House of Commons

Treasury Committee

Private equity: Responses from the Government and the Financial Services Authority to the Committee's Tenth Report of Session 2006–07

Second Special Report of Session 2007–08

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Second Special Report

The Treasury Committee published its Tenth Report of Session 2006–07 on *Private equity*, on 30 July 2007, as House of Commons Paper No. 579–I. The Government response to this Report was received on 22 November 2007, and is published as Appendix 1 to this Special Report. On 24 August 2007 we received a response by the Financial Services Authority to the same Report, which is published as Appendix 2 to this Special Report.

Appendix 1: Government response

1. We recommend that the Treasury and HM Revenue and Customs consider the tax treatment of carried interest as part of their review of the taxation of employment-related securities, and that they publish the results. (Paragraph 88)

The Government believes that the changes to the Capital Gains Tax regime (CGT) announced in the Pre Budget Report (PBR) will create a more sustainable tax system that is straightforward for all taxpayers and which remains internationally competitive. Along with the changes to residence and domicile rules to address loopholes and anomalies, these changes will increase the fairness of the tax system, including for individuals in the private equity industry.

The Government continues to remain interested in the wider aspects of the ways in which those involved in the private equity, and other industries, are rewarded including the application of the legislation on Employment-Related Securities (ERS) which includes carried interest, in the context of the need to ensure that the tax system as a whole is both fair and sustainable.

2. We ask HM Revenue and Customs to write to us:

- **setting out the rationale behind the production of the Memorandum of Understanding in 1987 and the update to it in 2003;**
- **explaining the extent to which the Memorandum is used by the private equity industry;**
- **assessing whether the context in which the Memorandum is currently being used conforms with the original rationale; and**
- **stating whether the override provisions of the Memorandum have been exercised and what internal (Paragraph 90)**

The rationale behind the production of the Memorandum of Understanding in 1987 and the update to it in 2003

In 1986 a working group of government officials, outside representatives and tax advisers was set up to review the application of section 79, of the Finance Act 1972, anti-avoidance legislation which applied to restricted securities. All accepted that this legislation was

necessary but that it caught a wider than intended target. As a result of this working group, sections 77–89 FA 1988 replaced the legislation.

In 1986 the BVCA informed the Government that it could encourage foreign capital to come into UK by way of limited partnerships to invest in UK industry. However, they were uncertain how section 79, Finance Act 1972 would apply to them. Inland Revenue officials met with BVCA to understand their arrangements and advise them what the tax treatment would be if they came into the UK by way of limited partnerships. The resulting guidance was set out in the 1987 MoU. The key point was that, based on the nature of the arrangements described by the BVCA and the wording of the legislation in force at the time, the assets held by the private equity managers were not acquired 'by reason of their employment', so section 79 did not apply to them.

Schedule 22 FA 2003 introduced significant changes to the tax treatment of employment-related securities. Key among these was a piece of legislation which said that if securities were made available by someone's employer then they would be deemed to be acquired by reason of employment, regardless of any other facts (now in section 421B (3) of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA). This meant that the assets held by the private equity managers would be now treated as acquired by reason of their employment.

Concerns were raised in Finance Bill Committee about how this would impact on the private equity industry and the Paymaster General gave assurances that Inland Revenue officials would meet the BVCA to discuss their concerns.

The outcome of these negotiations was that, providing the private equity managers paid full market value when they acquired their assets, that there would be no later Chapter 2 ITEPA 2003 charge and all gains arising would fall within the CGT regime. This is the same rule as applies to all restricted securities in all industries.

The 2003 MoU sets out the guidance for this, outlining a typical fact pattern for arrangements to show how to determine whether or not full market value had been paid in what are complex transactions.

The extent to which the Memorandum is used by the private equity industry

There are no statistics on the use of the MoU. This is because anyone involved in transactions affected by the tax legislation, primarily in Part 7 of ITEPA, can look at the guidance in the MoU and satisfy themselves of the correct tax treatment of those transactions, without needing to notify or seek clearance from HMRC. HMRC does receive applications for assurances under the HMRC Code of Practice 10 procedure from some customers who want additional comfort that they have interpreted the MoU guidance correctly, but it is not possible to say what proportion such applications represent of the total number of transactions to which the MoU is relevant.

Assessment of whether the context in which the Memorandum is currently being used conforms with the original rationale

As explained above, there is no requirement that customers should approach HMRC before applying the guidance in the MoU. This means that the evidence available to HMRC in making the assessment requested by the Committee is limited. However, on the basis of the cases seen, and taking into account other anecdotal evidence, HMRC has no reason to suppose that the original rationale is not being followed in the great majority of instances.

Whether the override provisions of the Memorandum have been exercised

The reference to the 'override provisions of the MoU' is taken to be a reference to paragraph 1.6 of the 2003 MOU. It is important to be clear that this is not an 'override'. It is merely a reminder that the guidance contained within the MoU has limited scope, and where arrangements are outside this scope, you must look at the underlying legislation to determine the applicable tax treatment.

The MoU is an example of a typical fact pattern used in complex financial (including private equity) arrangements. It sets out how the underlying legislation applies to that fact pattern. Where the fact pattern differs, the underlying legislation may deliver a different conclusion and therefore the MoU does not apply nor does it apply where 'avoidance' is involved.

These are not 'overrides' to the guidance in the MoU, they are merely instances where the guidance will not be relevant in the first place.

Therefore the 'override' is never 'used'. It is simply a question of whether the guidance in the MOU is relevant or not.

3. The Treasury is already reviewing "one specific aspect of the current rules that apply to the use of shareholder debt where it replaces the equity element in highly leveraged deals"; the outcome of this review will be reported in the 2007 Pre-Budget Report. We recommend that, in addition to reviewing the tax treatment of debt in highly-leveraged transactions, the Treasury and HM Revenue and Customs examine whether the tax system unduly favours debt as opposed to equity, thereby creating economic distortions. (Paragraph 94)

The outcome of the review of shareholder debt was announced in PBR 2007. On the basis of evidence to date, the 2005 changes to the transfer pricing rules have been successful in bringing private equity within the scope of the rules.

However, the Government remains concerned that the current rules—which are based on the internationally recognised arm's length principle—may be less effective in the context of highly leveraged private equity transactions. The Government will therefore continue to monitor closely the operation of the transfer pricing rules in these types of transactions.

The UK's tax system has long drawn a distinction between debt and equity, recognising them as different forms of finance. Interest payable on debt financing is typically considered to be an allowable business expense, whereas the return payable to equity holders is not as it represents the distribution of a company's profits. Many major tax

systems adopt a similar approach, although they often apply restrictions on interest deductibility which are absent in the UK.

There are no legal restrictions on how much a business can borrow. Lenders' decisions about how much to lend to a business and on what terms reflect market forces. However these may not operate where the lender and borrower are connected. As part of HM Treasury's overarching objective to promote a fair, efficient and integrated tax system, Government will keep all taxes under review and will therefore maintain a watching brief over the use of debt and its interaction with the tax system to ensure that the outcomes more closely replicate the operation of the market.

4. Whilst recognising that this issue is not exclusive to private equity, we ask the Treasury to inform us of the progress on the 2003 review of the residence and domicile rules as they affect the taxation of individuals, setting out what evidence has been assembled, whether any external advice has been commissioned and the rationale behind any proposed changes. Given the apparently rising number of the non-domiciled, and a perception that monitoring of the status of non-domiciles is weak, it is essential that the Treasury and HM Revenue and Customs are able to demonstrate that they have a rigorous approach towards claims of non-domicile status. (Paragraph 95)

In the Pre-Budget Report the Government announced the completion of the review of the residence and domicile rules that apply to personal taxation.

The Government has concluded that the existing arrangements make an important contribution to the UK's competitiveness, by making the UK an attractive place for skilled people to come to work and do business and where non-domiciles contribute £4 billion of tax on UK earnings. Reforms are required to make the current arrangement operate fairly: [see paragraphs 5.80–81 of the PBR 2007 document]

- first, from April 2008 resident non-domiciles who have been in the UK for longer than seven out of the past ten years will only be able to access the remittance basis of taxation on payment of an annual charge of £30,000, unless their unremitted foreign income or gains are less than £1,000;

- secondly, people who use the remittance basis of taxation will, from April 2008, no longer be entitled to income tax personal allowances. Again, people with small amounts of foreign income will be exempt;

- thirdly, the Government will introduce changes to the residence rules so that days of arrival in and departure from the UK will count toward establishing residence. This brings the UK into line with international practice; and

- finally, the Government will amend the current rules to remove flaws and anomalies that allow individuals using the remittance basis of taxation to sidestep UK tax, where it is due on foreign income and gains.

The Government will consult on a wider range of options and specifically on whether people who have been resident in the UK for longer than ten years should make a greater contribution, and on the detail of these proposals before the changes are introduced to ensure non-domiciles pay their share of UK tax.

Appendix 2: Financial Services Authority response

The Financial Services Authority (FSA) welcomes the Committee's interim Report into private equity, published on 30 July 2007, and the support which the Committee has given to our work in this area. In this Memorandum we respond to those recommendations in the Report which are directed to the FSA and provide further information on our continuing work on issues of particular interest to the Committee.

Highly leveraged deals

We welcome the Committee's support for our proposal to conduct a twice early survey of banks' exposures to leveraged buyouts.[1] In preparing this survey, we will specifically consider the potential for monitoring the incidence of covenant-lite loans.[2]

Systemic risk

The Committee makes three further recommendations with respect to the systemic implications of the leveraged loan market:

- We urge the FSA to investigate the operation of due diligence in highly-leveraged firms.[3]
- We recommend that the FSA examine incentive structures relating to debt.[4]
- We recommend that the FSA continue to work towards obtaining assurance that the banking system has the appropriate incentive structures and monitoring mechanisms in place to handle such risks (i.e. exposure to leveraged buyouts).[5]

On the first point: our mandate covers firms which conduct regulated activities within the UK, but does not extend to private equity-owned firms unless they themselves carry out regulated activities. Rather, we regulate the private equity firms and investment banks that arrange, structure and execute the takeover (and subsequent sale) of such firms. As we have outlined in our previous submissions to the Committee, regulated firms are subject to ongoing requirements and monitoring in terms of due diligence and risk management systems and controls.

We understand the Committee's second and third points to relate to the robustness of systems and controls through which the banking sector manages entry and exposure to private equity business. In line with our risk-based approach, we focus our supervisory attention on the areas which we believe represent the highest risk to our statutory objectives. When considering the leveraged loan market, our attention is appropriately

1 Paragraph 65

2 Paragraph 51

3 Paragraph 61

4 Paragraph 57

5 Paragraph 65

weighted towards the FSA-regulated banks which form the transmission mechanism for economic risk to be dispersed throughout the marketplace. Our concern is to check that those banks have in place, and operate, effective controls and risk management practices at each stage of their involvement in private equity business—including loan origination, risk transfer and ongoing risk management of exposures.

We will continue to work with domestic and overseas regulatory bodies to identify and address risks to financial stability presented by developments in market practice in the private equity sector.

Effective supervision of the private equity market remains a priority for the FSA. We will keep the Committee informed as our work in this area progresses.