of the size of the non-resident investor's interest and whether the investor is a company or not; and

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3. A fund manager/operator should be able to discharge tax payment and reporting obligations under the new regime on behalf of fund investors without the investors being troubled by such requirements.

The 25% threshold: aggregation of investors' interests

Funds managed by members of the BVCA are typically structured as limited partnerships, often (but not always) established and operated in the United Kingdom. They are clearly correctly categorised as collective investment vehicles (CIVs) and are collective investment schemes for UK regulatory purposes, but the position of investors in CIVs structured as limited partnerships is not addressed by the consultation document. The consultation document addresses the position of UK fund vehicles such as REITs, property authorised investment funds (PAIFs) and exempt unauthorised unit trusts. The proposal for such CIVs is that the existing tax exemption enjoyed by the CIV should continue, but non-resident investors with a 25% or greater interest in the CIV will be subject to tax on their gains from investing in the CIV under the rules on indirect disposals. As far as overseas CIVs are concerned (fund vehicles which are exempt from gains on disposal of UK real estate by virtue of not being UK tax resident), disposals by these funds will be chargeable in accordance with the normal rules, and presumably significant (25% plus) investors would also be subject to tax on gains arising on a disposal of their interest in the CIV.

The point to hold on to here is that, in its application to CIVs, the new regime would only impose tax on a non-resident investor in a CIV if he (taken with related parties) has (or had at any point in the preceding 5 years) a 25% or greater stake in the CIV.

As I indicated above, funds established by BVCA members will usually be structured as limited partnerships. There are two important differences between funds structured as limited partnerships and the types of CIV addressed in the consultation documents. These are:

- A limited partnership is transparent for UK tax purposes. This means that investors (partners) are treated as owning the underlying assets of the fund partnership and their share of the fund's income and gains is treated as arising directly to them. The types of CIV discussed in the consultation document are (or are treated like) companies – they own their assets and investors own (distinct) assets in the form of ownership interests in the CIV; and

- Under many UK tax law provisions partners are treated as associates so that (for example) in deciding whether a partner has a particular level of ownership or relationship with an underlying entity it is the partnership's overall level of ownership which is considered not that of a particular partner. On occasions (e.g. s467(5) and s474(7) CTA 2009, which provide that 'partner' does not apply to the general partner in a limited partnership that is a collective investment scheme within the meaning of s235 of the Financial Services and Markets Act 2000 (FSMA)) this approach, which was clearly designed with operating, professional partnerships in mind, needs to be abrogated. This is most relevantly to be seen in para 6, Schedule C1, TCGA 1992 which prevents association by partnership being a problem in deciding whether a company is closely or widely held for the purposes of the exemption of gains arising to widely held companies from disposals of UK residential property.

Funds operated by members of the BVCA would not normally seek to invest (whether directly or through vehicles) in "pure" real estate assets (that is to say, in real estate which is let out to a third party tenant as an investment). Funds operated by our members may, however, invest in businesses which are property rich. Examples of businesses in which our members have invested include care homes, hotels, pubs/restaurants/leisure facilities and schools and education businesses. These are investments in trading companies or groups, but in all cases real estate will be an important asset of the business. Whether 75% or more of the value of the company/group in question derives from

UK land will be a very fact specific issue to be addressed in each case. It may be affected by matters such as whether any business goodwill attaches to the operating business itself and its brands and intellectual property or to the real estate assets and the extent to which intangible assets (particularly self-generated assets not recognised in accounts) are taken into account in working the property rich test. You can see how some difficult questions, such as the value of brands and the extent to which intellectual property is an asset separate from real estate, could arise.

Even if a fund invests in a property rich business, investors will only suffer a tax liability under the new provisions if they have (or had within the five years leading up to the time of disposal) a 25% or greater interest in the business. The consultation document indicates (at paragraph 4.24) that in determining whether the 25% ownership test is met it is proposed to add together the interests of related parties and to define a related party using the connected party test (in s1122 CTA 2010) supplemented with "acting together" rules modelled on those in the corporate interest restriction rules (s465(3) TIOPA 2010) "to include situations where persons come together as a group with a common object in relation to the envelope entity". Because funds operated by our members are typically structured as partnerships, all investors in these funds will be treated as "connected" because s1122 CTA 2010 provides that all the partners in a partnership are connected with each other. This means that, however small a non-resident investor's participation in a limited partnership fund, he will inevitably be brought within the charge to tax on indirect disposals in cases where (as will almost inevitably be the case - our members take significant stakes in operating businesses with a view to bringing about change and value enhancement, so it is almost inconceivable that a fund would have a smaller than 25% stake in a business) the fund partnership has a 25% or greater investment.

This approach to related parties coupled with the tax transparency of partnerships creates a perfect storm for limited partnership funds: all non-resident investors in such funds will inevitably be liable to tax when the fund disposes of its interest in a UK property rich portfolio company.

The substantial shareholdings exemption (SSE)

The document indicates that, in appropriate cases, the substantial shareholdings exemption (SSE) may be available to assist non-resident investors. Where a company has a 10% or greater interest in the share capital of a trading company or the holding company of a trading group and has done so for at least a year prior to the time of disposal, any gain arising on the disposal will be exempt from corporation tax. As the consultation document notes at (paragraph 4.33) recent changes have expanded the scope of the SSE, so that the SSE can apply where an investment company has a greater than 10% stake in a trading company or group and also to cases where a company owned by a qualifying institutional investor makes disposal of an interest in another company.

It is accepted that, because a company can meet the requirement (for a 10%+ interest in the company invested in) in paragraph 8, Schedule 7 TCGA 1992 by holding an "interest in shares" as well as outright ownership, a company which invests through a partnership can in principle qualify for the SSE on a gain arising from a disposal of a partnership's investment in a trading company/group. However, it does not follow from this that the SSE is a solution to the problem we have identified.

First, the SSE will not help investors which are not companies; the SSE is an exemption from corporation tax for companies, not from tax on chargeable gains more generally.

Secondly, the SSE will not help the vast majority of investors in a limited partnership fund; very few investors will have a large enough interest in the fund to meet the 10% threshold.

Thirdly, investors with a large stake in a fund partnership will still struggle to reach the required investment level. This is because (following the fund model agreed in 1987 between the BVCA, the DTI and the Inland Revenue (as they then were)) the economic terms of a fund partnership give a priority share of income and gains to the general partner to enable it to meet fund operating costs and give the fund manager (or individuals involved with the fund manager) a carried interest in the profits of the fund once a performance hurdle has been met. This fluctuating economic "waterfall" can make it difficult for an investor (even one with a significant interest in the fund) to show that, throughout the period of a year up to the time of disposal, it would have been beneficially entitled to not less than 10% of the profits available for distribution to equity holders of the portfolio company. The economic arrangements in a fund would need to be changed significantly from the norm to enable an investor to establish a claim to the SSE even where the investor has a significant interest in a fund partnership.

The positions of CIVs and partnership funds compared

It will be readily apparent that:

(a) A non-resident investor with a small (less than 25%) stake in a CIV, including a non-resident CIV, of the type described in chapter 6 of the consultation will not be liable to tax when he disposes of his interest in the CIV;

(b) This is the case even though the CIV may simply hold passive investment real estate assets;

(c) All non-resident investors in a private equity fund limited partnership will be liable to tax under the rules for indirect disposals of real estate however small their personal holding when the fund disposes of an investment in a "property rich" portfolio company or when the investor disposes of his interest in a fund partnership which holds such an asset;

(d) This is the case even though the non-resident investor may have a very small stake indeed in the fund partnership; and

(e) It is also the case even though the fund's investment is in a trading company/group.

It seems to us that the proposals outlined in the consultation will discriminate against private equity funds which invest in property rich trading businesses in favour of investors in passive real estate funds such as a UK REIT or PAIF or a non-resident real estate investment company or unit trust. Leaving aside the question of whether this constitutes unlawful state aid to a particular segment of the fund management industry, it seems to us to betray a strange set of priorities to discriminate against investors in active trading businesses in favour of passive real estate investors just because of the traditional structures used by different parts of the fund industry, a fortiori where, as in the case of the private equity and venture capital industry, the fund vehicle it uses is an onshore UK vehicle expressly structured with government approval and encouragement (in the form of the 1987 Guidelines agreed between the DTI, inland Revenue and BVCA on the use of limited partnerships as venture capital investment fund vehicles) which has been used successfully for over 30 years.

Our proposed solutions

It seems to us that a fairer approach would be to treat investors in all collective investment schemes alike. This could be achieved by providing the persons are not to be treated as connected or acting together by virtue of their participation in a collective investment scheme as defined in FSMA. That would create a level playing field for all fund vehicles, however they are structured.

It would also seem to us to be sensible to exclude from the charge to tax a gain arising to a non-resident on a disposal of an interest in a property rich vehicle if that vehicle is a trading company or

the holding company of a trading group regardless of the size of the non-resident investor's interest and whether the investor is a company or not. In terms of addressing the issues raised by limited partnership funds, this provision would still be necessary if the government decided to implement our first suggestion because not all significant investors (those with a 25%+ interest in a vehicle through a fund) will be corporates and the fund economic "waterfall" will likely prevent significant corporate investors benefiting from the SSE. In any event, we consider that taking gains arising to all non-residents on a disposal of an interest in a property rich trading company or group would be a useful measure in its own right as it would remove a powerful disincentive to non-residents investing (on their own or in a joint venture) in, and thus providing valuable finance for the growth and development of, UK trading businesses without damaging the integrity of the new regime where (direct and indirect) pure real estate gains are concerned. This will particularly be the case if the rules for determining whether a vehicle is property rich are not clear and precise (so investors can readily work out whether a vehicle is likely to be property rich) or if they do not allow full credit to be given for intangible assets.

Tax compliance

Finally, it is very important that investors in fund partnerships do not have tax reporting or payment obligations in the jurisdiction in which a fund is established or in which it makes an investment. Typical fund documentation will require fund managers to try to structure investments to achieve this and many investors will simply not invest in a vehicle where the managers or their advisers are unable to confirm on establishment of the fund that investors would not have a payment or reporting obligation in that jurisdiction. This is important because institutional investors in funds are often very substantial bodies which invest in an enormous number of funds (established in and investing in a wide range of jurisdictions). If investors had tax reporting and payment obligations by virtue of participating in a fund, the scale of these obligations could rapidly escalate and become unmanageable. The practical effect of this is that a fund structured as a partnership (whether in the UK or abroad) will not want to go anywhere near an investment in the UK which could give investors tax payment or reporting obligations. Unless the proposed regime is relaxed in one or both of the ways outlined above, it is unlikely that fund managers would invest in businesses where there is a real risk that their investment could be regarded as "property rich", even though, the business is in fact an active trading one.

Some funds may, of course, already have made such investments and, if our suggestions are not adopted, will find themselves in a difficult position with investors. It is particularly important, if an investor in a fund partnership is liable to tax under these rules, that the fund manager/operator is able to pay the tax on behalf of the investor out of the realisation proceeds received by the fund and to discharge any tax reporting obligations on behalf of the investor without the investor being troubled by such requirements. We are not suggesting that investors be released from such obligations, just that fund managers are given an opportunity to discharge those obligations on behalf of investors without investors needing to be involved.

I hope that these thoughts are clear and helpful. If you would like to discuss any aspect of our submission, please do not hesitate to contact Chris Elphick at celphick@bvca.co.uk.

Yours faithfully,

Mark Baldwin
Chairman of the BVCA Tax Committee