Room 3/63
CT Losses, CTIS
HMRC
100 Parliament Street
London, SW1A 2BQ

By email: ct.lossreform@hmrc.gsi.gov.uk

18 August 2016

Dear Sirs,

Reforms to corporation tax loss relief; consultation on delivery

We are writing on behalf of the British Private Equity and Venture Capital Association (the "**BVCA**"), which is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of almost 600 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. While our membership is predominantly focussed on private equity and venture capital, a significant number of our members are active in infrastructure, debt and real estate. These types of alternative funds are a growing source of finance for investment by business.

Our members have invested over £30 billion in nearly 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 490,000 people and almost 90% of UK investments in 2014 were directed at small and medium-sized businesses.

We have reviewed the Reform to corporation tax loss relief: consultation on delivery document (the "**Con Doc**"), published in May 2016. Whilst we have considered all questions raised for consultation therein, and set out responses to each in Appendix I, we would like to bring particular attention to four items that cause significant concern for our members and have the potential to materially impact commercial behaviours in the industry. These items are:

(A) Proposed definition of Group for determining the use of the annual allowance.

(B) Rules for dealing with changes in ownership.

(C) Quantum of £5m annual allowance.

(D) Interaction with proposed new interest deductibility restriction rules.

We set out a summary of the issues created by each of these items in the subsequent sections (A) to (D) in order of priority. We have also highlighted the broader concerns and impacts that, in our view, the new rules will have on UK business in section (E) – with particular focus on the stated desire of the government to reform the tax system to enhance simplicity, certainty and stability – and urge these to be carefully considered in determining policy and drafting the proposed rules.

We would be very happy to meet to discuss any issues raised in this letter, or other aspects that you may wish to engage in further consultation on.

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(A) Proposed definition of Group for determining the use of the annual allowance

We strongly believe that the existing definition of group for group relief purposes should be used in relation to the annual allowance. This definition is well understood by UK business and provides consistency and certainty in application.

However we note that the Con Doc seeks to avoid using this definition and proposes a group definition by reference to IFRS 10 in paragraph 5.9. The definition of group per IFRS 10 consolidation principles has a significant detrimental impact on our members. This is because the direct application of the IFRS 10 definition does not itself factor in the accompanying IFRS 10 Investment Entity Exemption ("**IEE**") for fund/investment vehicles. The **IEE is critical to UK fund/investment vehicles** for accounting purposes to ensure that, whilst those entities may have majority equity control of target portfolio company investments, there is an exemption from requiring the fund/ investment vehicles to consolidate those target portfolio companies. The IEE was a key part of the implementation of IFRS 10 for fund/investment vehicles at that time.

The inability to access the IEE under the proposed loss relief rules would mean that economically separate UK portfolio companies invested by a single fund would be within one group for the purpose of applying the proposed allowance. These UK portfolio companies are economically and fiscally separate, operate on stand-alone bases and we believe that each of their respective groups should benefit from the full amount of the allowance. The proposed definition of Group using IFRS 10 without the IEE exemption would, where UK companies were invested by a fund portfolio including other UK companies, break the stand-alone economics of any single UK operating group invested by that fund. This would effectively taint UK portfolio companies (to reduce/remove access to the allowance) by the profits of other economically separate UK companies solely as a result of those companies seeking private fund capital in the form of equity to grow their business.

The application of IFRS 10, as proposed, without consideration to the IEE would be highly disadvantageous to the provision of private investment capital through:

(i) A significant economic disincentive for funds (UK and international) to invest new capital in UK companies where those fund portfolios included existing UK portfolio companies with incurred trading losses as a result of that investment reducing the ability of the existing UK portfolio company to utilise those losses to aid its recovery.

(ii) A reduced attractiveness of UK focused funds (vs European or internationally focused funds) to portfolio company management seeking finance who would, by virtue of the risk of having their allowance "shared" with other UK companies within a UK focused portfolio, prefer a fund with a largely non-UK focused portfolio. This is likely to cause conflict, impact commercial behaviour and ultimately be sub-optimal, for example as regards the skills and people available, for the portfolio company.

The solution here is to **include an investment entity exemption (IEE), as already reflected alongside IFRS 10, in the proposed group definition**. We do not see why this would be problematic. It is ultimately consistent with the "economic group" concept proposed in the Con Doc.

(B) Rules for dealing with changes in ownership

We do not consider that the proposal in paragraph 5.25 of the Con Doc that disapplies the relaxations on the use of carried forward losses in the event of a change in ownership is appropriate.

The current proposal causes significant concerns for our members who include both private funds/ private investors investing capital in UK businesses and UK management teams seeking such new capital for investment (portfolio companies). The private investment market operates on the basis of fixed life investment terms, typically 4-6 years, and the proposals create material risk to the efficient provision of new investment capital to UK businesses. This is because:

(i) Portfolio companies would be economically disincentivised to seek new equity capital to invest in the future growth of their business, when compared to debt financing for the same means. Debt financing for growth would avoid a change of control, hence enabling the use of valuable losses carried forward, but would add unnecessary financial risk and burden and create issues in terms of the new interest deduction restriction.

(ii) As a result of (i), conflicts of interest would be created between portfolio companies and private funds/investors. Private funds/investors typically look for a fixed term investment and ultimately need to generate an exit for their equity capital with a new owner (e.g. private fund or trade buyer). That transition, which is negotiated to be in the best interests of the business at the relevant time, would create conflict between the private fund/investor seeking exit and the company who would, at that time, lose the ability to utilise existing losses within their economic group. This may be a material economic loss of value to the portfolio company.

(iii) Private investment to support a turnaround scenario, typically where there has been recent or historic underperformance, would be especially negatively impacted by the proposed rules which would remove access to materially valuable losses carried forward as a result of seeking capital investment. As turnaround investment cases are often in businesses that would otherwise fail completely in the near term, they are important to protect jobs and add skills to generate future growth and productivity and the relative negative impact will make such private investment economically worse for both portfolio companies and private funds/investors.

We note your concern to avoid loss buying when the losses in question would be utilised by surrenders but suggest that this can easily be addressed by **restricting the surrender of such losses to companies within the same group relief group immediately prior to the change in ownership.**

(C) Quantum of £5m annual allowance

The **annual allowance of £5m of taxable profits will not be sufficient** to prevent a number of our members paying corporation tax at an earlier stage than would currently be the case. This causes real financial cost and creates cash flow disadvantage to the UK businesses.

There are significant concerns that we bring to your attention:

(i) A restriction in the use of losses by UK business will effectively add a pro-cyclical risk to business against the status quo by compounding the economic cost of poor performance or recession. This will increase the cash tax burden on UK business and reduce cash resource otherwise available for business recovery or growth. This is a disadvantage when compared to the status quo in the UK, and also an international competitive disadvantage when compared to non-UK businesses in the same position.

(ii) Private equity investment is intended to drive new business development and growth in portfolio companies. There is good historical data to support the economic impact that private capital can deliver for the benefit of the economy. Under the proposed allowance amount, new business developments or loss-making activities will become significantly more expensive by delaying the ability of a company to reclaim costs associated with growing and developing the business. This will discourage new business development. This time value of money trade-off will significantly impact discounted cash flow modelling and therefore impact the value of new business development projects or businesses acquired or sold to skew commercial value decisions. The venture capital fund section of our membership, which invests in early stage, high risk new businesses which we understand to be a sector that the Government is keen to support, will be particularly badly affected by the low level of the proposed allowance.

We note that the government forecasts that over 99% of UK companies will be unaffected by the restriction to a £5m full allowance. We understand the intention to limit the impact of the proposed allowance restriction of £5m, alongside the welcome relaxation on the use of losses, but note a resulting relative impact on medium and large size UK businesses. These businesses employ large numbers of people and invest heavily in the UK, both from UK and international headquarters. The Government should ensure that the proposed rules do not disadvantage specific sectors of UK business.

(D) Interaction with proposed new interest deductibility restriction rules

We responded to a separate HMRC consultation on the tax deductibility of corporate interest expenses on 4 August 2016.

The Con Doc does not detail how the proposed loss relief rules will interact with the interest deductibility proposals separately proposed. Both proposals create real economic cost to UK businesses through limitations on accessing tax deductions in any particular accounting year. It is critical that the implementation is aligned to prevent undue adverse economic impact.

The proposed effective date of April 2017 is fast approaching and there is significant uncertainty created through the lack of visibility on the interaction with the proposed interest deductibility restriction rules. We would like clarity to understand the proposals on this as soon as possible.

(E) Broader concerns

The proposals of the Con Doc represent a material change to the corporate tax landscape in the UK. Introducing the changes with effect from April 2017 is extremely ambitious for such a fundamental change to the corporation tax system, particularly given the other changes that have been proposed to take effect in 2017.

We highlight below our concerns that the proposals will have on the UK business community as a whole (these concerns are not specific to our membership).

- There is a real economic cost to the proposals which, for reasons as set out in this letter, will disincentivise investment in UK companies. The restrictions on using carried forward losses will add economic stress to UK business in scenarios of underperformance (where there is already economic stress existing) and effectively create pro-cyclicality by delaying capacity for recovery. We believe that the proposals, intended to raise tax revenue, go against the international competitiveness of UK business and create a negative perception – which is already of heightened concern to UK business post the EU Referendum on 23 June.

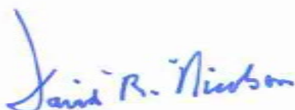
- The proposals add significant new complexity to the UK tax system and have accounting implications for corporate groups. The compliance burden arising from such changes should not be underestimated in terms of additional time and cost for UK business – both at implementation and ongoing. Such burden should not be ignored in its cost to UK business or competitiveness of the UK generally.

- We cannot see how the proposals are consistent with one of the three guiding principles in the new Business Tax Roadmap of "simplifying and modernising the tax regime" so that businesses "should find the tax system easy to understand and navigate". The proposals do not add stability, certainty or simplicity.

- Introducing restrictions on losses incurred prior to 1 April 2017, without including the flexibilities proposed for losses incurred after that time, is clearly inconsistent, adds complexity and is detrimental to UK business. We encourage the Government to consider grandfathering the treatment of losses incurred prior to the introduction of the new rules for a 5 year period to 2022.

- The timeline for introducing the proposed changes being April 2017 is too short. We strongly recommend that the proposed changes apply for accounting periods starting after April 2017, rather than mid-period. This should help to give businesses time to amend processes to capture data, model for increased cash flow need and at least to some extent start to deal with the increased compliance burden associated with the proposed rules.

Yours faithfully,



David R. Nicolson
Chairman of the BVCA Taxation Committee

Appendix I: Con Doc Questions

We have set out our responses to the specific questions raised in the Con Doc below. Where a question is not relevant to our membership we note N/A.

Q1: Will the proposed model be effective in delivering the objective of allowing businesses greater flexibility in the use of carried-forward losses?

The proposed rules are unduly restrictive and do not offer greater flexibility for the reasons outlined in our letter. We are supportive of the intention to relax the use of carry forward losses.

Q2: Could the calculation be made simpler or more effective?

We have raised a number of concerns about the proposals and suggested some solutions in our letter.

Q3: To what extent does this proposed model provide an effective means of applying the existing and proposed loss restriction rules to the banking sector?

No comments.

Q4: Could the calculation be made simpler or more effective?

We have raised a number of concerns about the proposals and suggested some solutions in our letter.

Q5: Is there any reason why the definition of a group for the surrender of carried forward losses shouldn't be aligned with the existing group relief definition?

No – we advocate this approach.

Q6: What definition of a group should be sued for the purposes of applying the £5 million allowance?

We have set out our position regarding this in the letter.

Q7: How should the reforms be applied to consortia relationships?

We have no specific comments on consortia arrangements.

Q8: How could the legislation be protected from abuse in a way that is simple and administrable for businesses?

We believe that the existing legislation in this regard is sufficient.

Q9: Do you have any concerns regarding the Government's proposed approach to loss-buying and trade cessation?

We have set out our position regarding this in the letter.

Q10: Are there other areas of the tax system with which these rules would have a significant impact? If so, what are these and what might the consequences be?

There is an important interaction with the proposed restrictions on interest deductibility. Please see our letter.

Q11: Do you have views on the Government's proposed approach to oil and gas and life insurance companies?

No comments.

Q12: What impact could the reforms have on public-private partnership or private finance initiative projects?

No comments.

Q13: What other sectors or specialist areas of taxation need consideration as part of these reforms?

There is an important interaction with the proposed restrictions on interest deductibility. Together, the reforms set out in the Con Doc and interest deductibility proposals represent material and fundamental changes to corporate tax in the UK. As regards the restrictions on interest deductibility, please see our letter.

Q14: What will be the impact of the reforms on insurer's regulatory capital?

No comments.

Q15: To what extent could the reforms impact on the business plans of new-entrant companies?

The proposed reforms will have an adverse impact on the business plans of new-entrant companies and disincentivise new investment in the UK. Please see our letter.