

23 October 2006

The Rt Hon Gordon Brown MP  
Chancellor of the Exchequer  
HM Treasury  
Horse Guards Road  
London SW1A 2HQ

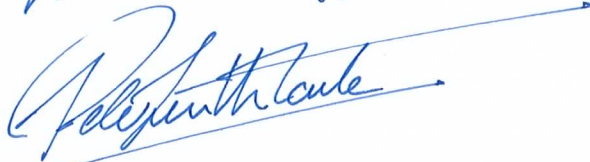
*Dear Chancellor,*

Please find enclosed the British Venture Capital Association's Pre Budget Report submission.

This submission outlines our general economic overview as well as specific issues about taxation policy.

Please do not hesitate to contact me if you require further information or would like to discuss any aspect of this submission further.

*Yours sincerely,*



**Peter Linthwaite**  
Chief Executive



**British Venture Capital Association**

**Pre-Budget Statement Submission**

**2006/2007**



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## **1. Introduction**

The British Venture Capital Association (BVCA) represents the overwhelming majority of UK based private equity and venture capital firms. The UK private equity industry is the largest and most dynamic in Europe, accounting for over 50% of the whole of the European market, and is second in size only to the United States on the world stage. Companies that have received private equity backing in the UK are now estimated to employ nearly a fifth of the whole of the private sector workforce.

For the sake of clarity we will briefly define what we mean by the terms private equity and venture capital. In the UK, Continental Europe and much of the rest of the world, 'private equity' means the equity financing of unquoted companies at many stages in the life of a company from start-up to expansion and also management buy-outs or buy-ins of established companies that have real growth potential if moved into a private equity environment. "Venture capital" is a subset of private equity, covering the seed to expansion stages of investment. The key elements of private equity and venture capital are investments in unquoted companies, equity risk capital by nature, medium to long term and targeted at companies with growth potential, which can ultimately be realised through trade sales or flotation on the public markets.

## **2. The impact of the private equity industry on the UK economy**

The provisional findings of the eighth report reinforces those in the previous surveys commissioned by the BVCA. Private equity-backed companies are a significant driver in the UK economy and its global competitiveness.

Private equity-backed companies create jobs at a considerably faster rate than other private sector companies. Over the five years to 2005/6, the number of people employed worldwide by UK private equity-backed companies increased by an average of 9% p.a. This compares dramatically with FTSE 100 and FTSE Mid-250 companies, at 1% p.a. and 2% p.a. respectively. Furthermore, around three-quarters of companies said their growth was organic, rather than by acquisition, since they had private equity backing.

It is estimated that companies that have received private equity funding account for the employment of around 2.8 million people in the UK, equivalent to 19% of UK private sector employees.

Private equity-backed companies boost the UK economy. The performance of private equity-backed companies significantly strengthens the UK economy and improves our international competitiveness. Over the five years to 2005/6, on average private equity-backed companies' sales rose by 9% p.a., compared with FTSE 100 companies (7% p.a.) and FTSE Mid-250 companies (5% p.a.). Exports grew by 6% p.a., compared with a national growth rate of just 2.2% and investment rose by 18% p.a., compared with 1.1% nationally.

92% of responding companies said that without private equity the business would not have existed at all or would have developed less rapidly.

Private equity investment is more than just the provision of capital. Around two-thirds of respondents identified strategic direction, financial advice and help with contacts as being key ways in which private equity firms had helped with the development of their businesses.

Half the firms said that their level of investment was higher as a result of private equity backing. It is estimated that companies which have been private equity backed generated total sales of £424 billion, exports of £48bn and contributed over £26 billion in taxes.

### **3. The impact of the private equity industry as a UK financial service**

In addition to our increasing impact on the economy as a whole the UK industry has a specific and positive impact as one of the UK's leading financial services. For the first time this year we have commissioned research to examine this impact in detail.

During 2005 private equity related activities generated estimated fee revenue for financial and professional services firms of over £3.3bn, representing around 7% of the total annual turnover of the UK financial services industry.

There are more than 5,500 individuals employed across 267 private equity, venture capital, funds-of-funds and secondaries investment firms in the UK.

The UK has a network of almost 700 financial and professional services firms providing advisory and financial support to private equity and venture capital firms. They employ a full time equivalent pool of close to 6,300 executives engaged in private equity related activities.

There are an additional 45 support services firms providing public relations, publishing, information services, conference/event organisation and training to the private equity industry. These firms employ a full time equivalent workforce of 370 professionals in the UK.

Taken together, there are almost 12,200 highly skilled people across over 1000 firms engaged either directly or indirectly in private equity related activities.

For every private equity executive investing directly in UK companies, there are 2.3 full time equivalent advisors or finance executives providing specialist advice and services.

Financial, professional and other business services executives working on private equity related mandates in 2005 generated an average of £500,000 per head in fees.

Private equity backed transactions account for a significant proportion of total M&A activity in the UK, which is reflected in the levels of fee revenue generated by investment banking firms from these deals. Almost 30% of all UK investment banking fees from M&A and loan financing were derived from private equity backed transactions in 2005.

Over 80% of the total £27bn of new capital raised by UK private equity firms in 2005 came from sources outside the UK. What's more, almost 60% of the total capital invested by UK firms during 2005 was committed to companies within the UK, demonstrating a positive net inflow of capital into the UK economy.

The UK private equity industry has long attracted capital investment from outside its own shores, with an annual average of £8bn of funding flowing into the UK market from abroad over the past six years. That's almost £50bn of foreign investment into UK private equity funds over the past six years, over 70% of the total raised over that period.

#### 4. General economic environment

##### **Background**

In recent years we have said that, overall, the economic environment of low inflation and low interest rates has been relatively benign. It should be noted that low interest rates are consistently cited as being the most important factor critical to our industry's success. This stability has been welcomed by our industry.

However there are areas of concern that we wish to highlight:

- i. The world economy impacts on the industry as never before, especially the United States which remains the source of the majority of our investors. Any serious downturn in the US economy would potentially have a serious impact on the UK industry;
- ii. Indications in recent months of an upward trend in inflation;
- iii. The short and long term implications of the rising level of public borrowing;
- iv. A number of reports which indicate the need to raise UK levels of productivity, for example the fact that Britain's productivity measured by output per worker was 9% lower than the average for the G7 last year;

##### **The BVCA's views**

Because our industry now has a major impact on the wellbeing of the UK's business environment, our submission is made in the context of encouraging policies which help to maximise the UK's competitive advantage over the long term. The context of our submission is one where our industry is an established major driver of the UK economy. Our members are invested in every sector of the economy across all regions of the country. They invest at every stage of a companies development, from seed capital through to large buyouts. Our interest is in encouraging enterprise and growth, maximizing the UK's competitive advantage over the long term.

In addition to the matters referred to elsewhere, we believe this requires the Government to continue to do certain things:

- i. Promote policies that encourage entrepreneurship;
- ii. Improve the skills base by raising the quality of education at secondary and tertiary level;
- iii. Increase the awareness and understanding of business and enterprise, particularly among younger people;
- iv. Recognize that GDP is closely linked to the level of population available for work.

To contribute positively to the policy debates in these areas, we continue to commission and/or been associated with a number of initiatives. For example:

- i. The report we published on how to improve the number of successful spin-outs from universities *Creating Success from University Spin-outs* and the conference we held at Imperial College to discuss its findings.
- ii. We continue to follow-up the recommendations of the report by our Education Commission on improving the understanding of enterprise and entrepreneurship in our secondary and tertiary level education sectors.

## Members' views

To assist us with this submission we have carried out a survey asking our members for their response to a number of key questions about their general attitude to the economy. They have expressed concerns about potential levels of taxation and regulation, as it affects both their own businesses and the companies they invest in.

In our quarterly confidence and attitude surveys, our members consistently highlight the level of interest rates as being critical to the success of our industry. Any move, therefore, that might threaten an upward trend in interest rates would be of serious concern to our members.

In the latest quarterly survey the majority of respondents paint an overall positive picture of the climate for business and fund-raising respectively, an assessment which represents a continued favourability in these areas over the whole of the past year. Moreover, the majority expect this to persist into the next quarter.

In comparison to May, BVCA members' assessment of the business climate is more positive when looking back at the last three months but marginally less positive when looking to the next three:

- Only 4% feel the climate has been unfavourable whilst just under three-quarters (74%) said it had been favourable.
- The majority (73%) expect continuity in the health of the business climate for the next quarter.
- 16% think the business climate will improve but just over one in ten are now predicting decline compared to about one in twenty in May.

Prospects for improvement in the health of portfolio companies and in investment opportunities reflect an optimistic trend that has grown since the same period in 2005:

- Over half foresee improvement in portfolio health in the next quarter (53%) with a significant proportion (44%) saying that it will remain the same, in an almost identical assessment to that given in May 2006.
- Those expecting improvement in investment opportunities have increased 10 points on the last wave: 46% to 56%.
- A further 41% expect investment opportunities to remain constant.

Moving on to the factors considered to be major external influences on business opportunities of particular note is 'Interest rates'. 65% of respondents now consider they will be one of the biggest external influences on business opportunities for their company over the next quarter. This is an increase of 27 points from last time and is now on a par with 'consumer confidence', previously adjudged the biggest external influence.

In addition, according to the respondents the influence of 'The sterling-dollar exchange rate' and 'Public sector spending' are not thought as significant as they once were. The former fell from 17% to 6% and the latter dropped from 25% to 18%.

The vast majority (95%) of respondents think the UK is an attractive place to do business but they are somewhat concerned for the future, compared to other world markets.

- Looking to the next 12 months, nearly a third (30%) say that the UK's attractiveness will worsen in comparison to other world markets, with almost two-thirds (63%) expecting it to remain the same.

- The majority of the respondents anticipate that the burden of regulation and taxation respectively to worsen (65% and 68%) with the remainder in the most expecting no change.

A large proportion of respondents are undecided when it comes to rating the Government's policies in terms of advancing the UK as an attractive place to do business - 40% answered 'Neither good nor poor' - and there was a fairly even split between those considering it to be good (28%) or poor (32%) making the verdict somewhat inconclusive.

Asked to consider the prospect of a change of Prime Minister, just more than half of respondents (52%) are concerned that the change of premiership will create a period of instability in terms of government policy whilst one in five (22%) disagree. Slightly fewer, but still approaching half (46%) are concerned that a change of premiership will create a period of economic uncertainty. In this case 31% disagree that it would have this affect.

## 5. Industry's economic environment

In 2005, UK private equity activity increased to its highest ever levels, in terms of funds raised, private equity investments made and also divestments. For further detailed information see the attached BVCA research *Report on Investment Activity*. To note especially are the following:

- Funds raised from investors reached £27.3 billion.
- Overseas investors accounted for 79% of total funds raised in 2005, compared to 66% in 2004.
- 1,535 companies financed.
- Worldwide investment by UK PE firms increased by 21% in 2005 to £11,676 million from £9,679 million in 2004.
- Companies financed at start-up stage increased by 9% to 208.

The UK private equity and venture capital industry is a UK success story. In recent times the Government has given us much support, but we are concerned that the economic environment remains fragile and any further erosion of our competitive position could seriously damage our ability to invest successfully across the UK, generating wealth and creating jobs.

The Myners report has helped to encourage a change in attitude towards investing in private equity and venture capital and has led to an increasing appetite for investing in the asset class by institutions. The message that the asset class provides consistently superior returns over the medium to long term seems to be becoming generally accepted, but is one that needs continual promotion.

## **6. Regulation and red tape**

We have welcomed the close cooperation of HM Treasury and the Financial Services Authority in the various stages of negotiation of the Markets in Financial Instruments Directive and the Capital Requirements Directive.

Most BVCA member firms fall outside the scope of MiFID and the CRD. As attention has turned to UK implementation, our key concern is therefore that there should be no UK gold-plating. As a rule, Directive concepts and standards should not be applied to non-scope business.

The UK private equity industry is already proportionately and effectively regulated by the FSA under the Financial Services and Markets Act 2000. The costs of adapting to the new European schemes of regulation should not fall on firms which will not benefit from the cross-border freedom to provide regulated services, which the Directives are intended to provide.

It will also be crucially important that the European Commission has the support of the UK in its efforts to secure timely and consistent implementation of the Directives across Member States. Otherwise the burden of compliance will fall significantly disproportionately on UK private equity firms.

Our members invest in growth companies both large and small. The prevalence of regulations affecting our portfolio companies, from early stage start-up businesses through to mature companies operating in large markets continues to be a major concern.

We welcome any initiatives to reverse the trend in the proliferation of 'red tape' and a year ago we submitted a paper to No 10 on the issue. We understand fully the need for regulation in many areas. However, we believe more consideration should be given to the use of specific exemptions for smaller businesses in order to provide them with greater freedom to develop and create employment.

## **7. Taxation**

In the following pages we outline the details of specific requests and the reasons for them. We begin with a summary and then outline the details in the appendices.

### **Summary**

#### **i) Provisions relating to smaller companies which unfairly penalise private equity backed companies**

For some time the BVCA has been aware that certain important tax reliefs aimed specifically at smaller companies are being denied to venture capital backed companies. In the BVCA's view, this unfairly prejudices these companies against their competitors.

This issue has recently been raised by the BVCA in a survey to its venture capital members, which covered four areas of particular concern, namely Enterprise Management Incentives, the Enterprise Investment Scheme, Research and Development Tax Credits and Small Companies Tax Rates. The feedback from this survey has confirmed the very great importance of this issue.

The BVCA recommends that changes be made to ensure the relevant reliefs are extended to venture capital backed companies, thereby creating a level playing field between such companies and their competitors. We would welcome the opportunity to discuss with you how best this objective could be achieved.

#### **ii) VAT issues**

The BVCA is concerned about a number of unresolved issues in the discussions that have been taking place with HMRC for the development of guidelines on the application of VAT in the private equity industry and its administration – in particular, relating to the recovery of VAT on fees related to the investment and recovery of VAT for the private equity firm itself.

Without equitable resolution of these issues, there is a threat that VAT costs will become embedded in investment structures to an extent exceeding the intended application and scope of VAT under the EU Sixth VAT Directive and case law. The BVCA would welcome further dialogue on these issues with a view to agreeing and revising the guidance for HMRC officers and the private equity industry.

#### **iii) Transfer pricing in connection with the capitalisation of private equity backed companies**

The BVCA has had helpful discussions with HMRC officials on a number of issues concerning interest deductibility in respect of shareholder debt by private equity shareholders, in particular on the way in which the corresponding adjustment mechanisms will be applied. However, our members still face practical difficulty and uncertainty in relation to the operation of the "clearance" procedure under which Policy Division (International) is prepared to consider and enter into forward agreements on capital structures.

We would welcome the opportunity of further discussions with HMRC to refine and improve the operation of the clearance procedure to the mutual benefit of HMRC and taxpayers. To this end, the BVCA has set up a transfer pricing working group from within its Taxation Committee to examine the working of this procedure: this will, among other things, consider the concerns reported by our members and their professional advisers in relation to the post-transaction clearance process.

#### **iv) Carried interest and management equity**

Discussions are ongoing with HM Treasury and HMRC on the tax treatment of investment by executives in private equity backed companies (in management buy-outs) and of private equity executives in their managed funds (carried interest).

The BVCA welcomes the assurance given by HM Treasury that any proposed legislative changes will be discussed with the BVCA at the proposal stage and there will be a public consultation period. We are also reassured that the issue is not being treated as measures to combat tax avoidance and thus implemented without notice. We reiterate our willingness to continue discussions with HM Treasury and HMRC.

It is worth restating our position that the current taxation of carried interest and management equity represents no "concessions" or anomalous treatment but fairly reflects the legislative intent. The industry has experienced a period of sustained success and tax policy should not be driven on the basis of hindsight. Even in such an environment where there has been success overall, it remains true that many private equity funds have generated negative returns and this underlines the inherent risks in private equity investment.

Finally, the UK industry enjoys at best a marginal benefit if you compare the overall taxation of our industry with that of our international competitors. It is a position that has been hard fought for by the BVCA and this Government, especially the Chancellor. It has enabled the UK to boast a world class and international industry. It is a position that should not be lightly ceded through the imposition of greater taxes at a time when other countries are mounting a serious challenge to the UK's leading position.

#### **v) Venture Capital Trusts**

With reference to the recent correspondence and discussions regarding the 2006 Budget changes, the BVCA notes and is grateful for the formalisation and publication by HMRC in September of the "inadvertent breach" guidance. In relation to the realisation of investments, however, we consider that there are a large number of situations which may not be covered by that guidance. The BVCA and its VCT manager members are greatly concerned that the FA 2006 change to include Non Interest Bearing Accounts within the definition of "investments", by inhibiting their freedom of action in relation to realisations, will distort the investment behaviour of VCTs.

The BVCA welcomes HMRC's commitment to ongoing discussions on this subject and the opportunity the industry has been given to provide specific examples of situations which we believe will be seriously problematic under the new legislation. The BVCA would welcome further HM Treasury engagement and support in driving appropriate legislative change, where this is necessary to enable the aim to be achieved whilst conforming to the stated policy objectives.

#### **vi) Share option schemes**

The BVCA considers that the benefits of approved share option plans should be available to all employees and not denied to large groups of employees simply because of the nature of the company's shareholders. We believe it is time that a consistent approach is brought to this entire area. The private equity sector is an increasingly important part of the UK economy, and preventing this entire sector from benefiting from approved share schemes is damaging to the overall economy.

The BVCA would be pleased to discuss how these share schemes can be extended to private equity backed companies whilst ensuring that rationale behind the various conditions is maintained.

#### **vii) Withholding tax issues**

Following our 2005 Pre-Budget Submission, the BVCA has had useful conversations with HMRC regarding the obligation of companies backed by private equity investors to withhold the correct amount of tax at source in respect of interest paid on loans from those private equity backers. This is an area that the BVCA continues to monitor carefully.

However, the BVCA notes that, where debt is provided by international capital markets, withholding tax on interest simply ensures that the borrowing costs of UK companies exceed those of their competitors resident in jurisdictions where no withholding tax is payable (most EU jurisdictions fall into this category). Accordingly, UK companies have to ensure that any internationally tradable or syndicated debt falls within one of the exemptions from withholding tax which have been introduced over the years to mitigate the problem – e.g. it takes the form of discount notes or a quoted Eurobond, or it is lent by a Luxembourg syndication vehicle.

As a result, it appears to the BVCA that the effect of retaining withholding tax is not to levy money for the Treasury but rather to force corporate debt into specific forms, thus imposing substantial costs on industry in the form of fees to advisers, costs of maintaining a listing etc. Those costs would only increase if the new requirements in relation to loans from Luxembourg companies were to apply to private equity following the Indofood decision. The BVCA is unclear as to the benefits of this system and would welcome the opportunity of further debate with HM Treasury and HMRC on this subject.

#### **viii) Capital Gains Tax - simplification of taper relief rules**

The introduction of taper relief for capital gains tax was a welcome development in the encouragement of private investment in equities, especially in private companies. The rules have, however, become very complex and are not always easily understood. Two particular areas which require addressing with possible solutions through legislative change relate to taper relief for business assets which become non-business assets, and for non-business assets generally.

The BVCA recommends (a) an extension to the qualification period for business asset taper relief following a change to non-business asset status and (b) an amendment to the definition of an unlisted company. In relation to non-business assets, the BVCA recommends that the period of time after which the maximum benefit is obtained is reduced to five years, with a lowering of the effective rate of tax after 5 years ownership to 20%.

#### **ix) Substantial shareholding exemption**

The BVCA supports the extension of the substantial shareholding exemption to investment companies, as suggested in the technical note on corporation tax reform issued in December 2004. We believe that this could significantly enhance the UK's position as an attractive location for private equity with the corresponding benefits to the UK economy. It would also make the operation of private equity funds potentially more straightforward as there will be less need to seek offshore solutions.

#### **x) Stamp duty on transfer of shares**

The BVCA is concerned that stamp duty on the transfer of shares may impact on liquidity in the trading of shares in technology and other smaller companies. More liquid capital markets like NASDAQ do not suffer from stamp duty on share transfers.

The BVCA recommends that the Government consider possible abolition of stamp duty on share transfers, or at least in respect of certain types of firm, as part of measures needed to stimulate the attractiveness of the UK as a preferred listing venue for small firms.

## Appendix 1

### Provisions relating to smaller companies which unfairly penalise private equity backed companies

*For some time the BVCA has been aware that certain important tax reliefs aimed specifically at smaller companies are being denied to venture capital backed companies. In the BVCA's view, this unfairly prejudices these companies against their competitors.*

*This issue has recently been raised by the BVCA in a survey to its venture capital members, which covered four areas of particular concern, namely Enterprise Management Incentives, the Enterprise Investment Scheme, Research and Development Tax Credits and Small Companies Tax Rates. The feedback from this survey has confirmed the very great importance of this issue.*

*The BVCA recommends that changes be made to ensure the relevant reliefs are extended to venture capital backed companies, thereby creating a level playing field between such companies and their competitors. We would welcome the opportunity to discuss with you how best this objective could be achieved.*

The BVCA wishes to highlight the following areas of concern.

#### a) Enterprise Management Incentives ("EMI")

- Issues arising from the BVCA's survey:
- The alignment of interest (between venture capital investor and management) which is created by equity ownership by management is a key component of success in early stage companies. The EMI reliefs are perceived to be an important tool to achieve this incentivisation in the venture capital market. In the BVCA's survey of its venture capital members, 100% of respondents said that their portfolio companies operated a form of employee share or share option scheme, illustrating the importance of this form of incentivisation of management. However many companies, which would otherwise meet all the conditions to satisfy the EMI legislation, are unable to qualify if they have secured venture capital backing.
- The technical concern arises because a company will not qualify for EMI where that company is under the control of a company or a company and its connected persons. This is likely to mean that a company will fail the test where a venture capital investor has a majority stake in that company. Depending on the precise drafting used, the test can also be failed even where there are a large number of investors none of which has a majority stake; this being the implication of the connected person rules.
- This issue was widely perceived to be unfair by members who responded to the survey. One said "this is a big issue for us and HMRC apply an unfair and brutal approach to our companies where we have more than 50%." The BVCA doubts whether it can have been the intention of the legislation to deny the relief in such circumstances.

- Taxation of EMI Options for Non-Executive Directors:
- The need to attract the very best commercial talent to start-up and early stage businesses and yet to do so in a way that does not over burden a young company with excessive salary costs is a key priority for government and the industry. Experienced executives who are able to provide such key skills to a number of young businesses at the same time through holding two or more directorships is a valuable asset in meeting this need. The BVCA is also concerned that the EMI rules operate in practice to undermine the attractiveness of non-executive positions (i.e. those not representing an investor) and therefore the desire of key highly-skilled non-executive directors to take on these roles which add significant value to entrepreneurial management teams. This is because, in practice, many non-executive directors of venture backed companies are unable to qualify for EMI options, as they do not work the required number of hours for each portfolio company. (Under the rules, an individual can only qualify for EMI relief if he works for the relevant company for a minimum of 25 hours per week or, if less, 75% of his total working hours.) Non-executive directors are, more often than not, unable to meet these thresholds. The BVCA and its venture capital members believe that the practical effect of the 25hour/75% threshold is an anomaly of the EMI rules and recommends that such rules be relaxed specifically to address the concerns regarding independent non-executive directors. Given the limited talent pool available and the challenges of attracting suitable qualified non-executives, the BVCA believes that such relaxation of the rules would help ensure that venture capital backed companies are able to attract the best people to non-executive positions from the outset and to fully exploit the significant contribution these individuals can make to the long term development of start-up enterprises.

b) Enterprise Investment Scheme ("EIS")

Venture capital backed companies that would otherwise meet all the conditions to qualify for reliefs under EIS can be prevented from qualifying by reason of the "control" rules.

For EIS, the rules are virtually identical to those applying for EMI in that a company will not qualify for EIS where that investee company is under the control of a company or a company and its connected persons. This can cause many early stage companies to fail the test for the reasons outlined above.

The BVCA's venture capital members perceived this to be a significant area of concern. One member said "since we are a co-investment fund putting in typically £50k to £100k alongside business angels, EIS relief is a vitally important aspect of our work. [If the relief is denied] ... HMRC is clearly working against the spirit of what the DTI/SBS provided us with our funding to do in the first place, to grow the amount of private angel investment in early stage technology companies."

c) Research and Development Tax Credits ("R&D Tax Credits")

The Research and Development Tax Credit Scheme is aimed at small and medium-sized enterprises ("SMEs"). For many SMEs, the cash flow and other benefits offered by the R&D Tax Credits are of critical importance, particularly when they are in the early stages of development.

When the BVCA consulted its venture capital members, they emphasised the importance of R&D Tax Credits. Indeed, the responses suggested that 80% of their portfolio companies both (i) carried out innovative research and development and (ii) qualified as SMEs (or would have so qualified were it not for the "control" concern).

However, despite the perceived importance of R&D Tax Credits, many venture capital backed companies are unable to qualify for those reliefs. This is because many such companies may be viewed by HMRC as being "linked" or "controlled" companies (under the SME definition) by virtue of having a major venture capital investor. Among respondents to the BVCA survey stating that they had portfolio companies eligible for R&D Tax Credits but which did not claim or had claims rejected, one-third said the portfolio company was advised that R&D Tax Credits were not available for the above reason.

At a time when the Government is seeking to make the Scheme more attractive to SMEs (see December 2005 publication "Next Steps for the R&D Tax Credit"), it seems particularly unfair that many venture capital backed companies should be automatically precluded from qualifying.

Although we recognise that it may be difficult to make changes to the Commission's definition of SMEs, we understand that there have been situations in the recent past when the Commission has agreed to a relaxation. (One recent example is the approval granted by the Commission to the French authorities for them to look through an FCPR in relation to a tax incentive given to individuals who invest into SMEs.) The BVCA recommends that HMRC should seek the Commission's agreement to a relaxation of the SME definition allowing HMRC to look through the limited partnerships in a venture capital fund when determining whether an investee company is an SME. Such a relaxation would generally enable venture capital backed companies to qualify for the R&D Tax Credits.

#### d) Small Companies Tax Rates

Venture capital backed companies (however small) are generally denied the benefit of smaller companies' tax rates and are obliged to pay their tax through the instalment regime. The BVCA believes that this penalises those growing companies that most need to minimise initial costs and conserve cash flow.

This treatment arises because, in determining whether the profits exceed £1.5 million, the profits of companies which are "controlled" by a venture capital investor generally have to be aggregated with other portfolio companies of that venture capital investor. This can have the result that even the smallest companies can be forced to pay tax on all their profits at the mainstream corporation tax rate; and in addition can be forced to pay that tax by instalments. This clearly increases initial costs and adversely affects cash flow.

## Appendix 2

### VAT issues

*The BVCA is concerned about a number of unresolved issues in the discussions that have been taking place with HMRC for the development of guidelines on the application of VAT in the private equity industry and its administration – in particular, relating to the recovery of VAT on fees related to the investment and recovery of VAT for the private equity firm itself.*

*Without equitable resolution of these issues, there is a threat that VAT costs will become embedded in investment structures to an extent exceeding the intended application and scope of VAT under the EU Sixth VAT Directive and case law. The BVCA would welcome further dialogue on these issues with a view to agreeing and revising the guidance for HMRC officers and the private equity industry.*

The BVCA has for some time been in discussion with HMRC to develop guidelines on the application and administration of VAT for the private equity industry. This process is nearing conclusion but we wish to draw attention to the following issues which remain unresolved.

#### a) Fees related to investments

The first issue in point is recovery of VAT on fees related to investments such as, inter alia, due diligence fees, monitoring fees and legal fees. HMRC is seeking to restrict recovery of this VAT to either the investor or the private equity management firm as being the recipients of the supply. The result of this is that much of the VAT will be irrecoverable by either party in whole or in part. However, this stance is ignoring the fact that often the recipient of these supplies is the investee as it is the investee company that may be the instructing party, the ultimate payer and the prime beneficiary of the services.

Under EU and UK case law and supported by case law (Monoglobal Ltd, LON/18559), the BVCA submits that the investee should be eligible to recover the VAT and that the internal guidance of HMRC be amended to reflect the principles of eligibility (instructing party, ultimate payer and prime beneficiary) for all fees to avoid VAT unnecessarily becoming an embedded cost for the industry.

#### b) Recovery of VAT by the private equity management firm

The second issue concerns recovery of VAT for the private equity management firm itself, whether as an investor or as an intermediary. It is accepted that where exempt supplies are made, the related VAT on expenditure is not recoverable. However, in many cases mixed supplies of an exempt and taxable nature exist and a partial recovery of VAT on expenditure is possible.

The BVCA is concerned that an overly restrictive approach is being taken by HMRC in relation to VAT which relates to taxable supplies and is thus recoverable. HMRC's position is, at its extreme, that all VAT, including that on overheads, relates to the eventual disposal of the investment, a transaction that would generally deny recovery of VAT on related costs. The result of this is that only VAT which fully relates to any taxable supplies alone is recoverable, rather than allowing a recovery of an element on overhead VAT.

The BVCA submits that this position is not in line with VAT principles in that it does not recognise fully the use of some expenditure in making taxable supplies, and that it is overly restrictive and inflexible to take such a general stance where use of input tax will vary across the industry. We request therefore that HMRC's internal guidance be amended to reflect the need for flexibility of application in order for the cost of embedded VAT to be restricted to only where it truly relates to exempt supplies.

## Appendix 3

### Transfer pricing in connection with the capitalisation of private equity owned companies

*The BVCA has had helpful discussions with HMRC officials on a number of issues concerning interest deductibility in respect of shareholder debt by private equity shareholders, in particular on the way in which the corresponding adjustment mechanisms will be applied. However, our members still face practical difficulty and uncertainty in relation to the operation of the "clearance" procedure under which Policy Division (International) is prepared to consider and enter into forward agreements on capital structures.*

*We would welcome the opportunity of further discussions with HMRC to refine and improve the operation of the clearance procedure to the mutual benefit of HMRC and taxpayers. To this end, the BVCA has set up a transfer pricing working group from within its Taxation Committee to examine the working of this procedure: this will, among other things, consider the concerns reported by our members and their professional advisers in relation to the post-transaction clearance process.*

The landscape on interest deductibility in respect of shareholder debt funding by private equity shareholders changed dramatically in March 2005 with the announcement of changes to Schedule 28AA where persons act together in connection with the financing of a company and a control relationship exists. The industry is still coming to terms with that change in landscape. Inevitably financing decisions and company valuations are being affected by the change. In itself that may not be a problem, but it has the potential to become problematic unless there is transparency and consistency of application of the rules and the means exists for those making investment decisions to obtain certainty. Capital markets generally dislike uncertainty and inconsistency.

We have had helpful discussions with HMRC officials in various forums since the introduction of the new rules and we are grateful for the clarifications that we have been able to obtain around (among other things) the way in which the corresponding adjustment mechanisms work.

One area where our members still face practical difficulty and uncertainty is in the operation of the "clearance" procedure under which Policy Division (International) is prepared to consider and enter into forward agreements on capital structures. HMRC has indicated that it is prepared to consider applications both pre-transaction (before capital structures are finalised) and post-transaction.

So far as we are aware, the pre-transaction process has been little used and we anticipate that this is likely to continue to be the case. This is simply a commercial/practical consequence of the way in which transactions typically develop and are negotiated, and the level of information that is typically available to our members about a target business in what are often competitive auction situations.

The post-transaction process is potentially much more attractive. Our members consider the ability to obtain certainty of tax treatment to be important. They are already seeing evidence in the secondary buy-out market that where companies are being sold and there is uncertainty over the level of tax deductibility of shareholder debt funding, buyers are seeking to use this to "chip away" at valuations (i.e. tax is distorting commercial decision-making). However, our members and their professional advisers who have used the post-transaction process have variously reported concerns around the time it takes to conduct such negotiations, inconsistency of outcome and in a few cases we understand HMRC has declined to enter into an agreement at all.

## Appendix 4

### Venture Capital Trusts

*With reference to the recent correspondence and discussions regarding the 2006 Budget changes, the BVCA notes and is grateful for the formalisation and publication by HMRC in September of the "inadvertent breach" guidance. In relation to the realisation of investments, however, we consider that there are a large number of situations which may not be covered by that guidance. The BVCA and its VCT manager members are greatly concerned that the FA 2006 change to include Non Interest Bearing Accounts within the definition of "investments", by inhibiting their freedom of action in relation to realisations, will distort the investment behaviour of VCTs.*

*The BVCA welcomes HMRC's commitment to ongoing discussions on this subject and the opportunity the industry has been given to provide specific examples of situations which we believe will be seriously problematic under the new legislation. The BVCA would welcome further HM Treasury engagement and support in driving appropriate legislative change, where this is necessary to enable the aim to be achieved whilst conforming to the stated policy objectives.*

We welcome the stated commitment of HM Treasury to ensuring that the VCT industry is viable and successful in supporting investment in smaller companies.

The BVCA believes that continuing dialogue is crucial to ensure that, in endeavouring to strike the right balance between providing incentives and preventing potential abuse, it does not become unreasonably difficult for VCTs to operate on a practical level in their role as an important source of finance. We draw attention in particular to the ongoing dialogue regarding "inadvertent breaches" and the realisation of investments, where we believe there are a large number of situations which may not be covered by that guidance.

As has been explained in these discussions, we are greatly concerned that the FA 2006 change to include Non Interest Bearing Accounts within the definition of "investments" will inhibit VCTs' freedom of action in relation to realisations and thus distort their investment behaviour.

Whilst those discussions are continuing and no final conclusion has yet been reached by HMRC Policy, our understanding is that there may be situations which fall within policy intention but cannot be accommodated without legislative change: if this proves to be the case, we would welcome HM Treasury support in driving the necessary legislative change.

## Appendix 5

### Share option schemes

*The BVCA considers that the benefits of approved share option plans should be available to all employees and not denied to large groups of employees simply because of the nature of the company's shareholders. It is time that a consistent approach is brought to this entire area. The private equity sector is an increasingly important part of the UK economy, and preventing this entire sector from benefiting from approved share schemes is damaging to the overall economy.*

*The BVCA would be pleased to discuss how these share schemes can be extended to private equity backed companies whilst ensuring that rationale behind the various conditions is maintained.*

Since the 1970's UK governments have supported wider employee share ownership. Employee share ownership is seen as more directly aligning the interests of employees and shareholders, and therefore improving overall economic performance.

Consequently the UK tax legislation includes a number of approved share option plans. These are as follows:

- Enterprise Management Investment Scheme ("EMI") – Schedule 5 ITEPA 2003
- Company Share Ownership Plan ("CSOP") – Schedule 4 ITEPA 2003
- Approved SAYE Options ("SAYE") – Schedule 3 ITEPA 2003
- Share Incentive Plans ("SIPs") – Schedule 2 ITEPA 2003

There are number of restrictions in each of the schedules mentioned above. In particular Schedules 2 to 5 ITEPA 2003 include conditions on the types of shares held under option. Crucially the relevant share must not be shares in a company which is under the control of another company unless that company is itself a listed company. For private equity backed companies whilst the portfolio company is not itself a subsidiary of another corporate the definition is such that the fund manager is likely to be in control. There are also conditions in relation to option exercise periods, transfer, and pre-emption rights. These also cause problems in the private equity environment.

Such plans have been extensively used in the UK listed sector and certain private companies but the benefits are largely not available to employees of private equity backed companies. Both SAYE and SIPs target the entire workforce and tend to be used for more junior employees. Therefore a key impact is that these particular groups are disadvantaged and effectively prevented from participating more directly in the success of private equity backed companies. There have been cases where a private equity fund has invested in significant enterprises and large groups of employees have had to be withdrawn from approved share option schemes.

The BVCA considers that the benefits of these share schemes should be extended to the private equity sector. Under the current rules employees of small enterprises backed by private equity funds are unable to participate in a similar manner to other employees. The same applies to employees of many larger enterprises simply because a private equity fund has invested in the underlying business.

## Appendix 6

### Capital Gains Tax - simplification of taper relief rules

*The introduction of taper relief for capital gains tax was a welcome development in the encouragement of private investment in equities, especially in private companies. The rules have, however, become very complex and are not always easily understood. Two particular areas which require addressing with possible solutions through legislative change relate to taper relief for business assets which become non-business assets, and for non-business assets generally.*

*The BVCA recommends (a) an extension to the qualification period for business asset taper relief following a change to non-business asset status and (b) an amendment to the definition of an unlisted company. In relation to non-business assets, the BVCA recommends that the period of time after which the maximum benefit is obtained is reduced to five years, with a lowering of the effective rate of tax after five years ownership to 20%.*

Two particular areas which require addressing with possible solutions through legislative change are addressed below.

#### a) Taper relief for business assets which become non-business assets

Appendix 5 in last year's recommendations of the BVCA to the Government pointed out the anomalous effects of the apportionment rules in paragraph 3, Schedule A1 TCGA 1992 on assets which qualify as business assets for only part of the qualifying holding period. The rules operate on a strict time apportionment basis, and in the BVCA's view do not reflect the reality of the accrual of gains in the value of companies owned by private equity funds.

A particular anomaly arises where the company in which shares are held becomes fully listed and the individual is no longer employed by the business. Unless he holds 5% or more of the shares, his holding will no longer qualify as a business asset. The appreciation in value of companies in which a private equity fund would invest will generally be at a faster rate while they are held privately than once they have been listed.

In addition, many private equity backed companies are fully listed for taper relief purposes as they are under the control of a listed private equity investor. This does not reflect the commercial reality of the situation, since the shares will be held by management in an illiquid private company.

The BVCA recommends two simple modifications to mitigate these effects:

- a) An extension to the qualification period for business asset taper relief following a change to non-business asset status of say, 12 months following the date on which the asset ceases to qualify, where it previously qualified under paragraph 6(1) but ceased to qualify by reason of not being able to satisfy one of the conditions (i)-(iii) in paragraph 6(1)(b). This would parallel similar provisions in the Substantial Shareholdings Exemption rules, which permit, for similar reasons, SSE relief to be available where a qualifying shareholding had been maintained for at least 12 months out of the last 24.

- b) In paragraph 22(1), remove (b) from the definition of an unlisted company. This would result in subsidiaries of a quoted parent being treated as an unlisted company for taper relief purposes.

b) Non-business assets

Maximum non-business asset taper relief can only be achieved after 10 years of ownership, and after this period any gain is still charged at an effective rate of 24%.

The BVCA recommends that the period of time after which the maximum benefit is obtained is reduced to five years, and furthermore the effective rate of tax after five years ownership would be lowered to 20% (with cumulative reductions of an effective 4% per annum after year one and before year five). Assets held for less than one year would continue to be taxed at an effective rate of 40%.

This would benefit growing businesses in the UK, providing private investors with an incentive to invest in equities as an alternative to lower fixed-income securities. The Government would thus encourage a far wider population of private investors to invest in shares of growing quoted companies which do not meet the business asset tests.

This would boost the market for shares in such companies and assist their capital raising efforts.

## Appendix 7

### Substantial shareholding exemption

*The BVCA supports the extension of the substantial shareholding exemption to investment companies, as suggested in the technical note on corporation tax reform issued in December 2004. We believe that this could significantly enhance the UK's position as an attractive location for private equity with the corresponding benefits to the UK economy. It would also make the operation of private equity funds potentially more straightforward as there will be less need to seek offshore solutions.*

The BVCA supports the extension of the substantial shareholding exemption to investment companies. The reasons for this are as follows:

- The UK is out of step with a number of key countries in Western Europe which have introduced local capital gains tax exemptions. These exemptions do not differentiate between trading and investment companies.
- Whilst the limited partnership is the most common vehicle for private equity investments it is not always appropriate since, for example, some jurisdictions would not regard it as transparent. In these situations it is often necessary to use an intermediate holding company to avoid the imposition of full withholding taxes as the partnerships themselves are not able to obtain tax residency certificates. These intermediate vehicles tend to be located in jurisdictions such as Luxembourg.
- If the UK did extend the substantial shareholding exemption to investment companies then the UK could become an attractive location for holding companies because of the capital gains tax exemption and also the lack of withholding tax on dividends.
- Removing the distinction between trading and investment companies would in addition significantly simplify the operation of the substantial shareholding exemption and introduce a greater degree of certainty into its operation.
- As the technical note on Corporation Tax Reform issued in December 2004 states it will be a requirement that the underlying portfolio company is a trading company. The BVCA supports this approach since the private equity industry would normally invest into trading companies both in the UK and offshore.
- In addition the BVCA has no objection to the exclusion of close-investment holding companies provided that the rules are such that the standard private equity limited partnerships do not, because of the association rules, cause the investment company to be close.

The BVCA believes that the extension of the substantial shareholding exemption to investment companies could significantly enhance the UK's position as an attractive location for private equity with the corresponding benefits to the UK economy. It will also make the operation of private equity funds potentially more straightforward as there will be less need to seek offshore solutions.