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British Private Equity and Venture Capital Association (BVCA)

The taxation of private equity/venture capital funds

A recent paper published in the British Tax Review by Mr Dan Neidle, who previously headed the tax practice at a major international law firm, suggests that most private equity funds should be treated as "trading" for tax purposes.

One of the consequences of taking this approach would be that all the returns private equity and venture capital (PE/VC) executives receive from their equity interests in the funds they manage would be subject to income tax, rather than the appropriate element of the returns being subject to capital gains tax as is the case at the moment.

The BVCA recognises that there is legitimate interest in ensuring the proper tax treatment of the returns managers make from the funds they operate and we have today set out our position on that question (see here). However, the basis on which the UK taxes returns from investment funds (more widely than simply private equity and venture capital) has been settled for many years and is generally seen (by HMRC and advisers) as correctly reflecting the law. A major change in the principles applied to investment funds would have a direct impact on the competitiveness of the UK that would go beyond the venture capital and private equity industry.

The BTR article argues that "a typical private equity buyout fund will in the author's view in most cases be carrying on a trade", but notes that, in all but the most exceptional case, HMRC will accept that a PE/VC fund is not trading. Attention is drawn in the article to the agreement between the PE/VC industry and the government in 1987, and it is suggested that HMRC are acting ultra vires in agreeing this position and holding to it in the intervening period.

The BVCA does not agree with this analysis. The purpose of this note is to set out the industry's perspective, that PE/VC funds are carrying on an investment business, and to set the discussion in a wider context to explain this view.

In the BVCA's opinion:

- the current approach taken by the industry and HMRC to the taxation of PE/VC funds, that they are carrying on an investment business, not trading, is consistent with how such principles are applied to the taxation of returns from transactions in securities generally and is wholly in line with established case law, where these principles have been tested and confirmed;
- the 1987 statement does no more than set out, for the avoidance of doubt, a common understanding of the legal position agreed between the industry and relevant government departments;
- reforms introduced by successive governments have all been based on the analysis that PE/VC funds are carrying on an investment business;
- the current regime (as well as being correct) is good for pension savers and charities as well as for the financial services industry and the wider economy;
- HMRC are fulfilling what the law and their duties require and so are not acting ultra vires.

Is the 1987 statement a "special deal" for the PE/VC industry?

In 1987 an agreed statement of position was published by HMRC's predecessor, the Inland Revenue, the then Department of Trade and Industry and the BVCA setting out how those bodies considered that the UK tax and regulatory regimes and general law would apply to investment funds structured as onshore UK limited partnerships. The statement was intended to give fund managers and investors confidence that UK fund

vehicles could safely be used for this type of investment, which had previously been run through non-UK vehicles. The 1987 statement has been enormously successful in anchoring the UK as a leading centre for this growing asset class in the global asset management industry.

The confirmation in the 1987 statement is that a fund which "purchases shares and securities with the intention of holding them as investments" will not be trading. That is a statement of a well-established principle, that if somebody buys something to hold as an investment, they are not trading. This statement was considered to be a fair reflection of the case law at the time. It has never been seriously called into question by anyone at any time in the 35 years that have followed.

Is HMRC's approach to PE/VC funds' tax position consistent with its general analysis?

The borderline between investment and trading is not always easy to discern and requires careful oversight; this is particularly the case in the sphere of professional investment. HMRC has addressed this issue more generally, beyond the 1987 statement and outside the PE/VC context.

In Statement of Practice 1/01 (SP 1/01), HMRC explain how a special regime (the Investment Manager Exemption (IME)) operates. This regime enables non-residents to appoint a UK-based investment manager with clarity that the profits made through their manager will not be subject to UK tax. A non-resident will only be liable to UK tax on its profits if it is trading and if its manager constitutes a UK tax presence of the non-resident. So, the IME is only relevant if the non-resident is trading.

In SP 1/01, HMRC explained that:

> "The active management of an investment portfolio of shares, bonds and money market instruments such as bills, certificates of deposit, floating rate notes and commercial paper does not constitute a trade. But every case must be considered in the light of its own facts.
>
> HMRC view short positions as conceptually the same as long positions and synthetic positions as conceptually the same as the equivalent 'real' positions. Neither going short nor taking synthetic positions using derivatives are in themselves indicative of trading."

The activities being described here are the activities of a managed portfolio with a considerably higher level of transactions than a typical PE/VC fund. The relevance for the industry is that these (higher frequency) activities are regarded as investment rather than trading in nature by HMRC, and this underlines the accepted position that the 1987 statement is a considered interpretation and application of the law, wholly consistent with the position taken by HMRC and advisers in other contexts.

The BTR article suggests that this position is different to the way in which HMRC operates towards other types of asset management:

> "HMRC's practice in relation to private equity funds contrasts sharply with their approach to other types of fund (for example, hedge funds), where HMRC have aggressively (and, in the author's view, quite correctly) taken action to counter planning that purported to create a capital return for fund executives."

This confuses the question whether a fund is trading with the question of how managers' returns from their equity stakes in the funds they manage are taxed. As we have just seen, HMRC regard many funds which actively manage their portfolios as investing. That notwithstanding, a special tax regime (the "Income Based Carried Interest" or "IBCI" regime) ensures that, if a fund's average investment holding period is less than 40 months, managers' returns on their carried interest in the fund will be taxed wholly or partly as income.

The average holding of an investment in a PE/VC fund will usually exceed 40 months, which is why that return is not within the IBCI rules and will be taxed as capital to the extent that is the correct treatment (ie there are other qualifying conditions before CGT is deemed the appropriate tax). If a PE/VC fund were to have an

average investment holding period of less than 40 months, the IBCI regime would apply to carried interest from that fund just like any other and the gains charged to income tax.

Why does it matter whether PE/VC funds are investing or trading?

The distinction between trading and investment is important for a number of investors in funds.

UK charities and pension funds (which includes insurance companies carrying on pensions business), who act on behalf of significant numbers of beneficiaries, are exempt from tax on investment income and capital gains but taxed on trading profits. If PE/VC funds are trading, these institutions would be taxable in full on their returns from these funds. It would seem odd for the government to be encouraging pension funds to invest in PE/VC funds, and changing the regulatory regime to facilitate this, if the returns they generate are going to be fully taxable whereas the returns from their other investments are tax exempt.

Furthermore, the analysis which leads to the conclusion that PE/VC funds are trading would also lead to many other investment activities (outside the PE/VC or fund spaces) being analysed as trading and taxed accordingly.

This distinction is important for non-UK investors, who provide significant sources of capital for UK funds to invest in UK (and other European) companies. A non-UK investor who participates in a UK fund which is carrying on a trade here (because the fund vehicle is established and run in the UK) would in principle be liable to tax on the profits it generates from that investment. Non-UK investors expect PE/VC funds to be treated as investment funds, because that is how they have always been treated and is consistent with HMRC's approach to the investment/trading borderline discussed above, which means that they are not subject to tax on their profits from such funds. It is far from clear that, if a PE/VC fund is trading, investors would be able to rely on the IME or a double tax treaty to avoid UK taxation on their profits. The 1987 statement is designed (as the IME is too) to give foreign investors confidence that they can invest in UK funds with the security of an unambiguous tax and legal framework: if investing in a UK managed or established PE/VC fund would give a foreign investor even the slightest risk of a UK tax liability, it would invest elsewhere.

If there were a real risk of PE/VC funds actually being regarded as trading (as opposed to investment) funds, no adviser could promote a UK PE/VC fund or allow their clients to invest in one. The 1987 statement would not of itself provide the required reassurance if there were real doubt in this area.

The government has recently (in 2022) introduced a regime which enables investment funds and institutional investors to use UK resident companies as asset holding vehicles. One of the qualifying conditions for a company to enter this regime is that its main activity is carrying on an investment business. If a PE/VC fund were deemed to be trading, it is highly likely that a company established by it to hold some or all of its assets in furtherance of its investment strategy would be, too. So, if it is correct that a PE/VC fund is trading, no holding company it established could meet this condition, and the regime (which was introduced to encourage UK and foreign PE/VC funds, among others, to use UK holding companies) would be flawed and too risky to be used. This would clearly be at odds with the public policy intent underpinning these asset holding vehicles.

Are PE/VC funds trading?

In addressing the question of whether or not PE/VC funds are trading, we must assume that we are dealing with a "typical" PE/VC fund. It is, of course, always possible that an "outlier" fund may have a strategy much closer to that of a securities dealer, beyond even the sort of situation discussed in SP 1/01 (see above). If these exist, they are very rare and are not typical of the funds managed by BVCA members.

In the BTR article there is consideration of the "badges of trade", to establish if trading is indeed taking place. The "badges of trade" are a list of indicators based on case law which have been developed by the courts to distinguish between trading and non-trading activity, although the courts have also made it clear that the badges of trade are not a checklist and should be used (if at all) as part of a rounded assessment. As Mr Justice Oliver commented in *Salt v Chamberlain*, a leading case on the trading/investing distinction in the context of dealing in financial assets:

> "I doubt whether the question whether, in any given case, a person is or is not carrying on a trade is capable of solution by the application of a logical progression of propositions culled from decided cases. The question is, I think, one of overall impression."

Notably, in this case, it was found that the taxpayer was not trading despite all but one of the relevant badges of trade being considered to be "met".

HMRC have followed the judge's guidance and in their technical manual they say that:

> "It is important to be aware of the limitations of this approach [applying the "badges of trade"] in considering an activity of buying and selling shares and other financial instruments… The better approach is, therefore, to look at the facts and circumstances of the transaction as a whole and then form a view as to whether the activity amounts to a trade or not."

The courts have held, on occasion, that there is a presumption that dealing in financial assets is not trading for UK tax purposes at least where individuals are concerned (for example, *Salt v Chamberlain*). The view taken with a trading company historically was (as the judge in one of the cases referred to below put it) "one expects a trading company's activities, apart from capital investment, to be by way of trade", so any activity carried on by a trading company which was not clearly capital investment would be seen as trading. Changes in company law mean that there is not the same pressure, even with a trading company, to find that everything which is not a capital investment is part of a trade. Following a House of Lords decision, HMRC now take the position that "there is no reason why [a company's] activities could not include speculative transactions which, while not being investments, might also not amount to trading".

The result of all this is that there is now considerable scope for an entity's activities in the field of securities transactions not to amount to trading. There are, however, cases in which companies have been found to be "trading" in securities. The two HMRC cite in their guidance involved companies that carried on a different trade but entered into a programme of dealing, on a short-term, speculative basis, in securities (gilts or publicly traded shares). In each of those cases, the court held that the company's transactions in the securities amounted to a trade for UK tax purposes. In the earlier of these two cases the analysis was much influenced by the older thinking discussed in the previous paragraph. In the second, the General Commissioners had found that the company was trading. The judge expressed some reservations about this conclusion (indeed, he indicated that, left to himself, he would not have come to this conclusion), but held that it was within the spectrum of conclusions open to the Commissioners and therefore their conclusion stood. He equated the position of an entity not already carrying on a securities dealing business with that of an individual, and reiterated the starting point here, that marketable securities are prima facie purchased and sold by way of investment and not by way of trade.

There have also been two recent cases where the tribunals have departed from the presumption that an individual dealing in financial assets will generally not be trading. In both cases, the relevant individuals were "day traders" dealing, on their own account, in publicly traded shares and other marketable securities or commodities on a speculative basis.

In all these cases the taxpayers were dealing on a short-term, speculative basis with a view to benefiting from market fluctuations. The assets were not acquired with a view to income yield or medium to long-term hold. That is why they were held to be trading.

This position (which is essentially the approach in SP 1/01), that dealings in securities would not be analysed as trading in nature outside the realm of speculative, short-term arrangements, is conclusive for typical PE/VC funds. Unless a PE/VC fund presents with that strategy (or perhaps behaviour pattern in practice), then viewed holistically, as required by the law, it should not be seen as trading.

For completeness, other issues considered in the article include:

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1. Holding period – The article notes that PE funds typically hold investments for between four and seven years and states this is neutral on the question of trading. However, a holding period of that length means funds are significantly exposed to general economic conditions and industry trends. There is much more going on over such a period than in the short-term, speculative transactions designed to exploit particular market opportunities we saw in the cases referred to above. In our view, a typical PE/VC fund holding period is a strong indicator of investment rather than trading activity.

2. Number of transactions – The article argues that a PE/VC fund making five or more acquisitions is indicative of trading. In the fund management context, the number of transactions is irrelevant. This will be a feature of the size of the fund, the need to spread investment risk and the size of investments. A number of medium to long-term investments does not amount to a trade, in contrast to a series of acquisitions, followed in each case by swift break-ups of physical assets and the disposal of the resulting parts, which was what was going on in the case cited in the article as authority for taking this into account.

3. Changes to the asset – A fund is likely to purchase a portfolio company because it believes there are aspects of its business that can be improved, but it will still be fundamentally the same business when it is sold. If there is a change in the company's business, it is likely to have been brought about by internal management, albeit that the fund manager may have been engaged in the strategic decision-making. What a fund seeks to do is very different from buying one type of brandy, blending it with another and then selling the result (which is the fact pattern of the case cited in the article as authority for this factor being important).

4. Methods of acquisition and sale – The article argues that PE acquisitions and sales typically involve a complex M&A process which is said to be indicative of trading. To our mind, this is a necessary consequence of the types of asset being acquired (large and very expensive investments in complex groups). Anyone buying or selling this type of asset would need to engage in a complex process to buy or sell such an asset, in contrast to someone buying a few shares in a quoted company on the market.

5. Organisation. The article suggests that having a well-run, ordered activity with well-defined strategies and a business which employs serious resources is indicative of being a trader. Again, we suggest that this has more to do with the size of an investment activity than its nature. Bodies which are clearly carrying on an investment business (such as a significant endowment or pension fund) will have an investment strategy and employ significant internal resources in order to manage their assets. The complexity of the investment process and the longevity of the asset hold require this, not least if all parties are to fulfill their respective fiduciary duties.

6. Source of finance – The article argues that the use of third-party debt by acquisition vehicles means that investments must be sold to repay that debt, which is indicative of trading. However, most debt in fund acquisition structures is long-term and part of an overall capital structure which supports different participants' investment objectives.

Conclusion

None of these factors point conclusively towards a typical PE/VC fund being a trading entity. Indeed, some point in quite the other direction.

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