By email: hybrids.mailbox@hmrc.gsi.gov.uk

10 March 2017

Dear Sirs

BVCA response to Hybrid and Other Mismatch – Draft Guidance

I am writing to you on behalf of the British Private Equity and Venture Capital Association ("the BVCA") in response to the request for comments on the draft guidance in respect of the 'Hybrid and Other Mismatch' legislation introduced by Finance Act 2016 (Part 6A of Taxation (International and Other Provisions) Act 2010).

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 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 385,000 people and 84% of UK investments in 2015 were directed at small and medium-sized businesses.

Imported mismatch – calculating the appropriate counteraction

In Private Equity structures it is common to have a hybrid instrument, for example a Preferred Equity Certificate ("PEC"), between a Luxembourg holding company and the fund. The PEC is treated as equity for US taxable investors and as debt for Luxembourg tax purposes and therefore likely to be a hybrid instrument for the purpose of 259CB(2). As the PEC is typically used to finance a loan into the UK group, Chapter 11 of Part A TIOPA 2010 will apply as a consequence of the imported mismatch, as the mismatch outcome from the PEC is not expected to be counteracted in either Luxembourg or the US for the purposes of 259KA(7). An example of this structure is included at Appendix 1.

Each fund investor will be entitled to their proportional share of the income on the PEC under the terms of the partnership agreement. The PEC is likely to be a hybrid instrument for US taxable investors, but for many other non US investors, the return on the PEC will be taxed as interest income on an accruals basis. Consequently, for non US investors, there is typically no deferral of ordinary income, no reduced rate and therefore no mismatch outcome, in respect of this proportion of the relevant payment.

Such funds will normally have a diverse mix of investors. A significant proportion of the investors are typically exempt investors (e.g. pension funds), or fund investors from outside the US, both of whom do not typically benefit from a mismatch tax outcome as a consequence of the hybrid nature of the instrument. Additionally, it is common that 'fund of funds' will also be investors, which will in turn have their own investors, participating through transparent fund vehicles.

The proportion of fund investors that are US taxable, and therefore may benefit from the hybrid nature of the instrument, will vary by fund but, as an illustration, in a typical US fund it could be approximately 10 – 20% of the fund investors.

It is typical that the mix of investors in a fund will vary over the life of the investment. For example, as the fund moves into carry, the fund executives who have an entitlement to carry, will increase their proportionate interest in the fund. Correspondingly, the proportion of US taxable investors would be expected to increase (in the case of a fund with US carry holders).

Based on the conditions within 259KA and 259CB and the guidance provided in INTM559300, where the receipt from the hybrid financial instrument (i.e. the PEC in this example) results in a mismatch (i.e. non-taxable receipt for US taxable investors) and the funds obtained under the instrument are passed to the UK via a loan under which interest payments are made and deductions claimed (the imported mismatch payments), then for the purpose of calculating the amount to be counteracted under 259KC, the 'relevant mismatch' should correspond to the proportion of the receipt from the hybrid financial instrument that has resulted in a mismatch outcome.

The question is therefore, what approach is the UK company required to follow in determining the proportion of the receipt from the hybrid instrument that results in a mismatch and what evidence will HMRC expect to be available to support the apportionment used in calculating the UK tax deduction for the purpose of 259KC?

In line with the principles contained elsewhere in the guidance, it is proposed that the UK payer in respect of the imported mismatch payment should be able to use 'a just and reasonable' approach in determining the proportion where a mismatch has arisen.

In practice, due to the number of investors in many private equity funds and the separation between the Private Equity firm and their investors and investments by fund of funds, it is not likely to be possible to provide evidence demonstrating conclusively the proportion of investors that have not benefited from a mismatch. The extent to which there is a mismatch could also change as the profit sharing arrangements change e.g. when carry becomes payable.

In line with the 'reasonable to suppose' requirement in 259CA(4), and the 'just and reasonable' approach in 259CE(6), it is proposed that if requested by HMRC, the UK payer should be able to provide analysis which supports how they have determined the proportion of investors who have not benefited from a mismatch in the payment period. This would not extend to being required to provide, for example, tax returns for the investors, but could for example discuss the territory of residence of the investor and the corresponding expected tax treatment of the receipt from the financial instrument in the investors hands.

We set out two fairly common scenarios below by way of example:

Scenario 1: UK company pays interest under a plain vanilla debt instrument to a Luxembourg company. The UK company asks the fund manager of the PE fund to confirm whether any interest payments could be counteracted under the imported mismatches rules. The fund manager confirms that (following an analysis carried out by a reputable adviser) it is expected that between 10% and 15% of interest receipts by the Luxembourg company will ultimately 'fund' a relevant mismatch in the fund structure. It is then reasonable for the UK company to assume that 10%-15% of interest payments will be disallowed under the rules.

Scenario 2: Same as scenario 1 but in this case the fund is a minority investor, and has not carried out its own analysis. The fund manager does not wish to (or is unable to e.g. because its investors are fund of funds) provide information about its investors to the UK company. The UK company is then entitled to assume that, given the payments are made to a Luxembourg company, there should be no mismatch.

In both scenarios, the UK company should request confirmation from the fund, but it is only required to make reasonable assumptions based on the information it receives. In the case of minority investments or complex fund structures, it should be accepted that this information may not be available and that the UK company can then act on the information that it has. In cases where the fund manager provides confirmation that an analysis has been carried out, the UK company should not be required to reanalyse the position.

This approach is in line with the principles contained within INTM551023, in respect of 259CA which requires an objective judgement that it is 'reasonable to suppose' there would be a mismatch and states:

> *"There is no definition of 'reasonable to suppose' in Part 6A. The phrase will take its ordinary meaning. It does not require either party to actually know how the transaction has been treated by the counterparty but only that it would be reasonable to conclude that a mismatch may or may not arise.*
> *"The inclusion of this phrase is intended to assist in the application of condition C. Parties to the transaction should take all reasonable actions to establish whether a mismatch is likely to arise taking into account the relevant tax laws of the territories involved. It is not necessary for the parties to await final resolution of the returns".*

It is worth noting that requiring specific details in relation to each investor may not only be extremely burdensome to gather, but it may also not be within the power of the fund manager to obtain. In particular, this would be the case for 'funds of funds'.

As this is a very common fact pattern which will be relevant for a large number of UK companies that are in Private Equity ownership, it would be helpful if the guidance at INTM559300 (Chapter 11 imported mismatches - counteraction) could include an example which covers the scenario and approach discussed above. In particular, it would be helpful if the guidance on this point could follow similar 'just and reasonable' and 'reasonable to suppose' principles.

An additional point relating to the operation of Chapter 11 is the application of 259LA, where an amount of ordinary income arises late. 259LA(1)(a) does not refer to Chapter 11 (imported mismatches), whilst it does apply to 259CD (hybrid instruments) as well as other chapters. Given 259LA applies to hybrid instruments, it is not clear why the same principle does not also apply to imported mismatches, where the mismatch is arising by reference to Chapter 3 (i.e. 259KA(6)(a)(i)). This point is significant, as the US/Luxembourg hybrid instruments used in Private Equity structures (as reflected in Appendix 1) typically only achieve a deferral of the income for the taxable US investors until exit. It would therefore be helpful if the guidance could clarify that 259LA should also apply to imported mismatches on a similar basis as they apply to hybrid instruments (259CD).

Definition of ordinary income - tax exempt investors

As discussed above, it is common for a substantial amount of the UK investment from Private Equity funds to be sourced from tax exempt investors, in particular from pension funds. Tax exempt investors achieve no tax benefit from the use of the hybrid, as to the extent there is a mismatch outcome, it arises from the tax exempt status of the investor, rather than the hybrid instrument.

When considering the application of the rules, it is necessary to determine the ordinary income that should be tested to determine whether a mismatch has arisen, for the purpose of 259CB(2), as well as determining dual income under 259EC(4) TIOPA 2010. It is therefore necessary to consider whether income received by a tax exempt investor should be considered 'ordinary income' as defined at 259BC.

Based on s259BC(3)(a), a receipt which is not brought into account for the purposes of calculating income or profits on which a relevant tax is charged by a tax exempt body, by virtue of this body's tax exempt status, should still be treated as ordinary income of the tax exempt body, on the basis that it is not being brought into account by virtue of an exemption which is general in its application. This can be contrasted from an exemption which applies to a particular type of receipt only.

If this is the case, then income arising to an entity benefitting from a general exemption will be regarded as 'included' and therefore, for the purpose of 259CB(2)(a), the relevant deduction would not exceed the amount of ordinary income that arises to the tax exempt investor. As a result there would be no counteraction in respect of the proportion of the receipt received by the tax exempt investor under 259KC where the mismatch is imported (as in Example 1). We agree with this approach, but consider that it is insufficient if read narrowly to cover certain pension funds. This is because UK pension funds (taking an example) are exempt only on investment income, and not on trading income. In practice they are likely to receive only investment income from their investments in Private Equity Funds, but we think it would be helpful if the guidance made clear that in such a situation, the UK pension fund would still be treated as recognising 'ordinary income'.

The guidance at INTM551031 and INTM551220 currently provides examples covering exempted charitable corporations and companies benefiting from sovereign exclusions. The draft guidance concludes that the proportion of the relevant deduction in respect of income arising to a tax exempt investor (that is a payee in respect of the hybrid instrument), would be treated as giving rise to a mismatch for the purpose of 259CB(1), and the counteraction would be applied on that basis in accordance with 259CD(2). Therefore, on the basis of the guidance as currently drafted, it appears the counteraction would include payments to tax exempt investors.

It would be helpful if the guidance at INTM550540 could be expanded to specifically confirm the interpretation on this point relating to the definition of 'ordinary income', given tax exempt institutional investors make up a significant proportion of the investor base for many investment funds and this is therefore likely to be a point that is frequently encountered by UK portfolio companies in Private Equity ownership.

If the ordinary income interpretation above is not correct, then it is not clear why the rules would calculate the counteraction to include payments to tax exempt investors, as no amount of the mismatch is attributable to any hybrid characteristics. This appears to be an extension that was not intended by the OECD in their Report of 5 October 2015, where at Para 13 it states that: "*While* *cross-border mismatches arise in other contexts (such as the payment of deductible interest to a tax exempt entity), the only types of mismatches targeted by this report are those that rely on a hybrid element to produce such outcomes*".

To the extent the receipt by the tax exempt investor is deemed to give rise to a non-inclusion mismatch, this would therefore be going further than the principles of the OECD's report and would put the UK at a comparative disadvantage to other countries, with no clearly identifiable reason.

This comparative 'disadvantage' is likely to remain even after fellow EU countries adopt their own hybrid rules. We have already referred to the OECD's proposed scope, which does not extend this far, but it is also worth noting that the latest amendment to the EU Directive 2016/1164 (published 21 February 2017) mirrors the narrower scope, in requiring that counteractions should only be imposed where the mismatch arises from a "*conflict in the characterisation of financial instruments*" and that a "*payment should not give rise to a hybrid mismatch that would have arisen in any event due to the tax exempt status of payee*".

Hybrid Payee Deduction/Non-Inclusion Mismatches

Typically, partnerships will be treated as transparent for the fund investors and transparent in the territory in which they are located. However, there are some territories, for example Australia, treat the partnership as opaque for tax purposes for an entity to be a hybrid entity. We propose that the guidance makes it clear that when applying the rule in Chapter 7, a mismatch will be subject to 259GB(3) only to the extent it is attributable to an investor jurisdictions which, when their relationship to the payer is viewed independently, gives rise to the hybridity targeted by 259BE.

As shown in Example 2 (Appendix 2), for Australian Superannuation funds the Cayman partnership ('X LP') will be opaque for Australian tax purposes and will not be subject to a CFC charge unless there are more than 50% Australian investors (which is unlikely). The fund will not pay tax on amounts arising to the partnership, and in Australia tax at 10% or 15% will be paid on distributions by the partnership.

Therefore, the requirements of 259GA would be met and a counteraction would apply under 259GC, equal to the mismatch described in 259GA(5), for the proportion of the receipt allocated to the Australian Superannuation funds, calculated to reflect the extent to which ordinary income will arise to the Australian superannuation fund within the permitted period under 259GB(6).

However, where there are tax exempt investors in the hybrid payee (i.e. UK pension funds as per Example 2), and subject to whether the receipt by the tax exempt investor is regarded as ordinary income (as discussed above), 259GB appears to extend the counteraction to also include the proportion received by the tax exempt investor, on the basis that the requirements of 259GB(3) would be met.

It therefore appears that there could be a situation where one small investor that regards the partnership as opaque, could make the partnership a hybrid payee and this would impact the calculation of the relevant deduction in respect of the investment by tax exempt investors. As discussed above, this appears to go further than the principles of the OECD BEPS report.

It would be helpful if the guidance could include an example confirming that, in such a situation, the extension/deeming provision within 259GB(3) should be interpreted as applying only to the extent that mismatch could be affected by the hybridity of the payee. Therefore, for the purpose of Example 2, 259GB(3) would only apply to the extent of the receipts attributable to the Australian Superannuation Fund.

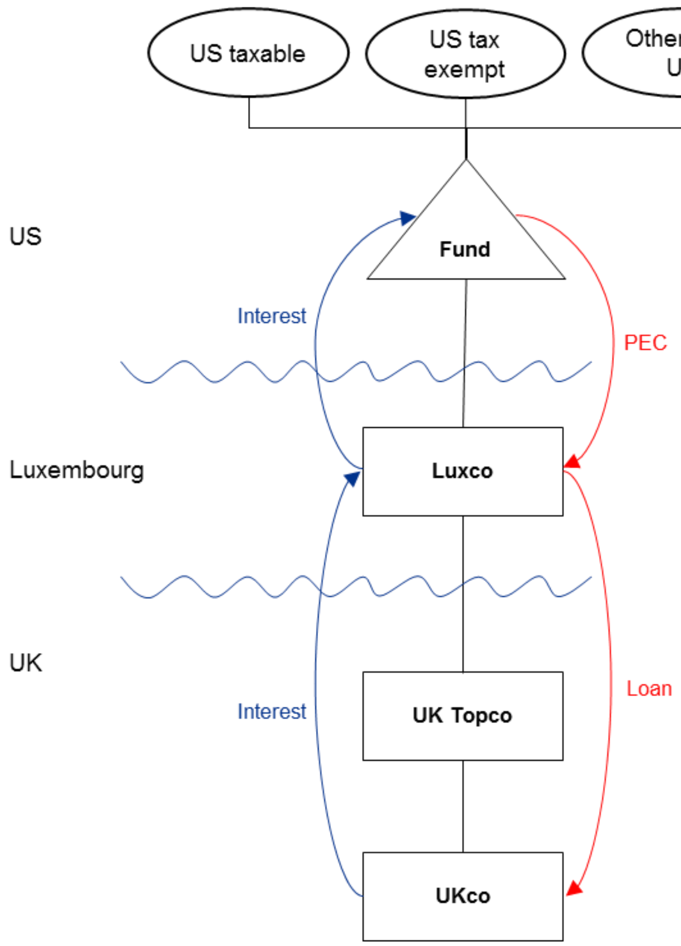
We would be grateful for an opportunity to discuss the difficulties this legislation creates for the industry and the UK companies it invests in. Please let us know when would be convenient for you and also if you have any comments or questions in the meanwhile.

Yours faithfully,

Mark Baldwin
Chairman of the BVCA Taxation Committee

Appendix 1

Example 1: Chapter 11 – Imported mismatches



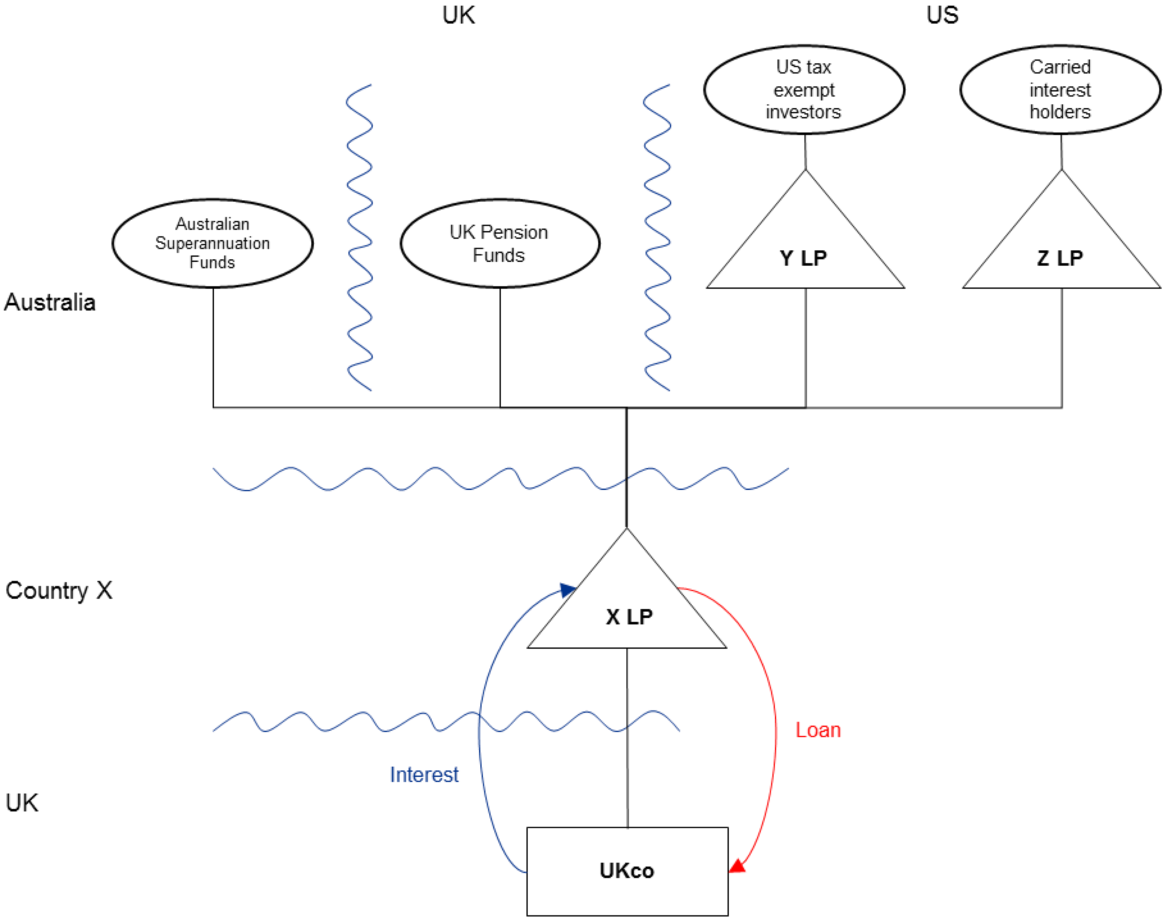
Background

- The Fund is resident in the US, and owns all the shares in Luxco.
- Luxco owns all the shares in UK Topco.
- UK Topco owns all the shares in UKco.
- Luxco issues preferred equity certificates to the Fund ("PEC") under which the payments of the return are treated as deductible interest in calculating Luxco's ordinary income, but are treated equity for US taxable investors in the Fund (typically comprising 10-20% of investors).
- The terms of the PEC satisfy the conditions in s259KA TIOPA 2010 and fall within the Hybrid and Other Mismatches from Financial Instruments rules.

- Neither the US nor Luxembourg have applied rules equivalent to the Hybrid and Other Mismatches rules under s257KA(7) TIOPA 2010, so do not counteract this hybrid or otherwise impermissible deduction/ non-inclusion mismatch which arises with the PEC.
- Luxco on-lends the funds provided under the PEC to UKco ("Loan").
- Luxco and UKco under the laws of Luxembourg and the UK respectively treat the Loan as a debt instrument, with the relevant payments of interest as deductible or taxable in the relevant jurisdictions accordingly.

Appendix 2

Example 2: Chapter 7 – Hybrid Payee



Background

- Australian Superannuation Funds is an investor resident in Australia.
- X LP is a Limited Partnership in Cayman.
- UKco is a company resident in the UK.
- Country X treats X LP as transparent for Country X tax purposes (that is, it is not a separate taxable person from Australian Superannuation Funds).
- Australia treats X LP as opaque, i.e. a separate taxable person from Australian Superannuation Funds.
- Australian Superannuation Funds will recognise distributions from X LP as ordinary income but will treat such distributions as dividends.
- UKco borrows money from X LP on arm’s length and standard commercial terms (the Loan).

- The UK allows UKco a deduction for interest payments made on the loan.
- Country X does not tax the interest receipt by X LP as it regards X LP as transparent and treats the income as belonging to investors including Australian Superannuation Funds.