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Profit Fragmentation Consultation
HM Revenue & Customs
Specialist Policy Team
Room 3C/04
100 Parliament Street
London
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8 June 2018

Dear Sirs,

Tax Avoidance involving Profit Fragmentation

We are writing in response to the consultation document on Tax Avoidance involving Profit Fragmentation dated 10 April 2018 (the "**Condoc**") to provide feedback on behalf of the British Venture Capital Association, and to follow up on the meeting between certain members of the BVCA Tax Committee and Mr Edney and colleagues from HMRC that took place on 15 May 2018 (the "**Meeting**"). The impression we took from the Meeting is that the draft legislation will be very different from the proposals in the Condoc and so we have addressed some key issues here rather than working through the detailed questions in the Condoc.

We should mention at the outset that we were surprised and disappointed to see the asset management industry referred to in paragraph 2.5 of the Condoc, but more encouraged by comments in the course of our Meeting that HMRC were not aware of any examples of structures adopted by asset managers that are targeted by these proposals.

The British Private Equity & Venture Capital Association ("**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 700 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers and investors. The UK has an active venture capital and private equity market which raises capital from investors and invests it globally. Our members are long-term investors, typically investing in unquoted companies for around three to seven years. This is a commitment to building lasting and sustainable value in the businesses they invest in.

Whilst the BVCA is fully supportive of efforts to ensure that strategies for unacceptable tax avoidance and evasion are effectively countered, we have fundamental reservations around the proposals in the Condoc and are concerned that, were the proposals to be implemented in the manner originally contemplated, this would introduce considerable uncertainty for taxpayers and make the UK a significantly less attractive jurisdiction for international businesses, including our members, to establish and operate.

With regard to the proposals in the Condoc, in high level, our concerns are these:

On Proposal 1 (targeted legislation) we consider that the new rules are cast far more widely than they need to be to counter the sort of artificial profit fragmentation at which the rules are said to

be aimed. The legislation isn't targeted at all and its breadth, uncertainty and uneasy overlap with existing specific codes are the cause of our concerns.

Proposal 2 (notification of schemes and payment of tax) exacerbates that concern. The obligation on the taxpayer to notify HMRC of arrangements which have three (but not all) of the characteristics for there to be a tax liability by means of an entirely separate mechanism from the normal self-assessment coupled with HMRC's ability to demand payment of tax if they have "reason to believe" that an amount is chargeable, where those arrangements will in most cases fall outside the charge to tax imposed by the new rules, will cause considerable concern to taxpayers, in particular where the notification relates to an anti-avoidance provision. Consequently, non-UK businesses and individuals may regard the UK as significantly less attractive as a place in which to operate or live.

In short:

- We support the introduction of necessary, targeted legislation to counter aggressive avoidance and evasion;
- Such legislation should be carefully framed to meets its objectives and avoid creating uncertainty or excessive compliance burdens which make the UK an unattractive place to do business;
- If this legislation is necessary (and we are not convinced that a vigorous application of existing rules would not achieve the desired goals), it should be more carefully targeted at the arrangements that it is intended to apply to;
- The proposed legislation is broad, imprecise and fits uneasily with existing codes. The fund management industry is subject to some carefully drafted sets of rules (e.g. those relating to disguised investment management fees and carried interest). These proposals overlap (but not neatly or completely) with those rules and the result is uncertainty which undermines the careful balance struck by the fund manager specific tax regimes;
- If there is to be a draconian compliance regime (requiring reports and tax payments where an arrangement comes close to but not necessarily within the regime) the new rules themselves must be precise and clear and their compliance infrastructure should be restricted to those who are (or are very nearly) clearly going to be subject to tax under these rules.

Proposal 1 (targeted legislation)

The proposals set out four tests for the rules to apply. The first three of these operate as a gateway and trigger for the notification requirement (on which see below), with the final condition determining whether a charge will actually arise. The Condoc appears to indicate at a number of points that the new rules would apply as a kind of quasi transfer pricing safeguard – which seems to imply that the actual transfer pricing rules in TIOPA will not apply in the majority of circumstances that the new rules are intended to apply to. For example, paragraph 2.15 of the Condoc describes common features of the arrangements under consideration as involving "offshore structures in low tax jurisdictions" with "little or no substance" which have "profit allocated offshore [that] is excessive having regard to the services carried out". However, the way the conditions for the rules to apply are described make us concerned that the rules (and certainly the notification element of them) will apply more widely.

Profits Attributable to the Individual

We note that there is no detailed consideration in the Condoc of precisely what this condition will require. We understand from our Meeting that the targeted mischief involves profits that are properly attributable to the activities of an individual that in reality are earned in the UK, but which an individual claims (by fragmenting the way his business operates) are earned overseas by an entity the profits of which are not taxed on him. However, the wording of the Condoc at paragraph 3.4 can be read as suggesting that the mere fact that an individual is resident in the UK will be sufficient to satisfy this condition if he has an interest in profits in an offshore vehicle. In this regard there is no clarity on what link is required to make profits “attributable” to the individual.

While there may be cases where an individual falsely claims that sums are earned outside the UK where, in reality, they have been earned by his individual activities in the UK, in other cases an individual's business activities will take place in a number of jurisdictions for purely commercial reasons. In the context of the examples in the Condoc it is easy to see a clear link between a particular individual and profits which have arisen in a non-UK vehicle. It is much harder to see a link in more complex situations and that is where our uncertainty and concern around the scope of the legislation comes from.

The businesses of many of our members are highly international in nature and individuals involved in them will often undertake significant levels of activity outside the UK for non-UK entities performing substantial functions within the business. These are not examples of what are fundamentally UK businesses which have been artificially fragmented in order to achieve a tax advantage.

In addition, the private funds that our members are involved with are commonly established (for a range of tax and non-tax reasons) as limited partnerships with offshore general partners. The general partner is an essential component of the overall structure and has its own distinct business activities and is the entity which receives all of the management fee (or equivalent) for managing the fund. That fee is then split between the various entities and individuals (some UK some, possibly, not) involved in the overall investment management activities for the fund. Thus, in one sense, it might be said that the general partner’s profits are “attributable” to the activities of the activities of individuals in the UK.

This point links to the “excessive profits” condition. As we note later, paragraph 4.6 of the Condoc expressly articulates the need for a link (a “personal connection”) between the individual sought to be taxed and the excessive nature of the profits arising overseas. That link is just not present in complex businesses, as opposed to the more straightforward essentially “one man band” examples in the Condoc. If, as was indicated in our Meeting, the real mischief is sole traders or other smaller (in headcount) businesses abusing the fact that the transfer pricing legislation does not apply to them, the solution is to make that factor a gating item to the new rules applying and not to introduce a broadly cast, imprecise code that complex businesses will struggle to apply.

Given the above concerns, we consider that it should be made very clear that the rules will only be on point where the activities that have generated the profits in question have in substance been performed in the UK by an identifiable individual and there has been an artificial (UK tax

avoidance motivated) fragmentation into a insubstantial offshore entity with no independent business purpose (and perhaps this could be addressed by including a motive test in the legislation).

Significantly Less Tax

The detailed consideration of the proposals begins at paragraph 4.1 with the "significantly less tax" condition. While we appreciate that many of the arrangements against which the new rules are targeted involve low tax jurisdictions, it is important to note that there are also many legitimate, non-tax reasons why businesses choose to establish in certain jurisdictions. In the fund management industry, jurisdictions such as Jersey and Guernsey offer attractive legal and regulatory frameworks that have not historically been available within the UK. These features may make a fund established in those jurisdictions more attractive to certain classes of investor, e.g. institutional, non-EU investors.

For the above reason, it is important the any new legislation does not have the effect that the mere fact of there being an entity established in a low tax jurisdiction operates as a "hair trigger" to the application of the rules or that the legislation is triggered just because profits arise in a corporate vehicle. Obviously, the extent to which this matters will depend upon how the other gateway conditions are ultimately enacted.

Another key point to make is that rates of corporate taxes in most (if not all) jurisdictions will be well below UK personal tax rates, as they are in this country. A business may have a presence in a jurisdiction which has a full rate of corporate tax (and in which the business may pay a full UK-equivalent amount of corporate tax). That rate would (of course) still be significantly lower than the amount of UK tax that would be paid by an individual on these profits.

Power to Enjoy

We understand the desire of HMRC to ensure that arguments against the correct application of tax legislation cannot be raised, based upon artificial alienation of profits. The fund management industry, we are very familiar with the disguised investment management fees ("**DIMF**") rules to which the Condoc refers. However, this raises an important issue.

The DIMF and carried interest rules effectively cover broadly the same ground as the profit fragmentation rules proposals but they do so in a way which has been the subject of extensive discussion with HMRC around the circumstances in which it is right for an amount arising to a fund management business entity to be taxed (or not) on individual participants. Those rules deal with issues such as the position of a non-controlling shareholder and the fact that corporate tax rates tend to be lower than the rates paid by individuals. It would therefore be unduly burdensome for taxpayers within the funds industry to have to deal with both industry specific rules (DIMF) and a set of new, more generally applicable rules, particularly if they were not absolutely aligned in application, which currently seems likely. We understand why it would be difficult for you to legislate an industry specific carve out from any new rules, but we do consider that it would be appropriate for any new legislation to provide that where sums fall within the scope of specific legislative cases, those more specific rules should dis-apply any new rules.

The important point here is that this exclusion should not just apply where, as currently contemplated in paragraph 4.28, the more specific rules operate to impose additional taxes. It is crucial that any exclusion operates in cases where sums fall within the scope of other rules but are then left untaxed by them because those other rules deliberately and properly do not impose taxes on those sums. If this is not done, the extensive exercise of moulding the DIMF and carried interest rules to fit the industry will have been a complete waste of time. We would be very happy to work with you on clarification of the interaction of the proposed regime and the existing industry specific rules.

Excessive Profits

Paragraph 3.5 states that the aim of the excessive profits condition is to provide businesses with "immediate certainty" as to the application of the new legislation. In this regard, we note that paragraph 4.6 states that if "sums paid…are in reality in return for services actually carried on in the UK" then the condition will be met. This would appear to be a relatively straightforward transfer pricing type requirement.

If that is to be the case, however, it is unclear to us why when a business reasonably considers, applying transfer pricing rules, that this condition has been satisfied, it must nevertheless go through the notification procedure. If, as became apparent during our Meeting, HMRC's real (and understandable) concern is simply that UK businesses (particularly sole traders – and we note the reference in paragraph 4.6 to "the personal connection between the relevant individual and the offshore entity results in excessive profits being allocated to the latter in order to minimise tax") outside the scope of the transfer pricing rules are abusing their position, the simple test for excessive profits could be that (using the same transfer pricing test) arm's length consideration is not being paid for work done in the UK.

Proposal 2 (notification of schemes and payment of tax)

As noted above, the funds industry is highly international in nature and it is essential that the UK remains an attractive place for individuals and businesses to establish and operate. While anyone coming to the UK will clearly accept the obligation to file tax returns and pay tax in the normal way, an obligation to make separate filings - particularly in the context of anti-avoidance rules - is likely to raise considerable concerns for international fund managers who are currently being courted by a number of other European jurisdictions. These concerns will be particularly acute where, as seems to be the case here, the notification and payment requirements (we note that HMRC can require payment if they have "reason to believe" that there may be a tax liability) may be triggered in a very wide range of entirely innocent circumstances where ultimately the legislation will not impose a tax charge.

The UK has introduced a number of complex sets of targeted rules dealing specifically with the fund management industry (such as DIMF, carried interest and income based carried interest rules) and as such many fund managers are struggling under a weight of new rules. To add further unnecessarily complex and imprecise rules can only harm the UK's attractiveness as place to base a fund management business, running contrary to the government's stated policy goal of promoting the UK as a competitive and stable tax and regulatory environment (para.2.5 of "The UK Investment Management Strategy II" published by HM Treasury in December last year) for the fund management industry.

In this regard we think that making sure that the notification requirement is properly targeted is as important as ensuring that additional tax is only paid by those individuals who are establishing arrangements that the rules are clearly targeted at.

As also discussed at the meeting, the international investment community is very conscious of being in any way linked with tax avoidance, which can include any relatively innocent notification outside of normal tax filing. If an innocent notification requirement could in any way be construed as being part of a tax avoidance arrangement, even where there is no tax liability, this could impact fund managers' ability to attract investment to the UK in the future if such an innocent disclosure had previously been required.

Likewise, individuals contemplating coming to work, or to remain working in the asset management industry in the UK, are conscious of any lack of certainty in relation to their personal tax filings and the possibility of an additional filing which is outside the relevant disclosure and time limits of the long standing safeguards of the self-assessment regime, could have a significant impact on the attractiveness of the UK as a place to come to work.

We would be happy to discuss these issues further once you have considered other responses to the Condoc and to assist in any way that might be helpful.

Yours faithfully,

Mark Baldwin
Chairman of the BVCA Taxation Committee