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Dear Sir/Madam

BVCA response to OTS Capital Gains Tax review – call for evidence

This letter contains the responses of the British Venture Capital & Private Equity Association ("BVCA") to some of the questions contained in the July 2020 call for evidence. We have confined our comments to questions which touch on areas of special interest to BVCA members or where we have a particular expertise or perspective to offer.

The BVCA is the industry body and public policy advocate for the venture capital and private equity ("PE/VC") industry in the UK. We represent the vast majority of all UK-based firms (over 700), as well as their professional advisers and investors. The UK has a dynamic PE/VC ecosystem which continues to be the second biggest hub worldwide. BVCA members invested over £43bn into 3,230 UK businesses in the period 2015-2019, the majority being SMEs. Companies backed by PE/VC currently employ 972,000 people in the UK.

Summary

Along with the tax systems of other major jurisdictions, the UK taxes capital gains at a lower effective rate than income. The top rates of income tax in France, Germany, Italy, Spain, Ireland and The Netherlands range between 43% and 50% whereas rates of tax on gains range between 23% and 33%. Hong Kong, Singapore and Switzerland tax income, but do not tax capital gains at all.

One key reason for this is to strip out (or compensate for) inflationary gains. The extent to which (even in times of relatively low inflation) inflation erodes long-term returns is readily apparent from looking at the old indexation tables[1]. When the UK taxed capital gains and income at the same rates it compensated for inflation by indexing base cost or allowing gains to be tapered (where the proportion of the gain that was taxed reduced the longer the asset was held), so that the full amount of gain was not taxed. The UK taper relief rules provided two rates of taper, one for business assets and one for pure investment assets. This evidences another important feature of the taxation of capital gains, that it rewards entrepreneurial risk-taking, sometimes simply by taxing profits as gains rather than income and at other times by providing for an even lower effective tax rate for gains derived from risk-taking in the commercial sphere.

[1] https://www.gov.uk/government/collections/corporation-tax-on-chargeable-gains-indexation-allowance-rates

We discuss these points in greater detail below, but the BVCA is firmly of the opinion that:

- it is important that gains are taxed at a lower effective rate than income in order not to tax the effect of inflation. Any other approach would be wholly out of line with international norms and signal that the UK sets no store by any form of investment and regards taxing inflationary gains as perfectly acceptable;

- because of the wider societal benefits it generates, it is important that the tax system recognises all forms of entrepreneurial risk taking in the commercial sector (not just financial investment). At the very least, capital profit from such activities should be taxed as capital gains rather than income. This makes indexation (which only values financial contributions) an unsuitable way of reducing the effective tax rate on gains. Tapering gains to compensate for inflation creates an artificial incentive to retain assets in order to maximise taper relief benefits. So, the only fair and effective way of addressing this issue is to do what other countries do and set CGT rates lower than income tax rates;

- there should be a hierarchy of gains, and entrepreneurial, business risk (properly defined) should be rewarded (by being subject to a lower tax burden) more than gains on passive investments;

- so far as the two areas of peculiar concern to BVCA members are concerned (the taxation of management equity and carried interest), the BVCA believes that the boundary between income and capital is conceptually drawn in the right place and its integrity is protected by existing rules. The UK carried interest regime delivers outcomes which are in line with those in competitor jurisdictions, and the UK's competitive position as a fund management centre should not be further eroded by negative changes in this area;

- there are a number of anomalies in the current CGT regime which need to be addressed so that the tax fairly reflects these principles and functions effectively.

Detailed response to questions in the call for evidence

Question 7: Are there particular issues around the boundary with income tax e.g. shares or share rights received by employees or the boundary between trading and investment?

The UK tax system has recognised for many years that taxpayers are entitled to capital gains treatment in respect of the profit they make from disposing of an interest in a business whether their investment in that interest comprises their skill and effort in working for the business or a purely financial investment. This is because capital gains treatment is intended to encourage all forms of risk-taking investment in businesses, as this is essential to the creation of durable value for the general good in the national economy. That entrepreneurial risk, when successful, is clearly of immediate financial benefit to the entrepreneur, but it will also have contributed wider employment and other economic benefits for the country, which is one reason why the tax system historically taxes capital gains in a different way to income. This is important now, as the country seeks to rebuild its economy after the Covid-19 lockdown and looks to build a dynamic future post Brexit, than it has ever been.

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The key criteria for capital gains treatment are whether the taxpayer has made an investment in a long-term asset and whether the return from that asset depends entirely on the growth in the value of the asset.

It would be regressive to "reform" the tax system so that only returns on financial investments in businesses are recognised by being taxed as capital gains. Returns earned on investments in a business held by those whose contribution takes the form of their skill and effort (e.g. by setting it up or developing it) should be recognised as being equally deserving of capital gains treatment.

These points are important to the PE/VC industry because both the management teams who run portfolio companies and the executives who manage funds invest their time and skill in the business they work for in partnership with their financial backers and hold a long-term interest in that business the value of which depends entirely on the growth of that asset and is not directly linked to their personal performance. Profits arising from holding those assets have (rightly) been treated as capital in nature for UK tax purposes, and it is important, if the risk-incentivisation objective discussed above is to be met, that this continues to be the case.

Management Equity

When a PE/VC fund invests in a company the fund will typically subscribe for preferred capital and ordinary equity securities. In addition, individuals who work for the company will also commonly acquire ordinary equity securities. The ordinary shares the managers subscribe for will usually only entitle them to participate in economics if the company's worth increases from its value at the time of the fund's investment at a rate which exceeds the cost of finance and preferred capital to the company.

These equity securities acquired by managers are clearly employment related securities. The only reason the managers are allowed to acquire them is because they work for the portfolio company, and the terms on which they are awarded the shares will normally require them to give up their shares if they cease to be employed by the portfolio company.

The UK has for many years had a very clearly defined approach to the taxation of interests such as these. The acquisition of employment related securities is an employment income tax matter. To the extent that the individuals acquiring the shares do not pay an amount equal to the market value of those shares, there will be an immediate income tax and national insurance contributions liability. In addition, if the individuals acquire restricted securities (securities like the ones we have just described which are liable to be forfeited if they cease to be employed by the relevant company) and wish to avoid employment tax charges in the future, they must either pay a higher price (the initial unrestricted, rather than actual, market value ("IUMV") of the shares) or be taxed on the difference between the price they actually pay and IUMV. Another way of putting the same point would be to say that the individual does not get anything free by virtue of being employed; the opportunity to benefit from future growth must be paid for or it will be taxed as employment income. As far as UK tax rules are concerned, any natural future growth in value is not regarded as an employment income tax matter and is subject to CGT. Of course, the individuals' investment is not at all guaranteed. Their business may not be as successful as they might have hoped and they may not be able to dispose of their interest, or their interest in the business may be forfeited. In such a case, there is no refund of the employment tax suffered when the equity stake was acquired.

The employment income tax charge is protected by rules such as those which impose an employment income tax charge if the value of employment related securities is artificially enhanced or if such securities are disposed of for more than their market value.

Even though managers' equity stakes may be taken off them if they leave employment, it is clear that their equity stakes should qualify for capital treatment on the criteria set out above. The managers hold an investment in a business and the return from their investment will be driven entirely by the growth in the value of the business.

It is very important, of course, that the shares operate properly as share capital in a company and are not a means of delivering a disguised bonus or similar arrangement. That is what we mean when we say that one of the key criteria for capital gains treatment is whether the return from the asset depends entirely on its growth in the value. The decision of the Court of Appeal in *HMRC v PA Holdings*, [2011] EWCA Civ 1414, demonstrates that the courts are perfectly capable of distinguishing between a genuine equity award and the use of shares as part of a contrived compensation arrangement. That taken with the parts of the employment related securities code referred to above, which prevent shares being used in an abusive way (e.g. by artificially inflating their value), means that capital treatment is only available for shares which confer a genuine participation in the equity of a business.

We agree that the return on managers' equity in portfolio companies is rightly treated as capital because that equity:

- generates a return which depends entirely on the growth in value of the business;
- rewards the managers for their entrepreneurial investment in the company and the durable value they create; and
- aligns their interests with those of the company's financial backers.

It will be readily apparent that, for the reasons we have just explained, we believe that UK tax legislation draws the line between capital and income in the right place so far as management equity is concerned and that the employment income tax charge is adequately protected.

Carried Interest

A fund is a joint venture between investors and managers and the carried interest, as its name suggests, is the manager's participating interest in the fund. It comprises a right for the manager to share in the economics of the joint venture alongside investors and is the fund manager's equivalent of the equity held in portfolio companies by the management teams who work in those businesses. PE/VC funds are typically structured as limited partnerships and so distributions, to investors and carried interest holders alike, will comprise partners' shares of income and capital (predominantly capital in most PE/VC funds) returns from underlying portfolio companies. As partnerships are transparent for UK tax purposes, partners are taxed by reference to the nature (income or capital) of the return received by the fund in which they share.

In Appendix 1 we explain the structure, function and effectiveness of carried interest arrangements in greater detail. Market practice regarding the basic carried interest model has not changed significantly for the past thirty years.

Carried interest distributions are not typically received by a fund manager until after the fund has generated enough cash returns from the sale of portfolio companies to pay back all of the investors' invested capital (including amounts drawn down to cover the fund's management fee/priority profit share and other expenses of the fund) plus a preferred return or 'hurdle' (of typically 8% p.a.)[2]. This is a profit share, which the fund manager only receives once the fund is already successful, i.e. the risk of any loss to investors has been eliminated and the negotiated benchmark return to investors has been exceeded.

In Appendix 2 we explain how carried interest is taxed. These rules have changed significantly in recent years and the combined effect of these rules is that carried interest will only be taxed as a capital gain (and then at the rate of at least 28%) if:

a) there is a significant risk that it will never pay out;

b) it is contingent on the fund generating value and making a realised profit on investments;

c) the carried interest is satisfied out of capital gains realised by the fund (with income included in the carried interest distributions taxed as such at higher rates); and

d) the investments on which the carried interest depends are held by the fund long-term (for 40 months or more on average), or the carried interest is subject to the comprehensive employment tax code applicable to employment related securities.

In broad terms, for both employees and self-employed people, growth in value is taxed as capital (subject to the detailed rules and safeguards we describe). Conceptually this is correct because carried interest is an investment in a long-term asset, which:

- generates a return which depends entirely on the growth in value of the fund (and clearly if the fund generates insufficient return there will be no carried interest distributions);
- rewards managers for the durable value they have created in the fund (for its investors) and in the portfolio companies from which the fund derives its value (for the common good); and
- aligns managers' interests with those of investors.

As well as being correct in broad principle, the UK taxation of carried interest is in line with the position in comparable jurisdictions. This is explained in greater detail in Appendix 3. Given our conclusion that the UK tax treatment of carried interest is conceptually correct, this should come as no surprise to anyone, but it is a useful validation of that point nonetheless.

PE/VC will play a significant role in the recovery of the UK economy. The investment environment needs to be as attractive as possible to encourage capital to be deployed in the UK. This means maintaining a competitive regime for asset managers that will fund investment in growth and innovation across the UK.

[2] As the preferred return is negotiated with investors on a fund by fund basis, there is variability (especially as return expectations change across economic circles). Some venture capital funds, which are usually higher risk and have longer holding periods, may have lower preferred return rates or, in some cases, no preferred return at all. This is in part to align the fund manager's attitude to risk with that of the investors.

The UK hosts the most important PE/VC ecosystem outside the USA and 50% of the European market. This generates significant numbers of highly skilled jobs, both within the PE/VC industry and the wider professional services community, and adds a significant dimension to the country's global importance as a financial services hub. However, in an ever-complex operating environment the tax, legal and regulatory advantages of establishing a PE/VC fund and/or manager in the UK have been eroded as overseas jurisdictions have developed more favourable regimes and the UK has not kept pace with these developments. There are plenty of jurisdictions which, particularly in light of Brexit, continue to evolve and strengthen their operating frameworks to ensure their country remains competitive with the UK PE/VC industry.

The government has publicly expressed its commitment "to the ongoing success of the asset management industry" and has launched a full review of the UK funds regime designed to "ensure the ongoing competitiveness and sustainability of the UK regime" (paragraphs 1.3 and 1.5 of the consultation document on the use of UK asset holding companies). As mentioned above, over recent years the UK carried interest taxation regime has changed considerably (e.g. with the introduction of a minimum tax rate of 28% and the significantly restricted scope for remittance basis users to access the benefits of that regime so far as carried interest is concerned) and it is no longer compellingly attractive when compared with the regimes in competitor jurisdictions. The UK now has one of the highest rates of tax for carried interest in Europe and internationally. The UK CGT rate on carried interest is 28% and many executives will pay higher blended rates where the underlying returns comprise a mix of capital and income. This headline rate (which will often be lower than the actual effective tax rate) is higher than the equivalent tax rate in some competitor European jurisdictions and only slightly lower than the equivalent rate in others.

Although (for geographic reasons if nothing else) it is not an obvious direct competitor jurisdiction to the UK, it may be instructive to look at recent developments in Hong Kong, where the asset management sector is widely seen as key to the territory's growth as a financial centre. The government introduced a number of measures to assist this, including a unified tax exemption for funds and a limited partnership fund vehicle to enable Hong Kong sponsors to establish funds with structures similar to those offered by competitor jurisdictions. Despite the government's best efforts to promote the territory to asset managers, commentators considered that continuing uncertainty around the taxation of carried interest limited the territory's attractiveness. Accordingly in August this year the government issued a consultation paper on a tax regime for carried interest in private equity funds operating in Hong Kong. Carried interest would be taxed at a "highly competitive rate", although the consultation paper does not clarify whether this would be a tax exemption or some other reduced tax rate.

Closer to home, it may also be worth noting that the requirements of the French carried interest tax regime were partially relaxed from the beginning of this year to the extent a fund has commitments in excess of €1bn. Also, in 2019 a specific regime was put in place for carried interest held by "impatriates" – i.e. for the carried interest rights held by fund managers who become French tax resident to the extent they held those carried interest rights before moving to France. This temporary regime also relaxes the requirements of the French carried interest tax regime (so that it is more likely to apply to impatriates) and applies to individuals who become French tax resident before the end of 2022.

All of this demonstrates that, if the government's stated policy aim is to have any chance of being successful, the UK's competitive position must not be allowed to deteriorate further and any suggestion that it might be must be dispelled as soon as possible.

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In a recent (23 September) answer to a question in the House of Lords on the taxation of carried interest from Lord Myners, Lord Agnew of Oulton said that the UK government "recognises that a competitive financial services sector in the UK, which includes the management of private equity funds, is an important part of attracting investment and driving growth. The UK's approach to the taxation of carried interest remains in line with most other G7 countries. It seeks to ensure that returns are taxed in line with their character and taxed at rates which appropriately balance the need to raise revenue with the importance of maintaining the UK's competitiveness for fund management."

The BVCA respectfully endorses Lord Agnew's comments. We hope we have demonstrated that the current UK carried interest tax regime, which is the result of extensive, recent modification:

- delivers an outcome in line with the regimes in competitor jurisdictions;
- reflects the essential nature of carried interest; and
- collects (and indirectly generates) material amounts of revenue whilst preserving the attractiveness of the UK.

As with management equity, it will be readily apparent that, for the reasons we have just explained, we believe that UK tax legislation draws the line between capital and income in the right place so far as carried interest is concerned and that the employment income tax charge is adequately protected.

Questions 16-18: Business lifecycle

The first point to make, in the context of entrepreneurs selling interests in businesses they have created, is that these individuals will often be selling the most valuable asset they will ever own and also an asset in which they have significant personal capital invested. They will, therefore, be particularly anxious to make sure that they sell their business for the highest price they can obtain whilst finding a buyer who will be a good steward going forward. Tax will clearly have an impact on their return. We have seen, at times when changes to CGT rates have been "trailed" that this has had an impact on the volume of transactions. This was seen most recently when the significant reduction in the value of entrepreneur's relief was widely anticipated. Individuals whose businesses are ripe for sale will understandably want to bring forward the time of sale so as to benefit from a more beneficial tax regime if they think that regime is going to disappear. It is always open to an individual to postpone making a disposal in order to delay a CGT liability. If entrepreneurs believe that any gain they may make on disposing of a business will be taxed at an unfairly high rate, they will simply not dispose of their interest. In that sense CGT is the ultimate discretionary tax. Taxing gains at too high a rate or in a way which entrepreneurs consider unfair is counterproductive in many ways. Gains will not be triggered and tax will not be raised. Businesses which should change ownership so they can move on to the next level of their growth and development will stagnate in their current ownership.

It is important that the tax regime does not artificially influence decision-making. One very obvious point to make here is that entrepreneurs who are relatively old or ill will be incentivised by the tax regime to retain their businesses and not dispose of them, even though the best course of action for the business might be to sell it to someone who is in a better position to take it forward. If individuals dispose of their businesses, they will be liable to CGT (now with very little in the way of entrepreneur's relief) and the sales proceeds they receive will be subject to inheritance tax at 40%

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on their death. Conversely, if the individuals retained their business until death, there would be no inheritance tax to pay and their estate would benefit from the CGT "tax free uplift on death". In other words, by retaining an interest in a business, which on any objective measure they ought to sell, individuals' estates will be very significantly better off in tax terms. This is a perverse incentive to retaining business assets which really ought to be disposed of.

If the CGT regime is to afford privileged status to particular gains, care should be taken to make sure that those exemptions properly reflect community values and contribution to the common good. The CGT regime has exempted from tax the gain arising on the sale of an inherited Old Master painting in a stately home (*HMRC v The Executors of Lord Howard of Henderskelfe (decd)*, [2014] EWCA Civ 278) and expressly exempts winnings from betting (see s51 TCGA 1992). It is not clear to us why the CGT regime should deliver these results and yet have been amended recently to reduce (almost to the point of oblivion) entrepreneurs relief and tax entrepreneurs' gains at the full CGT rate.

Any special regime for business interests will need to be carefully targeted. The problem with (the now significantly scaled back and renamed) entrepreneurs' relief was not its existence but the lack of rigour devoted to its design and, in consequence, its rather haphazard application. We can see real value in a regime where gains on disposals of "qualifying business interests" were exempt from CGT and where an individual's estate could be reduced for IHT purposes by an amount equal to the value of the consideration received for a disposal of such an interest to a third party, even if the IHT triggering event happened some time later. That would remove the tax incentive for an individual to retain a business that ought to be passed on to a new owner. A "qualifying business interest" would need to be carefully defined, but the qualifying conditions might focus on the business being a trading/professional one (not involving any material amount of investment activity), individuals being involved in the senior management of the business and this taking up all or substantially all their working time, the business being of a certain size when the qualifying stake was acquired (so the relief is restricted to the founders of a business or those involved with it at an early stage) and there being no artificial tax planning around the holding or disposal of the stake. There is a lot of detail that would need to be worked through (and this is clearly not an "oven ready" proposal) but we can see very significant attractions in a properly thought through entrepreneurs' relief.

Another area of difficulty, which you identified, is the position of earn outs. Often a business will be sold for consideration in two parts, a fixed cash amount paid up front and secondly an earn-out (an element of consideration which is paid, or not, at some point in the future and where the amount payable depends on the performance of the business in the first few years after the sale). Where a business is disposed of on these terms, the person making the disposal is initially charged to tax as if they had received at the time of disposal consideration equal to the fixed amount and the value at that time of the earn-out. If, when the earn-out comes to be calculated, they receive a greater amount than its initial value, that excess is treated as a gain arising on the disposal of the earn-out, which is treated as a separate asset for CGT purposes. Similarly, if they receive less than the day one value of the earn-out, the deficiency is treated as a loss arising at the time the earn-out payment is calculated.

This produces a number of anomalous results. Firstly, the person making the disposal is charged to tax at the time of disposal on an amount greater than the amount received at that time. If that earn-out value proves to be excessive, because in the events that transpire significantly less is received than expected, a loss will be triggered but that loss cannot be carried back and set off against the gain arising on the initial disposal. Looking at this transaction on its own, the individual will then end up being taxed on an artificially high amount of gain. Secondly, if the primary disposal

benefitted from a relief or exemption, that will not be available in relation to any gain arising on the deferred, earn-out consideration. Any profit arising on the disposal of the earn-out is treated as arising on a disposal of a separate chose in action, not the original asset. So, if the disponor is an individual entitled to entrepreneur's relief or investor's relief or a company which benefits from the substantial shareholding exemption ("SSE"), the benefit of that exemption will to that extent be lost. We have already drawn the government's attention to the SSE point in our response to the consultation on the use of UK asset holding companies. These concerns can lead to pressure to structure the terms of the disposal as far as possible (and, of course, it is not always commercially possible to do this) so as to take the deferred consideration outside these rules and into s48 TCGA 1992 (which provides a different regime for deferred consideration).

In our opinion, it would be much simpler and fairer if all forms of deferred consideration (whether simply fixed with a deferred payment profile or uncertain/ unascertainable at the outset) were treated in the same way and ignored when it comes to calculating the initial disposal, but then taken into account as an adjustment to the disposal proceeds when and if they are received. This would involve amending s48 TCGA 1992 (which requires the initial gain to be calculated as if all consideration will be received and an adjustment made if it is not). An exception might be made for fixed amounts payable within a short time (say a year) of the date of disposal which could be treated as received at the time of disposal, with relief being given if for some reason (the purchaser's insolvency is an obvious example) they were not actually received.

Questions 19-21: Reliefs available to business owners/shareholders

A number of our members raise funds from individual investors. They have no particular points to make in response to the questions you raised around the scope of CGT reliefs available to investors in EIS/SEIS/VCT companies. They did, however, stress the importance and value of these reliefs when it comes to raising relatively risky, early stage funding. They consider that it is important that the range of businesses which qualify for (e.g.) EIS relief should be kept under careful review, particularly in rapidly developing industries (such as fintech) so that relatively similar businesses are not in different positions so far as the availability of tax reliefs for investors is concerned.

Because of the power of EIS/SEIS reliefs, where an investment does not qualify for EIS/SEIS relief, CGT being charged at a markedly lower rate than income tax and the potential availability of share loss relief (s131 ITA 2007) helps to reclaim some of the ground lost when it comes to raising capital for smaller companies from individuals. This reflects the point we made at the beginning of our letter, than an important function of CGT is to encourage investment and risk-taking. In principle, investors relief should help to attract investment into unlisted companies whose trade is excluded from SEIS or EIS (such as hotels or property development) or where a company has outgrown those reliefs, but anecdotally there is not a lot of evidence of investment being raised off the back of this relief. This may be because (compared with SEIS/EIS/VCT) it is relatively ungenerous and also because its complexity means that there is no guarantee that relief will actually be obtained (e.g. if the company in question is sold within 3 years of an investor subscribing).

We have commented on entrepreneurs relief (as it was originally named) above and we repeat the comments made there, that the application of the CGT (and IHT) regime to business interests should positively mark and reward the wider social benefits of entrepreneurial activity and the risks taken by all those who invest (financially or in other ways) in unquoted trading businesses. We would support a broader and simpler CGT exemption, without any minimum holding period or lifetime or other cap, for individuals who invest (by way of subscribing new money for ordinary shares) in unquoted trading companies/groups. As with our earlier suggestion in relation to the CGT

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treatment of owner-managers, there is a lot of secondary detail that would need to be worked through (for example, around the size of the business when the investment is made), but we can see very significant attractions in a relief that encourages entrepreneurial, business risk taking.

Question 38: Are there any areas of complexity that are unique to partnerships?

The short answer to this question is "Yes; many."

The taxation of chargeable gains is one of the most complicated and confusing areas of partnership taxation, in part this is because of the uncertainty around the nature of a partner's interest in the underlying partnership assets and in part this is because of the lack of legislative provision in this area and the way that vacuum has been filled. Statement of Practice D12 ("SP D12") seeks to fill this legislative vacuum. SP D12 has been in existence for nearly 45 years without its status being challenged, perhaps because it provides a pragmatic answer to most questions relating to partnerships and chargeable gains. An alternative explanation, hinted at by the OTS in its earlier report on partnerships, may be that most trading or professional partnerships do not own significant capital assets on which gains may arise and the partnerships which are most likely to raise issues in this area are partnerships within an investment business where many partners will be non-UK resident or exempt bodies such as charities and pension funds.

We should just pause here to express our disquiet with the basic idea that the entire UK CGT regime for partnerships should be based on a statement of practice (however well-intentioned and largely fairly balanced). In *R v HMRC ex p Wilkinson*, [2005] UKHL30, the House of Lords set out the (relatively restricted) scope of HMRC's general management and collection powers in the context of its publication of extra-statutory concessions. Lord Hoffmann observed that "This discretion enables the Commissioners to formulate policy in the interstices of the tax legislation, dealing pragmatically with minor or transitory anomalies, cases at the margins or cases in which a statutory rule is difficult to formulate or its enactment would take up a disproportionate amount of Parliamentary time." It is an interesting question whether the scope of these powers extends to building such a complex superstructure as SP D12 without a clear statutory foundation, and it is clearly wholly unsatisfactory that an entire tax regime might turn out to have its foundations on the legal equivalent of sand.

We have sympathy with the OTS view that, whilst there are significant conceptual questions around chargeable gains and partnerships, the number of cases where those points cause a real problem is likely to be relatively low. As we have already noted, most professional partnerships will not own significant capital assets beyond their own goodwill (which will not have a balance sheet value or be dealt in). If chargeable gains issues are going to arise in partnerships it is in investment partnerships and here too we know that a significant proportion of investors are simply unconcerned by UK CGT. However, where investors for whom UK CGT is a concern participate in an investment partnership, the difficulties readily become apparent.

The Myners Report[3] in 2001 identified practical difficulties for life insurance companies investing in venture capital investment partnerships. These included difficulties in obtaining information and valuations where required and in particular the issues which can arise where a life insurer's interest in underlying partnership assets changes as a result of a change in the composition of the partnership and corresponding ownership proportions. This report lead to the introduction of what is now Schedule 7AD TCGA 1992 in 2002.

[3] https://webarchive.nationalarchives.gov.uk/20010603090552/http://www.hm-treasury.gov.uk:80/pdf/2001/myners_report.pdf

It may be worth pausing here to consider some of the particular concerns raised by the operation of SP D12 in the context of investment partnerships which lie behind this view.

Initially, SP D12 places a great deal of weight on the partnership accounts and crediting amounts to individual partners' accounts, but nowhere in SP D12 is there a clear statement of what the partnership accounts are and the basis on which they should be drawn up. Are they little more than a cash book which reflects partners' dealings with each other (which is what typical professional partnership accounts might well have been in 1975 when SP D12 was introduced) or do they signify something more substantial, especially where a partnership prepares accounts in line with GAAP which are audited? What if a partnership maintains two sets of accounts, one for publication and another to track partners' rights inter se?

Where individual investors dispose of their interest in a partnership, their disposal consideration under SP D12 is the aggregate of their share of the partnership's balance sheet value for its underlying investments together with any consideration received. This can result in a bizarre position. Suppose individuals had invested £100 in a partnership and their share of the partnership's balance sheet value was £100. They then sell their share in that partnership for £100 to another investor. Taken literally, SP D12 treats the consideration as £200. This is clearly a nonsense.

Profit shares in an investment partnership can change where new investors are introduced (resulting in existing partners' shares being diluted) or where a carried interest hurdle is reached (so that investors' profit shares reduce). In these circumstances there will be a part disposal by the investors whose profit share reduces. SP D12 provides that the consideration received by those investors is the appropriate fraction of the balance sheet value of partnership assets (paragraph 4.2 of SP D12) although there is some ambiguity here as another passage in SP D12 (paragraph 6) might suggest that this will only be the case if partners have been credited with a share in the revaluation surplus and possibly only where that crediting is of real commercial significance (ie the amount credited is an amount which will be payable to partners so that there would be an inequity if a subsequent reduction in their profit shares did not trigger a part disposal). These ambiguities should be cleared up and SP D12 should state unambiguously the circumstances in which a PSR change could give rise to a CGT liability. In our opinion, investors should not suffer a CGT charge which does not reflect their realised commercial return from the partnership. This point was reflected in the Myners Report and we endorse it wholeheartedly for all UK taxpaying investors, not just life offices.

We also consider that the SPD12 treatment of in specie contributions to and distributions by a partnership is not correct. Two cases, *Booth v Ellard*, [1980] STC 555, and *Jenkins v Brown*, [1989] STC 577, concern pooling arrangements where assets (not necessarily fungible or identical) are contributed to a pooling arrangement or distributed out of one. In both of these cases it was held that there was no disposal and no tax charge was triggered by the contribution of assets to a pool or by distribution out of the pool, provided that the contribution or distribution correctly reflected the contributor or recipient's proportionate interest in the pool. In contrast, SP D12 assumes that there will be a part disposal when an asset is contributed to a partnership and similarly a part disposal, with a tax charge on partners other than the recipient, where there is a specie distribution. Not only does this approach seem to us to be wrong in principle, it is out of line with established authority.

We consider that greater attention should be given to the issues raised by SP D12 than was given at the time of the OTS partnership review and this should result in a clear tax regime which does not expose investors to artificial, "dry" tax charges (e.g. on contributions or distributions in specie or changes in profit sharing ratios). We say this because VE/PC funds are typically structured as limited partnerships, and our members have an interest in the health and efficiency (in a number of respects, regulatory and general legal as well as tax) of the UK rules which apply to partnerships as investment vehicles. It does not seem to us that it is at all helpful (not least because it suggests that the UK has no real interest in such a key plank of the investment management industry) for the UK CGT regime to be replete with areas of doubt or difficulty for UK taxpayer investors in fund partnerships.

We hope that these thoughts are clear and helpful and a useful contribution to your researches. We look forward to our meeting with you on 13th October, when we will be able to discuss the issues we cover in this letter and any other areas where you consider our input would be helpful.

Yours faithfully,

Mark Baldwin
Chairman, BVCA Tax Committee

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Appendix 1 – Carried Interest Explanation

This Appendix includes an illustrative example to explain how the economics of venture capital and private equity funds typically work.

This is a typical example only and there will be variations across the PE/VC industry or across jurisdictions, depending upon local conditions and market circumstances.

Start of fund's life:

- A group of executives set up a fund manager and raise a fund from professional investors to pursue a particular investment strategy. This entails detailed negotiations with those investors regarding many aspects of how the fund will be managed.

- The investors do not actually make cash contributions to the fund at this point, rather they make a commitment to provide capital on request (a "draw down" request) from the manager so the fund can make investments into portfolio companies as and when the manager has identified appropriate opportunities.

- The fund manager agrees with its investors, in a legal contract, arrangements related to the: management fee (also known as a priority profit share (PPS) based on its legal structure), carried interest and its co-investment requirement (ie the extent to which the fund manager itself or individuals involved in that business are required to invest in the fund; this is typically 2-5% of total funds raised).

- Executives are participants in the carried interest and co-investment arrangements. Outcomes here are entirely dependent on the future (and unpredictable) returns that the fund achieves.

- The carried interest entitlement is created at this time. Carried interest may be paid at a future date, but only once investors have received their capital back plus an agreed preferred return.

- The fund starts to make investments.

Years 1 to 5:

- This is known as the "investment period", during which the fund manager draws down on the investors' capital commitments to make investments in portfolio companies.

- Capital is also drawn down to pay the management fee/PPS and other fund-related costs. The management fee/PPS typically between 1.5% and 2.5% of the fund's committed capital and is paid to the fund manager during the investment period to cover ongoing costs such as salaries, office rents, travel expenses, etc.

Years 6 to 7:

- The investment period has ended and the fund starts to realise its investments (e.g. sell portfolio companies to trade buyers, list them on the stock market, etc.)

- The cash proceeds from exits begin to be distributed to investors.

- At this stage, the fund manager is not entitled to any share of these cash distributions because investors have not yet received back the value of their drawn down capital for all investments, management fee/PPS and other costs plus the agreed preferred return (typically 8% p.a.). As the preferred return is negotiated with investors on a fund by fund basis, there is variability (especially as return expectations change across economic cycles). Some venture capital funds, which are higher risk and have longer holding periods, may have lower preferred returns (or even no preferred return at all) in order to create alignment between investors and fund managers. In a (relatively small) number of funds carried interest distributions may be permitted on a deal-by-deal basis, but in such cases there would be a clawback provision if the fund does not reach the agreed level of performance over its life.

Years 8 to 9:

- The fund continues to realise its investments.

- Investors have now received sufficient cash distributions to cover their drawn capital for all investments, management fee/PPS and other costs plus the agreed preferred return.

- At this point, the fund manager becomes entitled to its percentage profit share (carried interest) of all future proceeds from realisations in line with the agreement made with investors at the start of the fund's life.

- However, even then, the manager's carried interest entitlement will only be released to the fund manager once investors have received further cash distributions sufficient to cover any undrawn capital commitments which the manager could still draw down, and so the carried interest distributions will be retained in an escrow account until this point is reached.

Years 9 to 10:

- The fund continues to realise its investments in portfolio companies.

- Investors have now received sufficient cash distributions to cover their drawn down capital plus undrawn commitments (i.e. the total amount that they originally committed to the fund) and the agreed preferred return.

- The fund manager and its executives share in proceeds from realisations.

- The fund is wound down once all its investments have been sold, at which point any remaining proceeds held in escrow would be released to the carried interest participants.

Carried interest is not guaranteed for any PE/VC manager. A PE/VC fund may not achieve the agreed return in which case there would be no carried interest. A significant proportion of fund managers do not receive carried interest; the range of returns across the UK industry is included in the BVCA's annual Performance Measurement Survey (available here).

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Appendix 2 - Current Taxation of Carried Interest

Since July 2016, carried interest has been taxed according to the UK's specific and detailed tax regime, the "Carried Interest Rules" set out in Chapter 5 of Part 3 TCGA 1992. The disguised investment management fee rules (or "DIMF Rules") (found in Chapter 5E of Part 13 ITA 2007) are also relevant, in that carried interest needs to fall within a specific exemption from the DIMF Rules in order to be taxed (potentially to CGT) under the Carried Interest Rules rather than as trading income under the DIMF Rules.

These rules constitute a comprehensive regime for the appropriate taxation of carried interest. They also reflect and codify key features of carried interest that, as discussed above, reflect its nature as a long-term capital interest.

As we explained in the body of our letter, PE/VC funds are typically structured as limited partnerships and so distributions, to investors and carried interest holders alike, will comprise partners' shares of income and capital (predominantly capital) returns from underlying portfolio companies. As partnerships are transparent for UK tax purposes, partners are taxed by reference to the nature (income or capital) of the return received by the fund in which they share. Under the Carried Interest Rules, capital distributions within carried interest received by a fund manager are taxed as capital gains at a special tax rate of 28%. To the extent carried interest is satisfied through allocations of underlying dividend or interest income realised by the fund, higher tax income tax rates will apply to the carried interest. The regime does not result in the preferential taxation of income.

In order to be taxed in this way, carried interest must fall within a specific exemption from the DIMF Rules. There are two ways for carried interest to fall within the exemption:

a) there is a "safe-harbour" for carried interest that may only arise to carried interest holders after: (1) all or substantially all of investors' capital investments in the fund have been repaid; and (2) each third-party investor has received a preferred return (of at least 6%) on their capital invested (see s.809EZD ITA 2007); and

b) carried interest that does not fall within the safe-harbour must be a "profit-related return" (see s. 809EZC ITA 2007). This means that the carried interest must only arise if: (1) there are profits on the fund's investments; (2) the amount of carried interest that arises is variable to a substantial extent by reference to those profits; and (3) returns to third-party investors are also determined by reference to those profits. There must also be a "significant risk" that the carried interest would not arise at the time the entitlement is acquired by the carried interest holder and whenever a material change is made to the arrangements.

In addition, carried interest that meets these conditions may still be taxed as trading income under the DIMF Rules if it is "Income Based Carried Interest" which is elaborated in Chapter 5F of Part 13 ITA 2007. Broadly speaking, carried interest will be Income Based Carried Interest if the fund holds investments, on average, for less than 40 months. These rules do not apply to carried interest that is an employment related security, in recognition that, for employees, the appropriate boundary between capital and employment taxation is provided for in the interaction between the CGT rules (including the Carried Interest Rules) and the UK's employment tax and employment related securities ("ERS") rules.

The combined effect of these rules is that carried interest will only be taxed as a capital gain (at the higher 28% rate) if:

a) there is a significant risk that it will never pay out, either because it meets the significant risk condition described above or because it pays out only after a significant preferred return of 6% or more agreed between investors and the fund manager;

b) it is contingent on the fund making a profit on investments, either because it meets the requirements set out above or because the fund has managed to pay a preferred return to investors as well as returning their capital investment;

c) the carried interest is satisfied out of capital proceeds realised by the fund (with income taxed at higher rates); and

d) investments on which the carried interest depends are held by the fund long-term (for 40 months or more), or the carried interest is subject to the comprehensive employment tax and ERS rules discussed below.

All of these requirements mean that CGT treatment will only apply to carried interest which is a long-term capital investment interest. “Guaranteed” returns, income and profits from short term investment will not benefit from CGT treatment. It would be inappropriate to tax carried interest that meets all of these requirements as earned income, even more so when the interaction with employment tax and ERS rules is considered.

Interaction with employment and ERS rules

When carried interest holders who are employees of a fund manager acquire new carried interest entitlements, they are taxed under long-standing UK employment tax rules in the same manner as any other employee would be if they acquired something of value in connection with their employment.

Under s.62 ITEPA 2003, the carried interest holder is subject to income tax on any positive difference between the value of the carried interest entitlement they acquire and the price they pay to acquire it. Once that income tax has been paid, the carried interest is treated like any other capital asset (subject to the rules described above) and if it goes up in value, CGT (at the 28% rate) is charged on the gain.

If carried interest is acquired by an employee, as well as being an employment-related security it will also be a “restricted” security (because it will be liable to forfeiture in certain circumstances). Holders of restricted securities can be subject to future income tax liabilities in certain circumstances. In order to avoid this an individual must either pay a price for the carried interest equal to its unrestricted market value (or “IUMV”, ie its value as if it were not subject to the relevant restrictions) or make an election (under s.431 ITEPA 2003) to be subject to employment income tax and NICs on the difference between the price paid and the IUMV of the carried interest when acquired.

This is the employment tax regime applicable to all ERS assets; it is not a special carried interest tax regime. These rules reflect the general principle, long established in the UK tax regime[4], that the point at which a security or similar asset (even one which is forfeitable on leaving the relevant employment) is acquired is the point at which employment taxes are relevant.

[4] *Abbott v Philbin*, 39 TC 82

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Appendix 3 - Non-UK Taxation of Carried Interest

Tax rates

UK fund managers will generally be subject to capital gains tax at a rate of at least 28% on any carried interest proceeds they receive from a fund, without benefitting from a share of investors' base cost in fund assets but with credit for any amounts they paid to acquire their carried interest. As shown in the Table, this is higher than the equivalent tax that would be incurred by fund managers in Italy, Singapore and the US (at Federal rates) on similar proceeds. France, Germany and Ireland would each impose tax at a slightly higher rate.

In the UK, if carried interest is satisfied out of underlying income realised by a fund (rather than capital gains), it will be taxed at the significantly higher rates of 45% for interest and 38.1% for dividends. These tax rates exceed the tax that would be expected in every jurisdiction in the Table other than Ireland.

Tax classification of carried interest

Like the UK, most of the jurisdictions shown in the Table treat carried interest proceeds as investment income or capital gains rather than earned income. The exceptions are Germany and Singapore. In Germany, the carried interest tax regime exempts 40% of carried interest proceeds from the employment income tax that would otherwise apply, bringing the applicable rate down to a flat 28.5%, which is in line with the UK capital gains tax rate for carried interest. In Singapore carried interest may be taxed as personal employment income, but the applicable rate is just 22% (plus social security). In addition, carried interest is often structured so as to be received in Singapore exempt from tax (as dividends or capital gains generated by a foreign carried interest holding vehicle).

Though not shown in the Table, Switzerland and Luxembourg may also tax carried interest as employment income. The upper headline tax rates are 41.5% and 45.78% (plus social security). However, the availability of favourable tax regimes or structuring options means that these rates of tax are rarely paid in practice, particularly where executives move into the relevant jurisdiction from abroad.

Tax on acquisition

Where employees acquire carried interest for less than its market value in each of these jurisdictions, the discount could in theory be taxed as an employment benefit, as it could in the UK. However, broadly speaking, carried interest awarded at the outset of a fund is likely to be considered to have low or negligible value in each of these jurisdictions broadly in line with the position that would apply in the UK.

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COMPARISON TABLE OF CARRIED INTEREST TAX RATES IN SELECTED JURISDICTIONS

	Expected effective tax rate (upper rates unless rate is flat) (%)						
	UK	**France**	**Germany**	**Ireland**	**Italy**	**Singapore**	**US****
Specific carried interest tax regime?	Yes	Yes	Yes	No	Yes	No	Yes
Taxed as employment income?	No	No	Yes (subject to 40% exemption from tax)	No	No	Yes / No (if received as foreign dividends / capital gains)	No
Capital gains	28%	30% (plus 4 for high earners)	28.5%	33%	26%	22% / 0*	20% (if held for 3 years or more)
Interest	45%	30% (plus 4 for high earners)	28.5%	40%	26%	22% / 0*	37%
Dividends	38.1%	30% (plus 4 for high earners)	28.5%	40%	26%	22% / 0*	37% (unless qualifying dividends)

**Foreign source income received or deemed received by a Singaporean tax resident individual is exempt from income tax. Singapore does not tax capital gains.*

*** Federal rates*