

Memorandum of Understanding between the BVCA and Inland Revenue on the income tax treatment of Venture Capital and Private Equity Limited Partnerships and Carried Interest

25 July 2003

I. Introduction

- 1.1 This memorandum describes a typical venture capital/private equity ("VC") limited partnership fund structure and sets out guidelines agreed by the BVCA and Inland Revenue on the application of the provisions introduced by Schedule 22, Finance Act 2003, to a carried interest in a limited partnership fund structured in this way.
- 1.2 Section 2 of the agreed BVCA Statement on limited partnerships used as venture capital investment funds dated 26 May 1987 (the "1987 Guidelines"), provides that individual partners involved in the management of such a limited partnership, whether as directors or employees of the general partner or any body corporate providing services to the general partner or otherwise, and who receive full arm's length remuneration for the services they perform as directors and employees, will not be considered to have acquired either their partnership interests or their interests in underlying investments of the partnership after they became partners by reason of rights conferred on them or opportunities offered to them as directors or employees for the purposes of section 79 of Finance Act 1972.
- 1.3 This part of the 1987 Guidelines is of limited relevance following enactment of Finance Act 2003. This is because section 421B(3) Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) deems securities to be employment-related if the right to acquire them is made available by the employer or a person connected with the employer. This memorandum therefore sets out what the parties believe to be the appropriate treatment that the Inland Revenue will apply in relation to 'carried interests' issued on or after 16 April 2003, under the provisions of Finance Act 2003.
- 1.4 This memorandum makes no distinction between the acquisition of a direct partnership interest or an indirect one received, for example, by the assignment of such an interest or by the use of a feeder partnership (see paragraph 7.7).
- 1.5 All fund managers, from independent specialist UK houses to divisions of major financial institutions and fund managers for managed clients' funds, and all funds, can rely on the guidelines in this memorandum, provided they carry on a genuine VC fund business. In establishing whether or not there is a genuine VC fund business, for the purposes of this memorandum, regard will be had to the definition of venture capital investment partnership in Schedule 7AD TCGA 1992.
- 1.6 The Inland Revenue will not be bound by this memorandum:
 - (a) if the main purpose, or a significant purpose, of the arrangements is avoidance of liability to tax or national insurance
 - (b) to the extent that there are material deviations from the structure of the arrangements set out in this memorandum
 - (c) to the extent that the arrangements are varied subsequent to closing of a fund, other than as provided for below

In such circumstances, the Inland Revenue reserves the right to consider the application of all provisions relating to tax and national insurance, including Chapters 1 to 5 in Part 7 of ITEPA.

1.7 This memorandum does not affect the right of any taxpayer to argue that a different interpretation should apply to such taxpayer's specific circumstances.

2. Definitions

2.1 In this document the following terms have the meanings described:

- "general partner" - the general partner of a limited partnership that is used as a vehicle for the VC fund
- "the investors" - limited partners who provide both capital and loans to the fund partnership
- "carried interest holders" - individuals who are partners in the fund partnerships (either directly, or indirectly by virtue of arrangements such as those described in paragraph 7.7 below), who are employees or directors of the general partner or an associated company, who normally provide only capital to the partnership and who are entitled to share in the 'super profit' made by the fund.
- "carried interest" – an interest in a partnership which provides that the holder is entitled to participate in the "super profit" made by the fund which is allocated to the carried interest holders. In this memorandum, unless the context requires otherwise, "carried interest" means such an interest issued on or after 16 April 2003.
- "fund management or fund managers" - the management team of the fund (who will include the carried interest holders).
- "closing of a fund" – the time at which investors become committed to invest capital in the partnership.
- "preferred return" – the return to investors, paid in priority to the carried interest, as provided for in the Partnership Agreement

2.2 In this document statutory references are to ITEPA 2003 as amended by Finance Act 2003 unless otherwise stated.

3. Application of Part 7 of ITEPA 2003 to receipt of carried interest

3.1 Where all the following conditions are satisfied:

- (a) negotiations between investors and fund managers are at arm's length;
- (b) the fund is structured as described in Sections 7 and 8 below, and in the case of arrangements within Section 8, the economics are identical with the economics of the loan-based "fund-as a-whole" structure described in Section 7;
- (c) the carried interest holder pays the same per unit of capital for his or her partnership interest as the investors (or, if the alternative structures in Section 8 below are used, they pay an amount which is commensurate with the amount paid by investors for their equivalent interests, or commensurate with amounts that would be paid if the structure in Section 7 were applied to the same fund);
- (d) the only restrictions applying to carried interest are leaver, vesting restrictions and general transfer restrictions;

then

- (i) if a carried interest is acquired before the fund makes its first investment, the initial unrestricted market value ("IUMV") of the carried interest (within the meaning of Chapter 2 of ITEPA 2003) shall be taken as the amount actually paid for it, and
- (ii) if a carried interest is acquired after the fund has started making investments then IUMV will remain equal to the price paid (as in subparagraph (i) immediately above) if it can be shown that the aggregate value of the fund's investments has not increased above their aggregate acquisition cost at that time. This will need to be considered case by case.

3.2 If a carried interest holder gives up his or her interest and it is allocated to the other carried interest holders under the original terms of the relevant partnership agreement or otherwise, this will be treated as the receipt of an additional employment-related security. The IUMV of this additional security will not necessarily be the amount paid for it, rather it will need to be valued according to the circumstances applicable at the time. Chapters 1-5 Part 7 of ITEPA 2003 will apply accordingly. The principle in paragraph 4.1 below (no look through to underlying investments made by the partnership) will be applied to this additional security.

3.3 Where investors' loan commitments have been repaid and they have received any agreed preferred return and/or a carried interest becomes payable to participants under the original terms of the relevant partnership agreement (which might involve a change in the fund profit share ratio) it will be accepted that no "increase" occurs within section 421D(5) to give rise to a taxable event on the carried interest holders.

3.4 If the investor negotiations are not carried on at arm's length the tax treatment described above will apply provided it can be shown that the terms agreed conform to those in comparable cases involving unconnected third parties. This might be done by measuring the investors' return against what third parties would have agreed in negotiating the terms of any similar fund closed within a reasonable time before or after the one under consideration. An example of where this might be relevant would be where a fund is managed by the venture capital division of a financial institution and the financial institution (or perhaps its existing managed account clients) was itself the principal investor in the fund.

4. Application of Part 7 of ITEPA 2003 to Securities Acquired by the VC Limited Partnership

4.1 For the purposes of Part 7 of ITEPA 2003 only, it is accepted in the case of VC partnerships structured according to Sections 7 and 8 of this memorandum that the security (or interest in a security) acquired by a carried interest holder is the interest in the partnership – a security within section 420(1)(e) (unit in a collective investment scheme). When the fund partnership itself acquires securities within section 420(1), the carried interest holders will not be considered as acquiring on that occasion a new security (or a new interest in a security) within section 420(1), or section 421D(1) and (2). This treatment of a partnership interest (direct or indirect) as a unit in a collective investment scheme shall apply only for the purposes of the application of ITEPA 2003 to the carried interest arrangements, and not for any other purpose. Nothing in this memorandum is to affect the way in which the capital gains tax provisions will apply to the partners.

5. Parallel Interests

5.1 As explained in paragraph 7.9, money is invested in a partnership only as it is required for investment. Where:

- (a) investors require individual fund managers (or the management company) to make a material investment in the fund, in addition to their contribution to the capital of the fund, so that those managers expose their own money to the same commercial risks as those to which the investors are exposed, and
- (b) that investment is structured as a normal limited partner investment on the same terms as the other investors, such that the return on such a financial commitment is not postponed in the way that carried interest returns are postponed, and
- (c) the underlying securities acquired by the partnership are not themselves partly-paid securities, then

the Inland Revenue will accept that the related partnership interest is not a partly paid security for the purposes of Chapter 3C of Part 7 of ITEPA 2003.

6. Other Issues

6.1 Individual recipients of carried interest may not physically be available to sign an election under Chapter 2 of Part 7 ITEPA 2003 with their employer within the statutory 14-day period. An election can be validly made pursuant to a power of attorney on behalf of any individual.

6.2 An election may be made by a host employer as defined in section 421L (4) ITEPA 2003.

6.3 Inland Revenue will not require notice under Chapter 1 of Part 7 ITEPA 2003 of occasions on which persons outside the scope of the restricted securities charging provisions in Chapter 2 of Part 7, such as non-resident fund executives, acquire interests in employment-related securities.

6.4 Carried interests acquired before 16 April 2003 in funds formed before that date will be accepted as not giving rise to acquisitions of employment-related securities by the carried interest holders. The principle in paragraph 4.1 above will be applied so that there will be no acquisition of employment-related securities by the carried interest holders when the fund partnership itself acquires securities.

7. Typical Fund Structure

7.1 A typical VC fund structure involves investors contributing a small amount of capital to an English limited partnership and also agreeing to advance substantial additional amounts by way of interest-free loans to the partnership. This is because the limited partners are liable only up to their partnership capital and there is a prohibition on returning capital before winding up. The proportions of loan to capital contributed by investors will vary but the proportion represented by capital will often be less than 0.01% of the total investment.

7.2 The carried interest holders will contribute capital so as to ensure that they have 20% of the total capital contributions such that, after repayment of the loans and the preferred return (see below), they become entitled to a 20% share in the net profits if the fund is successful. For example, in a fund of £100 million of investor money the investors might subscribe for capital of £10,000 and loan commitments of £99,990,000. The carried interest holders will subscribe (usually via another partnership or by the assignment methods - see paragraph 7.7 for capital of

£2,500 which will then represent 20% of the total capital contributions of £12,500 (£10,000 from the outside investors and £2,500 from the carried interest holders).

- 7.3 The capital and loans are paid into the fund in cash only when needed. Typically this is a few days before the partnership needs cash to pay for a new investment, the priority profit share (see paragraph 7.4), or other expenses. Likewise, cash received by the partnership from selling investments is distributed to the partners virtually as soon as it is received. Thus, the partnership does not hold material amounts of cash except on a very short-term basis. The money to be invested into the partnership is therefore typically referred to as "commitments", and is "drawn down" in tranches when needed. The capital commitment will always be invested before the loan commitments.
- 7.4 The partnership will pay a priority profit share (often called the "management fee") to the general partner of, typically, 1.5%-2.5%p.a. of aggregate commitments. Typically the general partner will pay much of this to a management company or advisory company, who will use it to pay operating expenses such as salaries, rent etc.
- 7.5 In a traditional "fund-as-a-whole" model, there would be significant priority payments to investors, and payments to carried interest holders would only occur after these have been satisfied. The order of payouts is typically as follows.
- I. First, there is a repayment of either
 - (a) in some funds, all the drawn-down investors' loan commitments (in the above example 99.99% of the resources of the fund or £99,990,000, assuming it is all spent); or
 - (b) in other funds, only drawn-down loans that relate to exited investments (measured cumulatively so as to include previously un-repaid loans on investments sold at a loss, plus amounts equal to write downs of under-performing investments still held).
 - II. Second, there is a return to loan investors normally equal to
 - (a) a compounded 8%-10% p.a. of the loans drawn plus sometimes
 - (b) all the priority profit share payments made so far under 7.4 above, to the extent not already repaid under I above.

This return is often called the "preferred return" or "hurdle rate". In relation to particularly risky sectors such as technology companies, there may be no preferred return where the extra risk is considered to make the preferred return an unnecessary hurdle;
 - III. Only then can payments to partnership capital investors be made, as follows. These payments represent the distribution of what is referred to above as "super profit" of the fund
 - (a) First, it is now market practice that the carried interest holders receive a "catch-up" allocation of the profit sufficient to give them an amount equal to 25% of the previously paid preferred return (i.e. 20% of the aggregate of preferred return and this catch-up allocation).
 - (b) From then on, all profits are divided 80:20 (i.e. reflecting capital contributions).
- 7.6 The carried interest is not directly related to the work performance of any individual. Any concern on the part of the investors that particular people should remain as fund managers will be given effect through so-called "keyman" provisions in the documents. These provisions usually provide that on a material change in the personnel managing a fund (identifying the key

individuals by name) the fund will be terminated or prohibited (or suspended) from making any new investments

- 7.7 Employees invited to join a carried interest arrangement will typically form a special purpose limited partnership to hold the entire carried interest and so the special purpose partnership will itself be a partner in the fund partnership (or partnerships). The individuals will receive carried interest by way of distributions from the special purpose partnership. Alternatively, the fund partnership will be formed with a special purpose company holding the carried interest and this company will then assign the benefit of its partnership interest to the individuals concerned.
- 7.8 This assignment method is sometimes used as a simpler alternative to establishing a partnership. It involves the company contractually assigning its partnership share (i.e. the economic benefits of being a partner) to the individuals. Typically each of the individuals would reimburse the company for his or her proportionate share of the company's contribution to the partnership. Each of them will then receive their share of the distributions of the fund from the company partner, which is obliged to pass on the profits distributed from the fund.
- 7.9 Following a closing, the fund has available the loan commitments of the investors, which they are obliged to advance upon receipt of draw-down notices. The fund will almost always be constrained from investing more than a given percentage of its available finance in any particular portfolio company to ensure diversification; there will also be restrictions on the business sector and geography in which it can invest, and opt-out rights for some investors (such as rights not to invest in gambling businesses). The first draw-down is made in order to defray the set up costs of the fund. Then, suitable transactions must be identified, researched and completed with draw-downs being made on an "as needed" basis to fund each particular transaction. Therefore, the full amounts of the loan commitments are not paid up, in cash terms, immediately on a closing.
- 7.10 The fund may be constrained in its ability to invest the full loan commitments by prevailing economic conditions and the availability of suitable investments. The investors will normally stipulate an investment period (often 5 years) before the end of which all draw downs must be made and the balance not drawn down, if any, released.
- 7.11 Consistent with the 1987 Guidelines, all the fund managers will be paid full market rate salaries and bonuses, if appropriate, for their day-to-day work. These will be adjusted as in any other business to reflect the individual personal performance of the individuals. The amount an individual may receive from carried interest will reflect the performance of the fund rather than be directly linked to his or her individual performance. The aggregate percentage profit share made available as carried interest is determined not by the management company but by negotiation with the investors prior to the investors coming into the fund. While the long-standing normal carried interest percentage is 20%, in a hard market, such as at present, the investors may negotiate a different carried interest share. Investors will not confer any value unless and until the fund performs.
- 7.12 The fund managers interests are typically subject to "vesting" restrictions which provide that if an individual leaves the fund management team he or she must give up some or all of his or her carried interest, sometimes to the remaining holders, usually on a pro rata basis, sometimes to a new member of the team, or sometimes on a discretionary basis (such discretion being exercisable by the carried interest holders themselves, or a committee thereof, or by the management company/employer.

7.13 An individual joining the management team following a closing of the fund might be admitted to the carried interest. Normally this is done only in the early years of a fund if at all, because under general employment income tax principles, the receipt of a carried interest would be a taxable event, according to its value to the individual (absent the 1987 Guidelines confirmation). It is market practice that any employee joining late in the life of a fund would only receive carried interest in a subsequent fund. Where an individual is admitted to the carried interest in these circumstances, paragraph 3.1(ii) above applies.

8. Other Structures

8.1 Not all VC funds use the capital and loan structure described in Section 7. Some achieve the same economics in a different way. The purpose of dividing investor commitments into a large proportion of loan and a small proportion of capital is to limit their risk in the event of claims against or bankruptcy of the partnership, and overcome legal restraints on repaying capital. Partnerships formed under laws other than the UK generally do not have these risks and issues regarding investor capital, and therefore often do not use the loan structure. Often all commitments to these partnerships are just capital, and there are no loans. There will be a "GP participation" that ranks first for the priority profit share (the "management fee"). Then there will be "LP participations" which rank next for return of capital and the preferred return/hurdle. And there will be the "carry participation" which ranks last for 20% of overall profits once the prior-ranking profit shares have been satisfied. The economics are therefore identical with the loan structure described above. The price paid for the "carry participation" in such a partnership is commensurate with what is paid under the loan structure.

8.2 Non-UK partnerships or transparent vehicles (such as the French FCPR) are often used for technical legal reasons relating to aspects of partnership or securities laws or to meet investor demands. For example, German investors often like KGs, Dutch investors often like CVs, and US investors often want Cayman or Bermuda partnerships for investing outside the US and US partnerships for investing inside the US. Often these partnerships form part of a series of partnerships that make up the fund. There is no UK tax advantage to the use of foreign partnerships as they are all tax transparent and UK investors are taxed in the same way regardless of the partnership jurisdiction.

8.3 The 1987 Guidelines acknowledged (at paragraph 2.2 and paragraph 4.4 of Annexe A) that carried interest arrangements will differ from case to case (depending on the deal negotiated in each case with the investors). In some funds, particularly those influenced by American thinking, carried interest might be payable in relation to each investment by applying the agreed preferred return to each realisation. However, investors will almost invariably require that no carried interest holder is able to receive (or retain) any monies unless, looking at the fund as a whole, the investors have received the same result as on a fund-as-a-whole calculation.
