BVCA *Funding the future*

The Office of Tax Simplification

Sent by email to: ots-ess@ots.gsi.gov.uk

9 November 2012

Dear Sirs

Office of Tax Simplification's Review of unapproved share schemes: interim report (Publication date: August 2012)

A. Introduction

We welcome the Office of Tax Simplification's (OTS) Review of unapproved share schemes: interim report (the "Report") and the opportunity to respond to it.

B. About the BVCA

This response is submitted on behalf of the Tax Committee of the British Private Equity and Venture Capital Association ("BVCA"). The BVCA is the industry body and public body advocate for the private equity (PE) and venture capital (VC) industry in the UK. More than 520 firms make up the BVCA membership, including more than 250 PE, mid market and VC firms, together with 250 professional advisory firms. In 2010, the ongoing number of people employed by UK PE-backed businesses was 810,000 on a full-time equivalent basis.

The BVCA Tax Committee includes amongst its objectives the shaping of policy and the implementation of policy to ensure that it accommodates the needs of the British VC and PE community.

A number of companies backed by BVCA members implement unapproved share schemes and as such, we feel that we are well placed to comment on the difficulties that these investee companies often experience when seeking to establish unapproved share schemes. Accordingly, it is from this perspective that we respond to the Report.

C. Areas for Further Input noted in the Report

This response focuses on the following areas for further input outlined on page 11 of the Report:

- Issues around readily convertible assets (RCAs)
- Tax issues for Employee Benefit Trusts (EBTs)
- Issues around Disguised Remuneration (DR)

Issues around RCAs (Question 3 on the Areas for Further Input)

The provisions whereby a share is a deemed RCA unless the employing company would be entitled to corporation tax relief under Part 12 CTA 2009 can be problematic for certain fund structures. For example, it may be that shares issued in an investee company are in reality illiquid, but that the company cannot obtain corporation tax relief (such that the shares are deemed RCAs) because i) the majority of the shares in that company are held by a PE fund and ii) there is a corporate general partner ("GP") within that fund structure, such that the GP could be deemed to effectively "control" the board of the investee company.

Where a fund structure of this sort is in place, it can be difficult to determine in law whether any one corporate has "control", and it is common for different advisers to take different views on the point. This creates technical uncertainty for the investee company. In addition, the technical outcome can vary dependent on the precise composition of the fund. This creates a playing field which is not level as between portfolio companies.

If the "control" test is met (or if it is prudently considered to be met) the shares in the investee company could be deemed RCAs such that the company is required to collect any income tax via PAYE on any undervalue when those shares are issued to the employees, despite the fact that the shares themselves may be illiquid securities that are prohibited from being sold/transferred except in very limited circumstances.

We would suggest that the legislation is amended such that shares are not deemed to be RCAs where the shares are only considered deemed RCAs because of the existence of one or more corporate partners within a CIS limited partnership (within the meaning of section 376 CTA 2009).

Tax Issues for Employee Benefit Trusts (Question 6 on the Areas for Further Input)

In certain circumstances, a tax charge can arise under the loans to participators rules where a loan is made to finance an EBT's acquisition of shares. We agree with OTS's view that where such a tax charge arises this can be a disincentive to establishing share schemes for private companies. This can be of particular concern to PE investee companies that are considered 'close' even in cases where the underlying investor base is in fact very wide.

As you know, much investment in PE is made through limited partnerships which often take control of the group acquired. As things stand, the fact that partners are regarded as connected persons or associates means that the investee company is considered 'close', even though there are many underlying investors (so that but for the partnership, the target group would not be close). This is anomalous as participants in funds would not normally have any influence over structuring or indeed the information to analyse the fund's investments. We suggest, therefore, that in relation to the test in section 375 CTA 2009 the fact that investors are linked through partnership structures should be ignored. This might be done by stating that a

company would not be treated as close if it would only be close because one or more of its shareholders is holding on behalf of a "CIS Limited Partnership" within the meaning of section 376(5) CTA 2009.

"Disguised Remuneration" (Question 5 on the Areas for Further Input)

Since their introduction, the DR rules have impacted a substantial number of employee share ownership arrangements that are purely commercial in nature. We have found that the breadth and complexity of the rules mean that they have to be considered frequently and laboriously, and the conclusion is far too often that the DR rules apply to situations that we assume the rules were never designed to catch. The result is that many share incentives are materially less effective and in many cases no longer viable to implement. Below are a few generic examples of commercial situations where we commonly see the DR rules applying.

Example 1: Loans from PE investors

In certain cases, it may be appropriate commercially for PE investors to make loans to employees/directors of an investee company rather than a loan being made by a group company. For example it may be desirable (to align incentives and motivate the employee) to make the loan to enable the employee to invest in shares and securities in the group but:

a. the group has liquidity issues and cannot lend without consent from lending banks; or

b. for confidentiality reasons the investor does not want existing management within the company to be aware of the arrangement. For example the loan could be to enable the director/employee to acquire shares at a lower price/per share than that paid by other employees because the equity value of the group has fallen (such that from a public relations perspective it is preferable to keep the arrangements confidential).

Because the investor is a third party, the loan would be treated as remuneration under the DR rules and be immediately subject to income tax and social security. In addition, the tax and social security would not be repaid upon repayment of the loan. It can therefore become commercially unviable to provide the loan.

Example 2: Loan from shareholder

In an investee company, the shareholders wish to provide loan funding to an incoming CEO as part of a float process (as the investors are keen to persuade the CEO to join the company and participate in the float). As the loan would be provided by a third party (i.e. the shareholders), it would be treated as remuneration under the DR rules. It is decided this is not therefore feasible. This has damaging commercial implications for the float.

Example 3: Loan from bank arranged by PE investor

Fund employees are often required to make substantial co-investment commitments to the fund. Such co-invest commitments are typically a requirement of the limited partner investors. These co-investment commitments may be very substantial. As such loan finance may be secured to enable them to meet their co-investment obligations. These loans are always offered on a commercial basis but the facility is generally arranged by the investor on bespoke terms. These bespoke features could in some cases cause them to be considered as made otherwise than on "ordinary commercial terms" (as defined in the DR rules). Under the DR rules, such loans would then be subject to income tax and social security despite being repayable to a third party bank.

Example 4: Employees acquire shares from third parties with part of the consideration being left outstanding

It may be desirable to allocate shares and securities in an investee company to new employees (or rising stars) at a time after the initial allocations of shares have been made. The shares to be allocated may form part of a warehoused pool within an EBT, or be transferred from the existing PE investor. In either situation there would therefore be a transfer from a 'third party' for the purposes of the DR Rules.

If the shares have increased in value materially from the time of the initial allocations, it may not be viable for new employees to fund their acquisition 'up front'. Therefore commercially it may be desirable to leave part of the consideration outstanding, on the understanding that it will be paid at a later date.

Prior to the DR rules this would have been a commercially practical route, and the benefit to the employees would have been taxed under the beneficial loan rules. The impact of the DR rules is such that the full amount of the notional loan is charged to income tax at the outset, despite the employees having to pay for the shares over time.

For example, an employee may be offered the opportunity to acquire shares worth £1m on deferred terms such that he pays £100,000 up front and the remaining £900,000 at a later date. The application of the DR rules would meant that he is charged to income tax on the entire £900,000 outstanding at the time he acquires the shares, rather than (as would have been the case prior to the DR rules) being charged on any deemed interest on the notional loan as it accrues (e.g. income tax on 4% of £900,000 (being income tax on £36,000).

This application of the DR rules to a wholly commercial arrangement could make providing the equity incentive to the new employees far less feasible.

Example 5: Ear-marking by PE funds for investee companies

The investment by managers in the portfolio company alongside the PE/VC investors is a key part of the PE/VC model, and in certain scenarios investors will wish to transfer shares to managers. For example, if the CEO leaves and transfers his shares to the investor, in order to attract the best new CEO for the company, and in order to properly communicate the way in which it is hoped he/she will invest alongside the

investors, it may well be desirable to communicate the proposed amount to a potential candidate.

The concern is that by communicating this, the PE investor is arguably 'setting aside' an amount of its shares which could trigger an 'earmarking' charge under the DR rules. For example, there is a concern that even mentioning in a slide presentation the proposal to "set aside" some of the investors' shares could amount to an earmarking. This would clearly be non-sensical and have the effect of stifling the commercial objectives of the group and the investors. However, based on the breadth of the DR language this area remains a significant concern.

Example 6: Ear-marking by PE Funds for junior fund employees

A fund commonly wishes to incentivise its own employees. This can sometimes be done by agreeing to pay a cash bonus to junior employees by reference to an agreed proportion of the carried interest. Employees will be informed of their individual allocations and these allocations are funded by 'setting side' the relevant proportion of carried interest, often being held in an EBT or other third party vehicle for ease of administration.

The allocations are awarded to employees at a time which is earlier (and often substantially earlier) than the date on which carried interest cash payments from the fund materialise, which are then paid out to the employees..

The cash payments made to employees will be subject to tax as employment income and appropriate PAYE and NICs deductions will be made. However, under the DR rules, this arrangement could result in an initial tax charge as at the date of allocation, rather than any tax charge being delayed until a carried interest distribution materialises and the cash is paid to employees.

The credit and relieving provisions which are designed to prevent double charges to income tax are difficult to apply, particularly in circumstances as set out above which inevitably involve complex commercial arrangements as to the terms of the cash payments. It is not entirely clear that in these circumstances the provisions provide the appropriate credits. Furthermore, in certain circumstances, a tax payer has to consider what is "just and reasonable" which we consider increases uncertainty and compliance costs, particularly for employers when considering their PAYE obligations.

The earmarking charge could potentially be avoided if individual allocations to employees are not made until immediately prior to payment. However, given the intention of the arrangement is to be able to communicate the incentive to employees and thereby motivate them by reference to the value of the carried interest, the scheme would become commercially ineffective. This is therefore another example of the DR rules frustrating totally commercial transactions. We do not believe this can have been the original intention of the legislation.

Other Technical Issues

We have also come across a number of technical issues in relation to the DR rules that it would be useful to clarify. These include:

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

There does not appear to be an exclusion where a limited liability partnership ("**LLP**") takes a relevant step in circumstances in which its wholly owned subsidiary is the employer, whereas there *is* an exclusion where the LLP is the employer and its wholly owned subsidiary takes a relevant step. We are also unsure why, given that an LLP is normally treated as a partnership for tax purposes, an LLP is a relevant person in relation to an employee (A) of a member of the LLP (B – e.g. a service company member).

We understand that the "group" exclusion at section 554A(9) applies only to relevant arrangements where B is a limited liability partnership and P is a wholly owned subsidiary of B, and that this is an intended policy outcome as it is considered that a group exclusion to include an LLP taking relevant steps as a third party would be open to exploitation. However, on our reading of the legislation any such exploitation would be prohibited by virtue of the fact that the group exclusion does not apply in the event of tax avoidance (554A(10)).

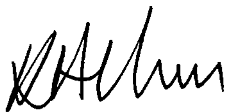
Restriction of exclusions at 554J to 554 M to situations in which B is a company

We understand that the exclusions at sections 554J to 554M are restricted to situations where B is a company to limit the wider potential for abuse that could arise if non-corporate entities were included. However, given the widespread use of LLPs as managers within the PE/VC industries this creates a significant problem, and it would be helpful to get your views on whether the ideas we have on how these rules could be made more workable (without opening them up for abuse) would be feasible.

An example of where the outcome under the DR rules would appear unfair is where a person employed by an LLP has to pay tax when he/she has some shares notionally earmarked for him/her, whereas someone who is employed by a company would not have to.

We hope the above points are useful. If you would like to discuss them further then please do not hesitate to contact Kathleen Russ of the BVCA, whose contact details are Kathleen.Russ@traverssmith.com and telephone number 0207 295 3230.

Yours faithfully,



Kathleen Russ
on behalf of the BVCA Taxation Committee