

Val Hennelly  
PSN Employment Team Leader  
HMRC

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Dear Val

**Re. Finance Act 2011**  
**Amendments to the Disguised Remuneration Rules (Part 7A ITEPA 2003)**

Now that the disguised remuneration rules have become law the BVCA would like to raise with you issues that are arising from their practical application. Significant problems do remain in the context of the private equity and venture capital industries (VC/PE). A key point that is relevant here is that VC/PE businesses interact closely with the managers of their portfolio companies and in these interactions the VC/PE manager will often be a "relevant third person".

We have set out our key areas of concern below. Based on our previous correspondence with you, we understand that some of these points touch on areas that are the particular targets of these rules. Accordingly, it would be useful if we could arrange a discussion with you once you have had a chance to consider the contents of this letter.

**1. Exclusion for employment-related securities (554N(7) and (8))**

**Issue**

The exclusion for employment-related securities at 554N only applies to the extent that:

- (i) "relevant consideration" equal to or greater than market value is given for the relevant asset on acquisition, or
- (ii) ignoring any "relevant consideration" given, the acquisition would give rise to an earnings charge (554N(7)).

"Relevant consideration" includes "money or money's worth" which is given "before, or at or about" the time of the acquisition but specifically excludes "a promise to do anything" (554N(8)).

This arguably means that the consideration given in a number of common scenarios on VC/PE transactions, which arise from the commercial necessities of those transactions and do not have a tax avoidance motive, does not constitute "relevant consideration".

For example, it is unclear whether the acquisition of partly-paid shares or the acquisition of shares on deferred consideration terms can fall within this exclusion.

### Example

A key executive is required by a company's investors to make an investment in the company and it is intended that he should acquire 10,000 shares for their market value of £100,000 but he cannot afford to pay the whole amount upfront. He therefore pays £50,000 now and agrees to pay £50,000 in 1 year's time.

The agreement to pay £50,000 in 1 year's time should constitute "money's worth". However, it is unclear whether this will constitute "relevant consideration" due to it being a "promise" to do something.

In addition, it is not clear whether the payment of a proportion of the consideration after 1 year will fall within the requirement for the consideration to be paid "before, or at or about" the time of the acquisition.

An alternative way of funding the management team would be for a bank loan to be arranged. However because of the risky nature of VC/PE backed companies banks are generally not willing to use them as security for a loan. Therefore such loans tend to require guarantees from someone with deeper pockets. The BVCA is concerned that loans of this type do not satisfy the "ordinary commercial terms" test.

### Action Requested

We request that HMRC confirm that (i) the acquisition of securities partly-paid or on deferred consideration terms will constitute "relevant consideration" for the purposes of 554N(8), and (ii) that the exclusion at 554N(11) can therefore apply in these cases.

## **2. Exclusion for exit bonuses (554K)**

### Issue 1

554K excludes from the earmarking charge at 554B awards which are made on deferred terms, provided that their main purpose is to ensure that:

- (i) shares are received; or
- (ii) a sum of money is paid,

only if a "specified exit event or an exit event within a specified description" occurs (554K(1)(d)).

However, the definition of exit event (at 554I(6)) is highly specific and does not reflect (i) the commercial reality of many exits or (ii) the requirement for "exit event" to be widely drafted in the terms of any plan to provide at the outset for all future exit possibilities.

If the definition of exit event within the terms of the relevant documentation is wider than the specific wording used in 554I(6), which it will generally have to be, then this exclusion does not appear to apply.



In addition, the exclusion only applies if B is a company (554I(3)). It is not clear why as a policy matter it is felt that the exclusion should be restricted in this way.

#### Example

We frequently see documents detailing exit bonus arrangements for junior employees in which exit event is not specifically defined (allowing the employing group to retain an element of discretion).

However, this means that the concept of an exit is much wider than the definition of exit event at 554I(6) and so the exclusion at 554K does not appear to apply.

Note that there is no tax avoidance motive here as the arrangements clearly contemplate that any bonus payments made will be subject to income tax and national insurance contributions.

#### Action Requested

We request that HMRC include within the definition of "exit event" at 554I(6) wording to cover "all events of a similar nature" to those already described in 554I(6).

#### Issue 2

The exclusion does not cover bonuses which operate, for example, by reference to interests in a partnership which is very common within the VC/PE industry as partnership interests may be held by a warehousing entity (perhaps acquired from leavers) and to incentivise executives who join the firm after the fund has been established or more junior executives it is important to be able to tell them that they have this interest in the successful outcome of the fund they are managing to achieve full alignment of interests.

This is because the exclusion applies only to "relevant shares". These are defined in 554K(1)(c) as:

- (i) shares (including stock) in; or
- (ii) instruments within the definition of "relevant shares" in 554I(4),

which are issued by a trading company or a company which controls a trading company.

This definition refers to, and conflicts with, the definition of "relevant shares" which already exists at 554I(4) (and which, when read in isolation, does not appear to exclude partnership interests).

#### Example

A junior employee is allocated an interest in a private equity partnership which is held within an employee benefit trust. The partnership holds investments in several trading groups.

The junior employee will be entitled to a bonus from the warehousing entity which is referable to proceeds received by the warehousing entity from the partnership

which arise in the partnership on the sale of the shares in several trading groups. The bonus will be subject to income tax and national insurance contributions when it is paid.

This payment will not fall within the exclusion for exit bonuses at 554K because the junior employee does not hold "relevant shares" for the purposes of 554K(1)(c) because the partnership interest is not issued by a trading company or a company which controls a trading company. This is despite the fact that any payment the junior employee ultimately receives will be referable to proceeds received by the partnership on the sale of shares issued by a trading company.

### Action Requested

We request that HMRC consider amending the definition of "relevant shares" at 554K(1)(c) to remove the requirement for the shares or instruments held by the employee to be issued by a trading company or a company which controls a trading company.

### 3. Exclusions from "relevant third person" definition for partnerships (554A(9))

#### Issue 1

The drafting of the exclusion from the definition of relevant third person at 554A(9) is of limited effect because it only applies if (i) there is an LLP, (ii) the LLP is the employer and (iii) it is a wholly-owned subsidiary of that LLP which takes the relevant step.

It is not clear why the legislation should require that:

- (i) the LLP is the employer (and not, as is commonly the case, an entity further down the group);
- (ii) the relevant step must be taken by a wholly-owned subsidiary company (whereas the exclusion for groups of companies at 554A(8) uses a 51% subsidiary test).

It is also not clear why a distinction should be made between a scenario in which the subsidiary is the employer and the LLP takes a relevant step (to which the exclusion does not apply) and one in which the LLP is the employer and the subsidiary takes a relevant step (to which the exclusion does apply).

#### Issue 2

It is also not clear why, given that a limited liability partnership (LLP) is normally treated as a partnership for tax purposes, an LLP is a relevant third person in relation to an employee (A) of a member of the LLP (B - such as a service company member).

#### Example

A company which is a wholly-owned subsidiary of an LLP employs the employees of the group.

As is common, the LLP makes a loan to an employee (for example, for an annual season ticket). The loan has no tax avoidance purpose.



The exclusion from the definition of relevant third person at 554A(9) will not apply because the employee is employed by the subsidiary company rather than the LLP. There will therefore be a relevant third person (the LLP) taking a relevant step (the making of a loan) which is arguably in connection with employment and Chapter 2 will apply.

#### Action Requested

We would welcome clarification from HMRC as to whether this is a policy issue or whether there is scope to make amendments to resolve these apparent technicalities.

- 4. Restriction of exclusions at 554J to 554M to situations in which B is a company (554I)**

#### Issue

554I(3) states that the exclusions at 554J to 554M do not apply unless the employer, B, is a company.

It is not clear why as a policy matter it is felt that the exclusions should be restricted in this manner. It is common for the manager of a VC/PE business to be an LLP and as a result any employees of the LLP would not be able to benefit from these exclusions.

#### Action Requested

We request that HMRC consider removing 554I(3) so as to allow other types of employer.

- 5. Requirement that vesting be on a "specified date" (554J)**

#### Issue

The exclusion at 554J requires that the "main purpose" of the award is to defer the receipt of (i) the shares by A or (ii) the payment of the sum of money to A, until a specified date ("the vesting date") (554J(1)(c)).

It is not clear whether the specified date must be a calendar date (in which case the wording is too restrictive to be properly useful in a whole range of commercial situations) or whether it can be the date on which some event or contingency occurs.

#### Example

An employee is told that she will receive a bonus from a trust holding shares in her employer company (calculated by reference to the proceeds received from the sale of 100 shares in the company on a sale of the company or its IPO) provided that she remains an employee on the date on which that event occurs.

It is not clear whether this will be specific enough to constitute a "vesting date" as required by 554J(1)(c).

### Action Requested

We request that HMRC provide guidance to make clear that the meaning of "specified date" in 554J(1)(c) includes the date of a specific event or events. Protection could be built in by, for example, requiring the specific event to be one which would be expected to occur within 10 years of the grant of the award.

## **6. Earmarking, transfers or payments made in respect of securities**

### Issue

It is unclear as to whether HMRC will regard an earmarking, transfer or payment made in respect of a security as falling within 554N(7)-(11) where the security is an interest in a partnership which is "transparent" for UK income tax purposes or the step concerned relates to monies or assets which arise from the ownership of the security.

### Example

If the security is an interest in a partnership the partnership would be "transparent" for income tax purposes and so an allocation of partnership profits to the person treated as owning the interest for income tax purposes would already have given rise to taxation for that person. Likewise, the allocation of profits by a company for distribution to shareholders, the subsequent resolution to pay and the actual payment of the distribution merely follows from the ownership of shares and the rights inherent in them

### Action requested

We ask that HMRC issues guidance confirming that they will see such earmarking, transfer or payment as falling within the scope of 554N(7)-(11). We note that this concept is already covered in part, in relation to dividends paid on shares, and the clarification is intended to remove concerns as to potential double taxation arising on profits arising and distributed to the owner of the security.

## **7. Exclusion for employment-related securities (554N)**

### Issue

We had understood from our discussions during the consultation process that HMRC's intention was to provide an exclusion from Part 7A ITEPA for any relevant steps which arise in connection with the holding or disposal of a security provided that:

- (i) (in the case of shares or securities acquired after ITEPA came into force) full consideration was given on acquisition and/or the relevant employee was taxed on receipt; and
- (ii) there is no connection between any subsequent relevant step and a tax avoidance arrangement.

The BVCA considers that this exclusion provided at 554N generally meets this objective and operates to bring all post-acquisition events in relation to shares or



securities for which full consideration was given or where the relevant employee was taxed on receipt outside the ambit of Part 7A ITEPA. We really appreciate its inclusion.

However, whilst the BVCA believes that the policy and intention behind the drafting is clear, there is one technical point on which we would appreciate guidance.

The point is that, to fall into the exclusion you have to show that the relevant asset (the securities or interests in securities) that is the "subject" of the subsequent relevant step (554N(11)).

However, a "relevant step" is very often an action taken (for example, the payment of a sum of money) in respect of an asset (554C).

As a consequence, there may be an argument that on a strict technical reading of the legislation, the relevant asset is arguably not the "subject" of the relevant step. This could apply in a wide range of scenarios where there is no tax avoidance purpose (including the receipt of proceeds on a third party sale, a liquidation, a share buyback, a loan note redemption or payments in respect of carry, dividends and interest).

#### Action Requested

As the BVCA takes the view that 554N means that all post-acquisition events in relation to shares or securities for which full consideration was given or where the relevant employee was taxed on receipt fall outside Part 7A ITEPA, we are not requesting a change to the legislation.

However, in order for the BVCA to be able to be certain that it can provide appropriate reassurance to its members we request that HMRC confirm that "subject to" in section 554N(11) can have a wide interpretation which will include "related to" and "connected with".

#### **Conclusion**

Whilst the examples provided above are by no means exhaustive, we hope that they serve to demonstrate the fact that there are still fundamental issues inherent in the drafting of Part 7A ITEPA.

These issues are currently having a wide-ranging and adverse impact on normal commercial arrangements and it is a matter of considerable importance to our industry. We would welcome the opportunity to discuss these further with you.

Yours sincerely



David Huff  
Chair of BVCA Tax Committee

