Report of Expert Group
on removing tax obstacles to cross-border Venture Capital Investments

European Commission

ABOUT THIS REPORT

This Report represents the conclusions of the work of the Venture Capital Tax Expert Group on Removing Tax Obstacles to Cross-border Venture Capital Investments.

The European Commission established this Group in May 2007 as part of a series of steps it is taking to try to facilitate cross-border Venture Capital investment within the Single Market and thus improve access to finance for small and medium-sized enterprises (SMEs).

The Group consisted of government and business tax experts from EU Member States. These experts were asked to provide independent advice to the Commission and were appointed to the Group in a personal capacity. The views expressed in the Report do not, therefore, necessarily reflect the official position of EU Member States' governments or of the private organisations from which the members of the Group were drawn. It should be noted also that not all members of the Group necessarily agree with every conclusion in this Report. In cases of dissent, the Report reflects the views of the majority of the Group's members.

The role of the Commission staff in relation to the Group was to facilitate discussions and to assist in the drafting of the Report. Consequently, the Report should not be construed as in any way reflecting the official position of the European Commission and its services. Neither the Commission nor any person acting on behalf of the Commission is responsible for the use which might be made of the information contained herein.

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Executive summary[1]

1. The issue

There is a need within the European Union (EU) for a dynamic venture capital (VC) industry that is capable of providing early-stage equity financing to the EU's most innovative high-growth small and medium-sized enterprises (SMEs). SMEs and businesses backed by financial and business support such as VC can generate economic growth, create new jobs and contribute to the design and use of new knowledge and technology. Active VC markets would be important drivers of the more competitive, entrepreneurial, innovative and dynamic European economy that the EU's Lisbon Strategy[2] aims to achieve. VC investment can also play a significant role in strengthening European economies in the current economic turbulence and downturn.

However, the EU VC market still works below its potential. There are natural obstacles arising from differences of language and legal and regulatory requirements. However, one of the main reasons identified is the lack of cohesion between the 27 tax systems across the EU that can lead to double taxation, tax treatment uncertainties and administrative obstacles. The result is that VC tends to be restricted to domestic national markets rather than extending across the larger EU and international markets. Most Member States have agreed bilateral double taxation conventions (DTCs) between each other that are generally based on the Model Double Tax Convention of the Organisation for Economic Cooperation and Development (hereafter the OECD Model). These should normally allocate taxing rights to prevent the occurrence of double taxation. However, this is not always the case because the often complex commercial structures used in VC are not always accommodated by DTCs. This is why the cross-border management of VC funds risks creating a layer of taxation at the level of the management of the funds. The different tax treatment of VC funds in different Member States creates further problems.

Furthermore, many experts in the Group that have produced the present Report believe that the tax treatment applied to VC Fund Managers and investments in VC is less favourable than that applied to public equity managers and investments in public equity. The experts point out that, regardless of the many similarities between the activities of managers of public and private equity[3], the activities of public equity managers are accepted as activities of independent agents and, as such, as not creating a permanent establishment for the investors in their country. The activities of managers of private equity funds, on the other hand, could constitute permanent establishments for the funds.

VC could make a greater contribution to the EU economy if the tax environment across the EU took better account of the industry's specific concerns. If funds were able to freely operate across borders, they would achieve economies of scale. In addition, specialised sectoral expertise would emerge which would increase investment amounts, diversify portfolios and improve investors' returns. Most importantly, this scenario would increase competition by lowering costs for existing participants and new entrants into the market.

Tax authorities are naturally concerned about protecting their tax bases. However, the current tax rules are such that a fund has to resort to restricting its activities artificially in order to avoid additional tax at the management level and this greatly reduces the effectiveness of VC in the

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[1] The group finished the main part of its work in June 2009. The report therefore mainly reflects the situation prevailing at that data, including in particular the tax legislation in force in EU Member States at that time.
[2] See glossary for definition of this and other frequently used terms.
[3] See later detailed comparison of public and private equity fund management activities.

EU single market. Therefore, the value of retaining the status-quo must be weighed against the impact of having a sub-optimal environment in the EU for attracting and encouraging VC investment into businesses. Addressing the taxation problems of the VC industry and improving the current environment will ultimately raise tax revenues from dynamic and growing European businesses. Successful venture companies often become, in time, major companies.

This report considers and proposes solutions to certain taxation problems that arise when VC is provided across borders within the EU.

2. Main findings

VC cross-border investments require a local presence (i.e. in the state of the portfolio company) to help the VC Fund Manager source new investments in those states and look after investments it has acquired there.

Ideally, the activity at the local level should include full management functions (basically the capacity to make or actively contribute to investment decisions and manage the portfolio companies).

Currently in Europe we see that, when a Fund Manager operates in the state of the portfolio company, the Manager's activities risk creating a permanent establishment for tax purposes for the VC fund or for its investors in that state.

The VC Fund Manager will wish to avoid this permanent establishment risk so as to prevent double taxation (i.e. to prevent taxation of the investment in the country where the investment takes place and also in the country where the investors are located). Such double taxation can make investing in private markets uneconomic for investors.

Owing to the uncertainty regarding whether tax authorities of the local state view the activities of the VC Fund Manager as creating a permanent establishment or not, the Fund Manager currently has to limit its activities at the local level to the mere provision of advice. This advice is, in fact, usually provided by separate advisory companies which analyse the local market, identify and evaluate potential investment opportunities and prepare investment proposals, with appropriate input from the VC Fund Manager, but do not carry out management functions.

At present, such a situation is highly inefficient, costly and complex and can potentially deter investments (and it does not completely eliminate the risk of permanent establishment).

Another problem for VC funds is the fact that the tax classification and tax treatment of the funds varies from one Member State to another. The funds may be treated as transparent or non-transparent, subject to tax or not subject to tax and trading or non-trading. Different treatment in different Member States is a further potential source of double taxation which is not currently addressed.

3. Conclusions of the Expert Group

The VC Tax Expert Group looked into these problems from May 2007 to June 2009. In accordance with its mandate, the Group identified a number of situations where taxation, and specifically the risk of double taxation, was a potential issue in cross-border investment situations. In the light of this, the Group discussed a number of possible solutions that could provide a "toolbox" for consideration by EU Member States. Some experts of the Expert Group believe that the conclusions should be limited to VC funds and investors resident in EU Member States, arguing that expanding the favourable treatment proposed in the report to entities or individuals that are located in non-EU low tax jurisdictions or are not subject to full liability to tax could cause competition between non-EU funds and investors and EU funds and investors. However, the majority of the experts represented in the Group oppose such a limitation. The possible solutions are as follows:

1) The optimum solution to the taxation problems would be for the tax authorities of the state of the portfolio company to confirm that the activities of the Manager of a VC fund in connection with the VC fund and its investors can be classified as those of an independent agent, as defined in the OECD Model, and therefore cannot be treated as a permanent establishment of the VC fund or its investors in the country where it carries out its management functions. This could be achieved through clear statements from tax authorities that they agree with this treatment of VC Fund Managers.

2) If, however, an investor has a permanent establishment in another jurisdiction and the investment in the fund is properly attributable to that establishment, the profits arising to the investor could be taxed in that other country.

3) The state of the portfolio company would still retain full taxing rights over any income/gains arising to the VC fund in its jurisdiction. If the VC fund is non-transparent for tax purposes, then the state of the portfolio company would apply the DTC between itself and the jurisdiction of the fund vehicle (if one exists and if the fund meets the conditions provided by the relevant article of this DTC to be considered a resident) in order to determine whether to apply tax on dividends, interest and capital gains flowing to the fund. If the VC fund is transparent, the state of the portfolio company would apply the DTCs between itself and the countries of residence of the investors.

4) The VC Fund Manager should be taxed on an arm's-length basis on the management fees that it earns in respect of services that it performs in each jurisdiction in which it has a presence.

5) Those Member States agreeing with the conclusions of this report should arrive at guidelines or at a legally binding agreement concerning mutual recognition of the classification for tax purposes of the legal forms of VC funds. This would provide that all Member States would recognise the tax classification and tax treatment applied by the home country of a VC fund (i.e. as transparent or non-transparent; subject to tax or not subject to tax; trading or non-trading). Where a VC fund is treated as non-transparent in its home country, Member States would, as a result of this mutual recognition, agree that the fund is resident in that country for the purposes of the application of DTCs if it meets the conditions provided by the relevant articles of these conventions to be considered a resident. This would help to increase legal certainty and reduce the risk of economic and/or juridical double taxation.

6) Another solution would be that EU Member States would agree on a list for the classification as either transparent or non-transparent of certain specific legal forms which are often used for VC funds.

Although there was some discussion of the possibility of a common or universal EU VC vehicle along the lines of the European Company (Societas Europaea) or the European Private Company (Societas Privata Europaea), it was beyond the mandate of the Group to consider the case for such a vehicle.

Report

I. Preface

Many commentators view the EU VC industry as currently operating below its potential. Among the chief reasons for this situation are that the VC operating environment in the EU is fragmented, with 27 sets of tax, legal and regulatory systems hindering national and cross-border fundraising and investment processes.

The EU's Council of Ministers has on several occasions recognised the need to reduce this fragmentation of the VC operating environment across the EU. Furthermore, the Council has invited EU Member States to continue their own individual efforts to address the current failure and barriers. The Council has acknowledged[4] that, in order to flourish, an EU-wide VC market requires clarity and certainty, including in the field of taxation. Professional VC Fund Managers must be able to raise capital and invest across borders within the Single Market without incurring unfavourable tax treatment and disproportionate administrative burdens. There is, above all, a need to eliminate double taxation problems and legal and administrative uncertainty at national level.

The European Commission has taken certain steps towards identifying and tackling obstacles to cross-border VC investments in order to create a true EU VC market. As regards taxation, it created the VC Tax Expert Group in May 2007. The mandate of the Group, which consisted of representatives of business and of national administrations in Member States, was to identify cases of double taxation and other direct tax obstacles encountered by cross-border VC investments and reflect on ways to overcome them.

The Group finalised its work in late 2009 and its main findings and conclusions are summarised in this report.

All the experts were appointed in a personal capacity and the European Commission facilitated discussions and acted as secretariat.

It should be noted that not all Group members necessarily agree with every conclusion in this report. In cases of dissent, the final report reflects the views of the majority of experts. Nor should the VC Tax Expert Group's report be construed as in any way reflecting the official position of the European Commission and its services, of the Member States or of the private organisations represented.

[4] *Cf Competitiveness Council Conclusions (29-30 May 2008) http://register.consilium.europa.eu/pdf/en/08/st10/st10174.en08.pdf*

II. Background

The European Commission has taken several initiatives that have included elements aimed at improving the tax environment for cross-border VC investment in the EU.

II. 1 Risk Capital Action Plan[5]

The Commission in March 1998 published a Communication *"Risk capital: a key to job creation in the European Union"* that was intended to promote co-ordinated action at Community level to stimulate the expansion of risk capital markets[6]. This Communication identified six categories of barriers (one of which was taxation) to the creation of EU-wide risk capital markets and proposed an Action Plan and timetable to remove those barriers.

Following discussions with Member States, the Commission adopted this Action Plan, known as the Risk Capital Action Plan[7], in June 1998. It suggested that Member States should, inter alia, address the following tax issues: the economic double taxation of the profits of VC funds; capital gains tax; and the difference in the tax treatment of low-risk capital (e.g. bank deposits, bonds) as compared with that of VC.

In November 2003, the Commission's *Final Report on the Implementation of the Risk Capital Action Plan*[8] highlighted the need to eliminate tax obstacles to cross-border investments (such as the tax treatment of dividend, interest and royalty payments, cross-border losses and restructuring), and the need for co-ordinated action in international fora to eliminate economic and juridical double taxation.

II. 2 Green Paper on the Enhancement of the EU Framework for Investment funds[9]

The Commission in its *Green Paper on the Enhancement of the EU Framework for Investment funds of July 2005* concluded that the EU market for investment funds is still fragmented. It proposed the creation of an Expert Group on Alternative Investment funds[10] to report on how the EU framework for investment funds could be improved. In July 2006 the Expert Group published its report: Developing European Private Equity[11] which called for a better tax environment for investments in private equity and VC, suggesting that the guiding principle for the taxation of private equity funds should be that the investor would only be taxed in its home country on capital gains.

II.3 Commission Communication "Financing SME Growth – Adding European Value"

The Commission, in its Communication *"Financing SME Growth – Adding European Value"*[12] of June 2006, said that EU businesses including SMEs require an integrated, open and competitive financial market for risk capital and in particular for VC in order to be internationally competitive. Facilitating cross-border VC investments is therefore a key goal and the Commission called for concrete and pragmatic steps to overcome the existing legal, tax and regulatory barriers to such investments.

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[5] http://ec.europa.eu/internal_market/securities/docs/risk_capital/sec98_552_en.pdf

[6] This Communication defines risk capital markets, as markets providing equity financing to a company during its early growth stages (start-up and development). It covers three types of financing: 1) business angels 2) VC and 3) stock markets specialised in SMEs and high-growth companies.

[7] http://ec.europa.eu/internal_market/securities/docs/risk_capital/risk_cap_act_plan_en.pdf

[8] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2003:0654:FIN:EN:PDF

[9] COM(2005)314 final

[10] http://europa.eu/rapid/pressReleasesAction.do?reference=IP/06/96&format=HTML&aged=0&language=EN&guiLanguage=en

[11] http://ec.europa.eu/internal_market/investment/docs/other_docs/reports/equity_en.pdf

[12] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2006:0349:FIN:EN:PDF

Annex I to this Communication outlined the actions that the Commission would take to create a single market for VC funds. Those actions included establishing two expert groups: one group with a broad mandate to identify obstacles and solutions concerning cross-border VC investments ('the VC Expert Group'), and a second group to look more specifically at the tax issues arising in conjunction with those investments ('the VC Tax Expert Group').

While the VC Expert Group dealt only to a limited extent with tax issues, since those issues were not part of its remit, the Group's final report[13] nevertheless identified a number of direct tax issues hindering cross-border VC investment and proposed some possible solutions.

II. 4 Commission Communication "Removing Obstacles to Cross-border Investments by Venture Capital funds[14]"

The 2007 Commission Communication *"Removing Obstacles to Cross-border Investments by Venture Capital funds"* highlighted the fact that, at present, there is a need to put in place complex fund structures with parallel vehicles in order to minimise the tax disadvantages from investing across borders. The high transaction costs of setting up and managing such structures, together with the existing legal uncertainty, act as a disincentive to cross-border VC investment.

II. 5 Commission Proposal for a Directive on Alternative Investment Fund Managers

The Commission's proposal for a Directive on Alternative Investment Fund Managers[15] (AIFMs) of 29 April 2009 aims to create a comprehensive and effective regulatory and supervisory framework for AIFMs, including VC, in the EU. Subject to compliance with high and stringent regulatory standards, the proposed Directive would give AIFMs Single Market rights in return, permitting AIFMs established in Europe to provide their services in the Community and market European Alternative Investment Funds across the EU. The Directive would also allow the marketing of Alternative Investment Funds from non-EU countries into the Community, but on the condition that these countries comply with stringent requirements on regulation, supervision and cooperation, including on tax matters. With respect to proportionality and the impact of the proposed AIFM Directive on VC business, the proposed Directive acknowledges the need to ensure that smaller Managers are not subject to disproportionate requirements and that venture capital companies are not put under additional pressure, because their continuing ability to provide risk capital is of particular importance in the current economic climate.

II. 6 VC Tax Expert Group on Removing Tax Obstacles to Cross-border VC Investments

The Commission set up the VC Tax Expert Group on Removing Tax Obstacles to Cross-border VC Investments in May 2007, building on previous Commission work and on the conclusions of the VC Expert Group and of the Expert Group on Alternative Investment funds. The VC Tax Expert Group consisted of 33 representatives[16] of business and national administrations in EU Member States, who were appointed in their personal capacity as experts in their field.

The VC Tax Expert Group had a two-fold mandate:

1. to identify cases of double taxation and other direct tax related obstacles encountered by cross-border VC investments; and
2. to consider possible ways of overcoming such obstacles.

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[13] *http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc_id=1094&userservice_id=1&request.id=0*
[14] *http://ec.europa.eu/enterprise/newsroom/cf/itemlongdetail.cfm?item_id=2033&lang=fr*
[15] *http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf*
[16] *Those members of the Group who have agreed to have their names published are listed at Annex VIII.*

The Group has not dealt with uncertainties regarding state aid, forms of management remuneration such as carried interest, or VAT.

9 meetings took place between May 2007 and February 2009 and the Group finalised its work in June 2009. Its main findings and conclusions are summarised in this report. The Annexes to the report contain relevant background information including a glossary of useful terms and the treatment of various VC vehicles and tax regimes within the Member States, as well as a chapter on Difference in Treatment. This chapter gives an overview of the existing case law of the European Court of Justice on the different treatment of residents and non-residents in various cross-border situations in order to clarify some of the potential situations where VC tax treatment may constitute an infringement of EU Treaty freedoms.

III. The Concept of Venture Capital

III.1 Definition and characteristics

For the purposes of this report, **'venture capital'** (VC) is understood to be a subset of private equity. VC investments[17] are those which are made in unlisted companies for the launch, early development or expansion of a business. VC is thus capital co-invested with the entrepreneur in order to provide seed or start-up capital, or to fund an expansion of the business. The bulk of the capital is in equity form, not debt. The high risk that investors take over a long term of investment and the increased risk of loss are offset by the expectation of higher than average returns.

Table 1 below presents the typical VC characteristics.

Source: OECD Paper on Venture Capital and Innovation[18]

A venture capital investment is generally characterised by the following key aspects:

- Venture capital shares the business risk with the entrepreneur.
- Investment is generally long term, between 3 and 7 years.
- As the capital is at risk, venture capitalists work in a partnership with the entrepreneurs of the business. They assist at the strategic level and provide support and advice to entrepreneurs based on their expertise, experience and contact base. In short, venture capitalists add value to their equity investment to maximise the long-term return.
- Venture capitalists look at a company's market, at the strategy and above all at the management and entrepreneurial team before looking at the financial side of a prospective investment.
- Venture capital has no special need for dividend returns, and investment returns are harvested primarily in the form of capital gains at the exit, when the company is listed on a stock market or when it is sold to another investor.

Table 1. Typical VC characteristics

III.2 The importance of Venture Capital and its operating environment

From a public policy viewpoint, VC has long provided equity finance to young, innovative, high-potential, growth-oriented SMEs and businesses in the EU. These companies are vital for job creation[19], economic growth, innovation and competitiveness enhancement. Thus, VC investment activity is consistent with the EU's Lisbon Strategy objectives, as well as with many other EU policy goals, such as SME initiatives[20], the Competitiveness and Innovation Programmes[21], and the development of cross-border 'clusters' to support technology transfer[22].

[17] *VC investments are also made by private equity firms, when expanding their respective horizons in order to capture new opportunities. From the portfolio company's point of view, there is a need for different funds to invest in the different stages of the expansion. One single VC fund is often from an investment portfolio perspective unable to fund the portfolio company alone, and will have to rely on multi-stage funds. Some of the largest and most established private equity funds, particularly in the US, have historically made the most seed investments. Refer to: Dimov, D. & Murray, G. (2006); The Determinants of the Incidence and Scale of Seed Capital Investments by Venture Capital Firms.*

[18] *See page 22 in OECD (1996), Venture Capital and Innovation, available online under http://www.oecd.org/dataoecd/35/59/2102064.pdf*

[19] *Private equity and venture-backed companies employed close to 6 million people in Europe (the EU, Switzerland and Norway). Venture-backed companies accounted for close to 1 million jobs. 630,000 new jobs were created by venture-backed companies, growing employment by an average rate of 5.4% annually over the period between 2000 and 2004. This was eight times the annual growth rate of total employment in the EU 25 (0.7%) between 2000 and 2004. Source: "Employment Contribution of Private Equity and Venture Capital in Europe". EVCA. November 2005.*

[20] *http://ec.europa.eu/enterprise/sme/index_en.htm*

[21] *http://ec.europa.eu/cip/index_en.htm*

[22] *http://ec.europa.eu/enterprise/innovation/doc/com_2008_652_en.pdf*

VC investments also provide longer term risk-adjusted returns to institutional investors.

However, despite the benefit of the VC industry to the EU economy, the industry still works below its potential, because it does not benefit from the same level of integration as public financial markets. Its operating environment is a patchwork of 27 different national regimes[23]. The VC industry could make a greater contribution to the EU economy if the tax environment across the EU, in particular, took better account of the industry's specific concerns and did not differentiate between this investment class and investments in public equity. If funds were able to operate across borders, they would achieve economies of scale. In addition, specialised sectoral expertise would emerge which would increase investment amounts, diversify portfolios and improve investors' return.

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[23] *Annex VII provides an overview of 25 Member States tax regimes for VC investments.*

IV. Typical Venture Capital fund structure for cross-border investments

Prior to detailed consideration of the particular direct tax obstacles to cross-border VC investments, it might be helpful to present an example of a typical cross-border VC fund structure illustrating the different players, the flow of income, management and advisory services.

Figure 2 below presents a typical VC fund structure. The flows of capital in such a structure are described in Annex III.

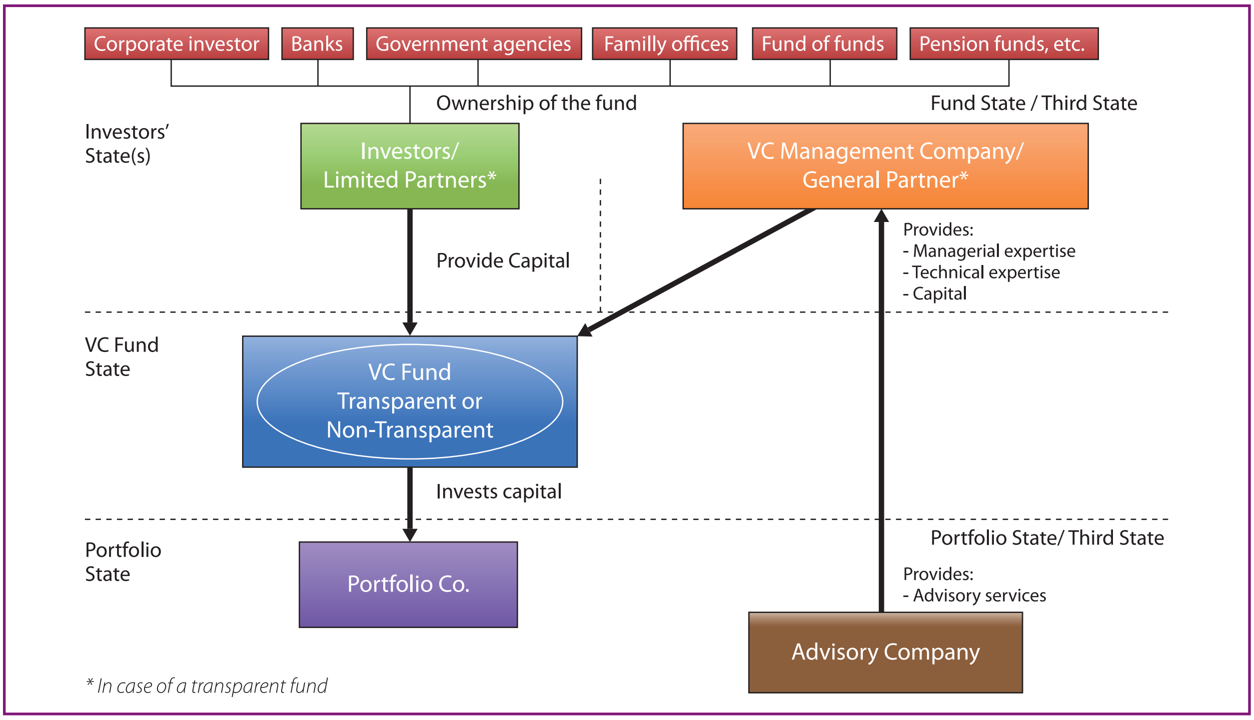

Figure No. 2. A typical VC fund structure

There are five major components to a VC fund and its investments: the investors, the VC fund, the VC Management Company (the VC Fund Manager)[24], the Portfolio company and one or several Advisory companies.

IV.1 Investors

These provide capital, which is pooled together by external managers (VC Management Companies/ VC Fund Managers) into collective investment vehicles (usually called VC funds). The investors seek external VC Management Companies with the investment objectives, track record and capabilities that best match their requirements.

In the case of a transparent fund structure (the most common type), the investors are the fund's 'Limited partners' with limited liability.

The vast majority of VC financing comes from investors with long-term investment horizons, such as institutional investors, (including corporate investors, banks, government agencies, family offices, funds of funds and pension funds) and high net-worth individuals. They invest for a period of approximately ten years on behalf of themselves and their

[24] *Both terms are used interchangeably throughout the report.*

investors (who are acting on behalf of their own policy holders, e.g. pension/ insurance policy holders) to achieve risk-adjusted returns. The usual return the investors receive takes the form of capital gains.

Figure 3 below shows the sources of VC funds financing for 2008.

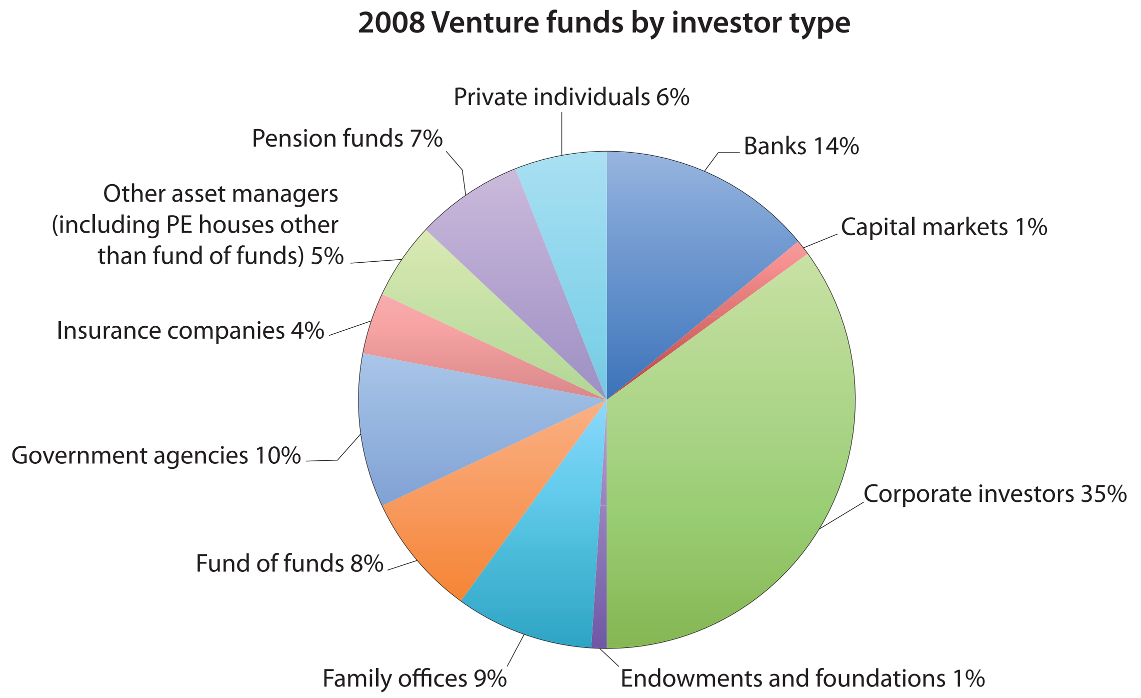

Figure No 3. Venture funds Raised by Investor Type in 2008[25]

IV.2 The Venture Capital fund

This is a collective investment vehicle into which the investors commit their capital. Typically the fund's life is ten years (with a possible extension of one to three years[26]), but this varies considerably between funds. VC funds are established under a variety of legal forms and regimes across the EU. Structures can include:

- Partnerships – with or without legal personality (usually transparent for tax purposes)
- Corporations – with legal personality (non-transparent for tax purposes)
- Other VC fund vehicles, either fiscally transparent or non-transparent, which are designed to benefit from a preferential tax regime.

In the EU, VC funds are typically structured as transparent limited partnerships. The European Investment Fund is the largest EU investor into VC funds, having committed some €5 bn to the sector through investments in funds in a variety of European jurisdictions. The majority of the Fund's investments are into limited partnerships. However, the number of non-transparent VC funds has increased slightly in recent years.

[25] *Source: PEREP Analytics. Corporate investors include corporations that produce products (manufacturing companies) or deliver non-financial services. It excludes banks, fund of funds, insurance companies, pension funds and other asset managers.*
[26] *The life time of a fund is a function of the economic environment.*

IV.3 The Portfolio Company[27]

This receives the capital. Portfolio companies are predominantly unlisted young high-potential growth companies or companies quoted on exchanges that need an active ownership that can help them to achieve growth and to secure funding for expansion. They are typically too small and generally not profitable enough to raise capital in the public markets or to secure a bank loan or complete a debt offering.

A significant part of VC capital is invested in life sciences and healthcare, technology-related areas such as new information and communication technologies, electronics and new materials industries. In recent years, the sector has also been an important driver in the financing of energy and 'green' and 'cleantech' environmental technologies.

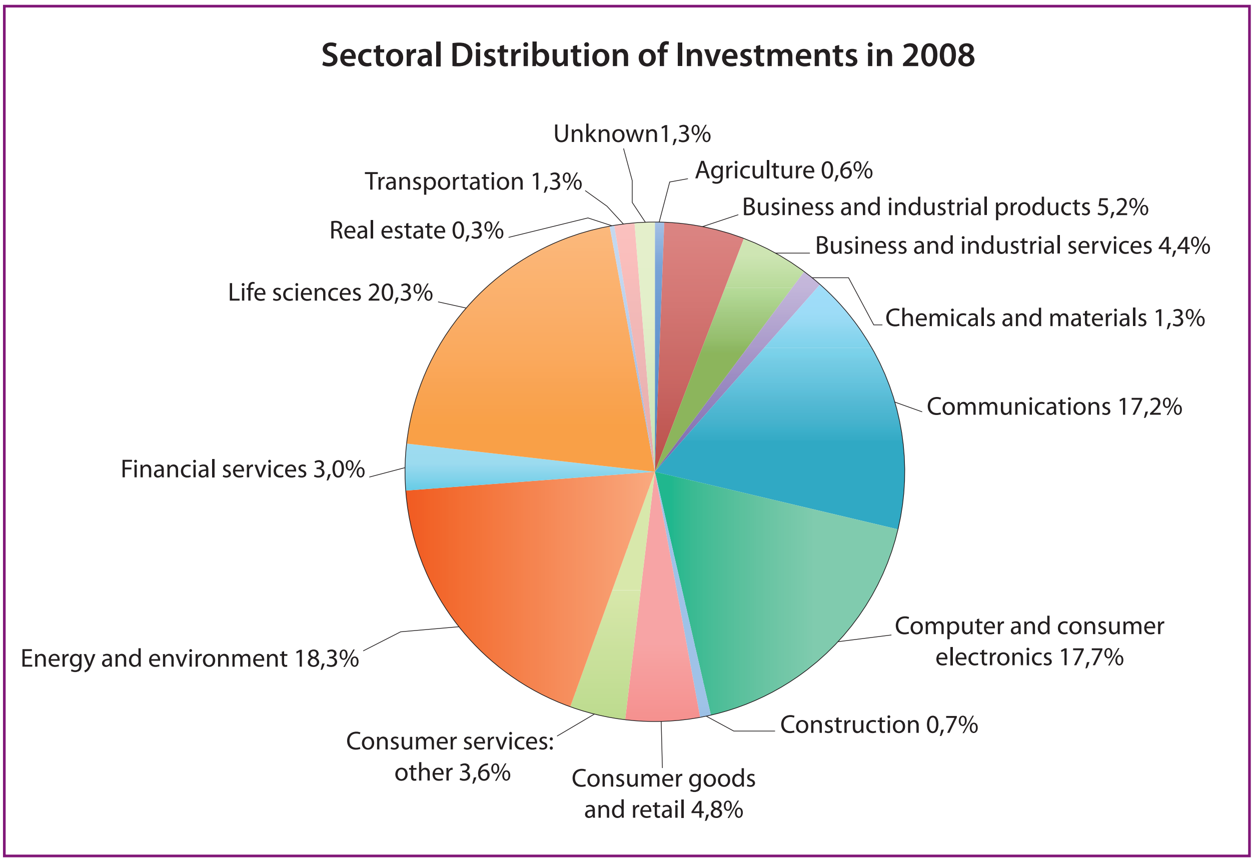

Figure No. 4. Sector distribution of VC[28] investments for 2008[29]

IV.4 The Venture Capital Management Company/ Venture Capital Fund Manager

This entity manages the VC fund. In the case of a transparent fund structure, the VC Fund Manager or an entity in the VC Fund Manager's group is usually the fund's 'General Partner' with unlimited liability, or a related entity.

The VC Fund Manager will often wish to invest in portfolio companies outside its own jurisdiction but the tax uncertainties identified in this Report generally make it unattractive to do so except for the larger funds. From a tax perspective, the aim is that the VC Fund Manager does not create a permanent establishment for the fund or its investors as that could, as explained in Section VI below, give rise to double taxation.

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[27] *The portfolio company is sometimes referred to as: the investment, target or investee company, but for the purposes of this report it will only be referred to as the portfolio company.*

[28] *Venture includes rescue/ turnaround*

[29] *Source: PEREP Analytics*

IV.5 The Advisory Company

In the case of VC cross-border investments a local presence in other EU jurisdictions may be required to enable the VC Fund Manager to find new investments in those jurisdictions and to look after investments it has acquired there. Often such a local presence will be limited to advisory activity because of concerns that if it operates as a Manager it could, as in the case of the Fund Manager, risk being treated for tax purposes as a permanent establishment of the VC fund or its investors in the state of the portfolio company.

These advisory entities analyse the local market, identify and evaluate potential investment opportunities and prepare investment proposals with appropriate input from the VC Fund Manager. These proposals are then submitted to the VC Fund Manager for a decision on whether to proceed with an investment or not.

V. Main tax issues related to cross-border VC investments

The VC Tax Expert Group on the basis of the guidelines given by previous expert groups[30] analysed in detail the main tax issues related to cross-border VC investments. These broadly consist of two sets of issues:

1) The risk of a deemed permanent establishment for the VC fund or its investors in any other jurisdiction other than that in which they are based or resident together with the resulting double taxation, and

2) The entitlement to double taxation conventions including the mutual recognition of the tax qualification of legal forms.

The experts, particularly those involved in structuring VC, considered the first issue to be the most important, but were of the opinion that solving both issues should lead to more cross-border investment and a more efficient system of management of VC funds.

The Expert Group also considered issues arising from Difference in Treatment in EU law and its observations are set out in Annex VI.

[30] *The Expert Group on Alternative Investment funds and the VC Expert Group*

VI. Permanent Establishment issues related to cross-border Venture Capital investments

VI.1 Background

One of the main concerns of the VC industry derives from the management of VC funds' cross-border investments. The decision to invest in foreign securities requires research, advisory and managerial activities which are carried out by the VC Fund Manager. Many of these activities are carried out in the state where the portfolio company is established. The tax authorities of this state may conclude that the VC fund or the investors are acting in its territory through the Manager. In particular, they may consider a Fund Manager to be a permanent establishment of the VC fund or of the investors.

A permanent establishment is a fixed place of business through which the business of an enterprise is carried on in another jurisdiction. It can take a structural form, such as a branch, or it can just be created by the activities of the enterprise in that other jurisdiction. This concept also applies to the cases where an enterprise carries on its activities in a foreign state through a person acting on its behalf, provided that that person is not an agent of independent status acting in the ordinary course of his/her business.

The concept of a permanent establishment is necessary to ensure that jurisdictions can protect their tax bases. Without this concept, a business could be carried on in a country and not be taxable there if it was not carried on as a separate business through a local entity such as a subsidiary. If a permanent establishment exists then it normally follows that the profits attributed to that establishment are subject to tax in the state where it is situated. It would normally be a matter of discussion between the taxpayer and the tax authorities to agree on the appropriate level of profits to be attributed to the permanent establishment.

Each state generally has its own domestic definition of what constitutes a permanent establishment but this is usually overridden where there is a DTC between the state of the enterprise and the state where the permanent establishment of the enterprise is situated. In such a case the definition contained in the DTC would apply. The DTC definition would usually be based on the definition contained in Article 5 of the OECD Model[31].

Some experts believe that the analysis and conclusions which follow should only be valid if the applicable DTC is based on the OECD Model, but the majority of the experts in this Group disagree with this approach.

VI.2 The role of Venture Capital Fund Managers

The VC Fund Manager or the VC Management Company provides the managerial and technical expertise required by the VC fund for investing in the portfolio companies. The VC Fund Manager usually serves a number of investors for several reasons:

1) the need to have a broad range of investors so as to spread risk and not be too dependent on any one particular source of funding; and
2) the fact that capital from several investors is required to execute the investment policy.

[31] *OECD (2008), Model Tax Convention on Income and on Capital 2008: Condensed Version – July, 2008. See Annex IV for the full text of the quoted articles and their commentaries.*

The investors' funds are usually grouped together into a VC fund of some type, in order to facilitate their management and to put them on a proper legal footing. The Manager of this VC fund will identify potential investments and put together proposals relating to these investments, including proposed terms and price. It will decide whether or not to make the investment and may establish additional conditions or terms to be satisfied.

It is also important to note that, if the VC fund invests in other states outside that where the VC Fund Manager is based, local knowledge is vital. Thus the Manager usually needs to have some form of presence in the state of the portfolio company with appropriately skilled local staff. It might set up an office in the new country the staff of which would provide it with advice. Alternatively, executives working for the Manager might travel to that particular jurisdiction for periods of time to review an investment. In some instances the Manager would buy in the resources of a third party adviser.

The VC Fund Manager receives arm's-length remuneration in the form of a fee or equivalent from the VC fund (since this is an arrangement with independent third parties, i.e. the investors in the VC fund).

VI.3 Description of the legal context: OECD definition and commentary on permanent establishments

The OECD Model[32] defines a "permanent establishment" as either

- "a fixed place of business through which the business of an enterprise is wholly or partly carried on" (Article 5, paragraph 1) or
- the presence of a person who is "acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise" (Article 5, paragraph 5).

However the latter category specifically excludes a person who is an "agent of an independent status, provided that such persons are acting in the ordinary course of their business" (Article 5, paragraph 6).

The role and the business of the VC Fund Manager are different to the roles and the business of the VC fund and its investors. Accordingly, the VC Fund Manager cannot be regarded as creating a permanent establishment within the first part of the definition; it is carrying out its own independent business of providing services to the VC fund or to the investors, rather than being a place of management, a branch or other fixed place of business of the fund or its investors in the state of the portfolio company. The situation would be different if the Fund Manager acted from a fixed place of business of its own in the latter territory.

Accordingly, the "agency" definition of permanent establishment – the second category above - is the only potentially applicable category. It is relevant to explore the definition of dependent agent and differentiate it from the concept of independent agent since the latter does not constitute a permanent establishment.

Concerning the dependent agent, paragraph 32 of the OECD commentary to Article 5 of the Model notes that the scope of Article 5, paragraph 5, is restricted because it is not considered to

[32] *See Annex IV for the full text of the quoted articles and their commentaries.*

be in the interest of international economic relations to provide that every situation involving an agent would lead to a permanent establishment for a non-resident enterprise. For this reason, only persons having and habitually exercising the authority to conclude contracts are considered to have a sufficient participation in the business activity of the enterprise concerned to constitute a permanent establishment.

Under paragraph 32.1, the concept is extended to an agent who concludes contracts binding on the non-resident even if the contracts are not actually in the name of the non-resident. The commentary states that a lack of active involvement by the non-resident may be indicative of a grant of authority to the agent to conclude contracts in the non-resident's name, such as, for example, where the non-resident routinely approves transactions which are in reality dealt with locally.

As regards the power to negotiate contracts on behalf of the non-resident enterprise, paragraph 33 states that "the basis of the commercial realities of the situation" is relevant. Thus an indicative factor would be if the agent is authorised to "negotiate all elements and details of a contract in a way binding on the enterprise... even if the contract is signed by another person". In such a case, that agent would be considered to have authority to conclude contracts on behalf of the enterprise. However, paragraph 33 also states that the mere fact that the local representative attends or participates in negotiations in relation to a contract is not sufficient to demonstrate that he/ she has exercised contractual authority although it may be a relevant fact in determining the exact functions performed.

As regards independent agents, paragraph 37 of the OECD commentary to Article 5 of the Model provides that agents would be regarded as not constituting permanent establishments of the enterprises for which they carry out their activity if they: (a) are independent of the customer, legally and economically; and, (b) act in the ordinary course of their own business when acting on behalf of the customer.

Paragraphs 38 to 38.5 of the commentary provide that an indication of independence could be if a person has general freedom to act (albeit within an agreed scope of authority), rather than being subject to detailed instructions. The provision of information to the non-resident enterprise is not indicative of dependence provided that the independent agent has general freedom to apply its special skill and knowledge.

Paragraph 38.6 of the commentary also notes that a factor indicating an independent status is the number of principals that the agent represents. While this factor is not in itself determinative, the commentary notes that independent status "is less likely" if the activities of the agent are "performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time".

VI.4 Implications for Venture Capital

As mentioned above, one of the key concerns that a VC Fund Manager has when managing a VC fund across borders, within the EU or into a Member State from outside the EU, is to ensure that its activities (or those of the adviser) do not create a permanent establishment for the VC fund itself or for the investors in the fund in any jurisdiction other than that in which the VC fund is based or in which the investors are resident. This is to prevent double taxation arising (i.e. at both the level of the deemed permanent establishment, and at the level of the investors) which would make investing in private markets uneconomic for investors.

Currently within the EU the different approaches by the tax authorities of Member States create uncertainty as to whether the activities of the VC Fund Manager, if carried out in the state of the portfolio company, would be considered to constitute a permanent establishment of the VC fund or its investors in that state. That is because it is not clear whether the VC Fund Manager or its personnel would or would not be regarded as dependent agents of the investors or of the fund placed in the jurisdiction of the portfolio company. In particular, there are some doubts as to whether the provisions of Article 5, paragraphs 5 and 6, of the OECD Model and the corresponding paragraphs of the commentaries would always be interpreted consistently and result in a satisfactory commercial outcome. There are no publicly available statements of interpretation of this Article in the context of VC which would eliminate this uncertainty. In particular, it is unclear which criteria tax authorities would follow in order to establish whether a VC Fund Manager has the authority to act for an enterprise. Typically, tax authorities take the view that it is not necessary in this regard for there to be written authority or power of attorney[33].

Many commentators argue that Fund Managers act as independent agents with respect to VC funds and investors. Rather than being subject to detailed instructions from VC funds or investors, they conduct their activities under a general freedom to act. These elements are indications of independence. The provision of information to the investors is not an indication of the VC Fund Manager's dependence provided that they have general freedom to apply their special skills and knowledge, which are the required means to conduct their activity. VC operations are characterised by the existence of the necessary skills and expertise to research the local market and identify and assist possible investments which the VC fund and the investors do not have.

As noted above, the VC Fund Manager is normally working for a significant number of investors in each VC fund even if a particular VC management group has few funds in operation at any given time. Generally a new fund will be created when its predecessor has been invested. It should be noted that these activities would continue even if one or more of a number of investors withdraw from a particular fund, or if a fund is subscribed to by fewer investors than the VC Fund Manager had hoped. In such circumstances, its activities would remain the same in relation to those investors who are in fact present in the fund, which is indicative of the activities' independence of any particular investor's participation.

Nonetheless, there is no general public acceptance that the activities of the VC Fund Manager are such as to constitute an “independent” agency. As a result, the VC industry is effectively forced to adopt remedies to ensure that no permanent establishment of the VC fund or of the investors is deemed to exist in the state of the portfolio company. For this reason, the Fund Manager in most cases limits the activities it carries out at a local level to a merely advisory role. It does so because of the tax uncertainties but this is disadvantageous from a commercial point of view and is also sub-optimal in terms of facilitating cross-border investment.

In such a case the VC Fund Manager may decide to set up an advisory company in the state of the portfolio company. The advisory company would analyse the local market, identify and evaluate potential investment opportunities and prepare investment proposals, including proposed terms and price. It would submit these proposals to the VC Fund Manager for approval and decision on whether to proceed with an investment or not. Once the investment is made by the VC fund, local expertise would also be required to act in the portfolio company as board members, to add value and to monitor its performance. Among other tasks, the adviser would recommend to the Manager how to vote at shareholder meetings and would make recommendations for an exit strategy although this would be dictated by the requirements of the Manager.

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[33] *See Annex V for experience in Italy and Finland.*

The VC Fund Manager would remunerate the advisory company with an advisory fee which would reflect the level of remuneration received by the Manager itself but would be reduced to take account of the fact that the activities being carried on would be merely advisory rather than managerial.

When cross-border VC investment is managed with the assistance of advisory companies, these companies would not be granted authority to conclude contracts and their participation in negotiations would be subject to detailed and frequent reporting to the Fund Manager which would be responsible for approval and decision on whether to proceed with an investment. This would ensure that it could not be said that the advisory companies were able to create contractual relationships in any binding form in relation to a third party. Because of the current permanent establishment uncertainties, managerial authority is instead reserved for and is exercised by the VC Fund Manager. Thus, advisory companies would generally restrict their activities to pure advice, collation of information, identifying target companies, proposing investment terms, etc.

These practices create distortions for VC funds in their cross-border activities. Removing these obstacles would allow the VC Fund Manager to simplify the processes used in making and managing investments across the EU. The Manager could operate across borders in a more efficient way if decisions could be taken at the appropriate level and if legal structures were in place that ensured that taxation would take place at the investor level only. The present structures are not only inefficient, costly to implement and keep in business and therefore from a management point of view, but also creating lower returns.

Many experts believe that the contrast between the tax treatment of a VC fund manager (where there are significant tax uncertainties) and a manager of public equity (where the permanent establishment risk described above does not arise) is unfavourable given that their roles are fundamentally similar. A manager of public equity is engaged to do, and can do, whatever is necessary, and whatever the markets dictate, to make, sell and manage the underlying portfolio without being considered to be a permanent establishment of the public equity investors. Such a manager is considered an independent agent for tax purposes although its functions are no more independent than those of VC fund managers. Both approach several institutional investors, provide services for these investors consisting of creating returns through buying and selling investments in companies and have discretionary mandates. The only real difference is that private equity requires a more hands-on approach and requires closer involvement with the business, in searching for and evaluating investments, making acquisitions, holding the investment and or making an exit. Annex II compares the roles of managers of public and private equity.

VI.5 Proposed solutions: Tax consequences in the state of the portfolio company

The optimum solution to the above taxation problems would be for the tax authorities of the state of the portfolio company to confirm that the activities of the Manager of a VC fund in regard with the VC fund and its investors could be classified as activities of an independent agent, as defined in the OECD Model and therefore as not constituting a permanent establishment of the VC fund or its investors in the country where it carries out its management functions. This could be achieved through clear statements from tax authorities that they agree with the above-mentioned treatment of VC Fund Mangers.

The key factors justifying this treatment are that the VC Fund Manager normally:

1) provides its services of identifying, making, managing and selling investments whilst acting in the ordinary course of its business. These services are provided to a VC fund vehicle into which a number of third party investors have invested. The number of investors can range from a relatively modest number, say 10, to over 100 in larger funds;

2) is paid an arm's-length fee for its services;

3) is not subject to detailed instructions or comprehensive control by the investors (the terms and investing policy of the VC fund are set out in the agreement that the investors have negotiated and accepted and that is presented in the placing memorandum); and

4) bears the risks of its business activity. If it does not manage a successful VC fund it will be very difficult for it to raise a further fund and it could be replaced if a majority of the investors so vote, just as they could vote in the case of an agent investing public equity on their behalf.

As the VC fund would generally be located in a jurisdiction which does not impose tax at the level of the fund vehicle, investors in VC funds would not, in this scenario, except in the circumstances noted in the next paragraph, be regarded as having a permanent establishment in respect of their investments. There would therefore be no double taxation (i.e. taxation of the fund profits both at the level of the deemed permanent establishment and of the investors), unless that jurisdiction imposes local withholding taxes or imposes capital gains tax on assets situated in its territory.

However, if an investor had its own permanent establishment in a jurisdiction and the investment in the fund was properly attributable to that establishment, the investor's profits arising from the investment could be taxed in that jurisdiction.

Most experts[34] believe that the solutions described here for DTCs based on the OECD Model should also be available with regard to investors and VC fund vehicles outside the EU or the OECD Model-based DTC network. Without this, the benefits to the VC industry from the certainty created would be lost in many instances as there are few funds investing across the EU which only have investors from within the EU. A significant source of funds for VC is the US and the Middle East. Without this extension, there would be no operational savings for the Manager as it would still have to keep the advisory, etc structures and methods of operating to protect those investors from outside the EU/DTC countries. However, EU Member States should be able to continue to apply their existing anti-avoidance or evasion rules where these comply with the EU Treaty freedoms and non-discrimination rules.

[34] *Some experts of this Expert Group believe that the independent agent treatment should apply only among EU Member States with regard to investors and VC fund vehicles which are resident or established within the EU and that in other cases the provisions of DTCs, if any, should apply.*

It is not intended that the treatment proposed above would reduce the ability of the State of the portfolio company to subject investors to tax; it simply concerns how to prevent the activities of a Fund Manager from being categorised as a permanent establishment. The state of the portfolio company should, in fact, as a result of this proposal become a more attractive location for VC investors.

The various parties would in this scenario be subject to tax as follows:

a) VC Fund Manager

The VC Fund Manager would be taxed on an arm's-length basis in each jurisdiction in which it has a presence on the profits that it earns in respect of services that are performed in each such jurisdiction.

b) VC fund vehicle

The taxation rules in the state of the portfolio company would continue to apply to the VC fund vehicle.

If the fund vehicle is transparent for tax purposes, then the rules of the state of the portfolio company would apply to determine whether any activities of the fund themselves create a permanent establishment in its jurisdiction. It could, for example, be viewed as carrying on a trading activity in Germany and in the UK because of these countries' concepts of trading. However, the VC Fund Manager would not, provided that it is acting in an independent capacity having regard to the key factors mentioned above, constitute a permanent establishment of the fund or of the fund's investors.

If the VC fund is a non-transparent vehicle, then the state of the portfolio company would apply the DTC between itself and the jurisdiction of the fund vehicle (if one exists, and if the fund meets the conditions provided by the relevant article of this DTC to be considered a resident) in order to determine whether to withhold tax on dividends, interest and capital gains flowing to the fund vehicle.

c) Investors

If the VC fund vehicle is transparent, then the state of the portfolio company would apply the DTC between itself and the country of residence of the investor in order to determine what rate of withholding tax to apply to payments made to that investor.

For example, if the investor is resident in a tax haven then the full withholding tax rates of the state of the portfolio company would most likely apply, whereas if the investor is resident in a DTC jurisdiction or within the EU the appropriate reduced rates under the DTC/EU law would apply.

If the VC fund vehicle is non-transparent and if the conditions for the application of the DTC are met, the DTC between the state of residence of the investor and the state of the VC fund vehicle would apply.

d) General principles

In implementing these solutions the tax authorities must abide by Community law and, in particular, with the EU Treaty freedoms[35].

[35] *See Annex VI for an overview of the existing case law of the European Court of Justice on the different treatment of residents and non-residents in various cross-border situations.*

VI.6 Summary

Provided that the VC Fund Manager satisfies the criteria explained above to qualify as independent agent, the state of the portfolio company should agree that the Fund Manager's activities do not constitute a permanent establishment of the VC fund vehicle or of the investors in its jurisdiction. This would allow the Fund Manager to act more effectively, would increase the attractiveness of the asset class and would provide more funds for investment into the states of the portfolio companies that would be less costly for investors.

The state of the portfolio company would still retain full taxing rights over any income/gains arising to the fund in its jurisdiction. It would apply its domestic legislation and any applicable DTCs between itself and the various investors in the fund, or the fund vehicle, to determine what if any withholding tax to deduct or taxes to levy. If the returns to an investor were linked to a permanent establishment that the investor itself had in the state of the portfolio company, then nothing in this analysis should prevent that state from taxing that investor's permanent establishment on that return.

The Manager should also receive and be subject to tax in the state of the portfolio company in which it has a presence on an arm's-length level of fees remuneration for the services being provided there. That is to say: the investors in the VC fund will have agreed (at arm's length from the VC Fund Manager) an overall fee income for the Manager and that fee income should be taxable according to the places where the management of the fund is carried on. That fee income will, therefore, have to be apportioned between the different Member States where the Manager carries on its business or where the Manager and other related entities share the management of the fund.

VII. Entitlement under Double Taxation Conventions

VII.1 Double Taxation or Non-Taxation

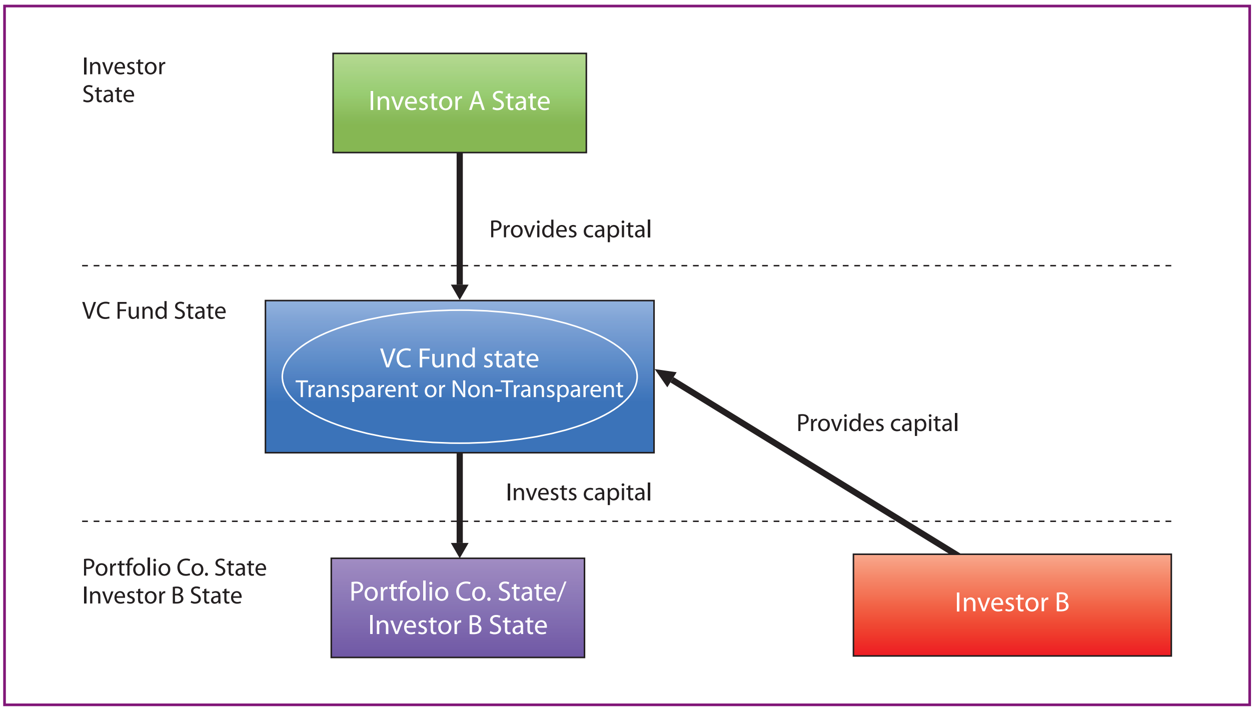
VII.1.1 Different classification of VC funds as transparent or non-transparent

In circumstances where there are three different states involved in a VC investment i.e. the state of establishment of the VC fund vehicle (the "VC fund"), the state of residence of investors in that VC fund and the state of the portfolio companies in which that VC fund invests, double taxation may arise. This is because different states may classify the VC fund in different ways (as transparent/non-transparent, resident/non-resident, subject to tax/not subject to tax and trading/non-trading) and the application of bilateral double taxation conventions by the tax authorities in the respective states may not prevent this.

Take the case where one state treats the fund as a non-transparent entity while the two other states treat it as transparent. In the case of the first state, taxable income and gains will be attributed to the VC fund and the VC fund will be deemed to be entitled to the benefit of relevant DTCs. However, the other states will attribute taxable income to the investors rather than to the VC fund and the fund will be deemed not to be entitled to the DTC benefits.

Different classifications may also result in double non-taxation, where income and gains are not attributed to either party. There may not always be bilateral and domestic switch-over-clauses or anti-tax-avoidance rules in place to avoid this.

Example:



Suppose the following:

- The domestic tax laws of all three states involved in the above example provide that capital gains derived from the sale of shares in corporate entities are subject to tax;

- The DTC between the state of residence of the portfolio company and the state of residence of Investor A prohibits the imposition of tax on capital gains by the state of residence of the portfolio company and allows the taxation of capital gains in the state of residence of the investors. The DTC between the state of residence of the portfolio company and the state of residence of the VC fund has an identical provision, prohibiting taxation in the state of residence of the portfolio company but allowing taxation in the state of residence of the VC fund;

- The state of residence of Investor A treats the VC fund as fully transparent and, thus, not entitled to the benefit of the DTC between the Investor A state and the VC fund state;

- The state of residence of the VC fund treats the VC fund as non-transparent and therefore subject to the provisions of all DTCs concluded by that state.

In such a scenario, capital gains tax may be applied:

- To the VC fund in accordance with the DTC between the state of residence of the portfolio company and the state of the VC fund, because the VC fund is considered a resident of the state in which it is located and subject to the provisions of that DTC[36].

- To Investor A in his state of residence according to the DTC between the state of residence of the portfolio company and the state of residence of Investor A (because the tax authorities of his state of residence look through the VC fund).

Furthermore, when the VC fund distributes the proceeds from the sale of the portfolio company, the state of establishment of the VC fund would recognise this distribution as a dividend from which it could withhold tax on a gross basis. Because Investor A's state of residence treats the VC fund as transparent, it might not recognise the distribution as a taxable event and might therefore not grant any tax credit or tax exemption in respect of the tax withheld on the dividend by the state of establishment of the VC fund. This may result in double taxation.

Double taxation may also arise in the above example with regard to Investor B who is resident in the same state as the portfolio company:

- if that state treats the VC fund as fully transparent and, thus, not entitled to benefit from the DTC with the state of the fund, the tax authorities of that state will impose tax on the capital gain (insofar as attributable to Investor B) under its domestic law as if this was a purely domestic situation, i.e. without granting any DTC relief;

- if the VC fund's state of establishment treats the VC fund as non-transparent and hence subject to the DTC, its tax authorities will impose tax on the capital gain at the VC fund level, which it regards as being in line with the DTC with the portfolio company's state of residence. The state of establishment of the VC fund may also withhold tax on distributions to Investor B, for which Investor B's state of residence may not grant a tax credit since it does not treat the distribution as a tax event because it considers the VC fund as fully transparent.

Together with the cases of double taxation illustrated above, there may also be cases of double non-taxation which are problematic for tax authorities. If the state of establishment of the VC fund treats the fund as transparent while the state of residence of the investor regards the VC fund as non-transparent, the latter could assume that the state of the establishment of the VC fund is taxing the fund and consequently exempt the investor from tax on capital gains or

[36] *Participation exemptions might but do not necessarily always apply.*

income distributed. The capital gains or income might not, as a result, be taxed either in the state of establishment of the VC fund or in the state of residence of the Investor.

VII.1.2 Classification of a transparent Venture Capital fund as constituting a permanent establishment

In cases where all concerned states treat the VC fund as transparent, it may be that some states classify the VC fund as constituting a permanent establishment for the investors. In Germany, for example, the VC fund Partnership may be considered to be trading which leads to the conclusion that a permanent establishment exists for German tax purposes. Such states may allocate the VC fund's income and gains derived from portfolio companies to such a permanent establishment. At the same time, other states might not recognise a permanent establishment or entitlement of the VC fund to the benefit of DTCs and thus allocate the VC fund's income and gains to the investors without being willing to grant tax credits for the taxes imposed by the VC fund's state of establishment.

In such a case double taxation may arise due to differences in the concept of tax transparency. For one state (in the example: the state of residence of the investor) this may mean that the VC fund should be treated as if it did not exist so that investors are taxed as if they had made the investment in the portfolio company directly. At the same time, other states (in the example: the VC fund's state of establishment) will treat the VC fund as a permanent establishment of the investors in the state where the VC fund is established, and tax the non-resident investors in relation to their respective part of the profits of the permanent establishment. The state of residence of the investor may not be willing to grant a credit for the tax imposed by the state of establishment of the VC fund.

VII.1.3 Mutual agreement procedures between the tax authorities of the states concerned - interposing of holding companies

Theoretically, double taxation resulting from the denial of DTC benefits due to the different classification of VC funds by different states could be avoided by way of a mutual agreement procedure between the tax authorities of the states concerned.

In practice, however, tax authorities are not obliged either to launch a mutual agreement procedure, in response to a VC fund request, or to reach mutual agreement when such a procedure has been launched. Even in the case where mutual agreement is reached, it would generally only be binding on the two contracting states concerned and only in relation to a specific case.

Therefore mutual agreement procedures are considered very burdensome and as such not usable in practice for VC funds. Thus, in order for the VC Fund Manager to avoid double taxation and to obtain legal certainty, it has to interpose in the VC fund structure legal entities (such as holding companies) the classification of which is certain. However, this structuring is not considered a viable solution as it represents a significant and un-commercial additional cost.

VII.1.4 Proposed solution: mutual recognition of the classification of legal forms for tax purposes

The best way to eliminate double taxation would be general acceptance of the tax treatment of a VC fund in its state of establishment (i.e. its treatment for tax purposes as transparent/non-transparent, resident/non-resident, subject to tax/not subject to tax, trading/non-trading) by other states involved. Thus the states where the investors and portfolio companies reside would abide by the rules of the state of the VC fund.

Such recognition should not only relate to the entitlement to DTC benefits but should also be implemented in domestic tax laws. Thus the general rules of the domestic tax laws of EU Member States other than the State of establishment of the VC fund would not be decisive for the classification of the VC fund. Compatible tax results would thus be achieved in all EU Member States involved in the VC fund's transactions.

At present, the principle of mutual recognition is not applied by EU Member States and the DTCs between them do not contain any clear provisions in this regard. It is acknowledged that this proposal could, therefore, be contentious.

The concept of mutual recognition should be introduced by an EU Directive, in order to ensure a common implementation into the domestic law of all Member States.

VII.1.5 Alternative solution: agreement on a list for the mutual classification of certain legal forms

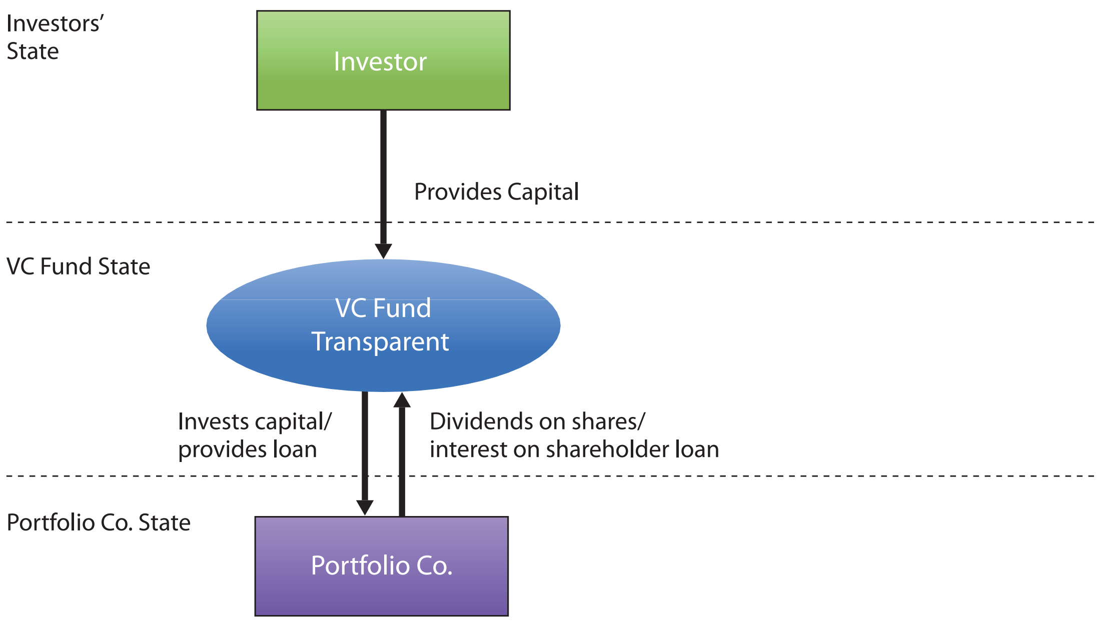
If mutual recognition of the tax classification of legal forms, as recommended in section VII.1.4, is not achievable, EU Member States could agree on a common classification of certain specific legal forms often used for VC funds as either non-transparent or fully transparent. The Member States could issue a list detailing these different legal forms of taxable or fully transparent VC funds (on the lines of the list of companies in the Annex to the EU-Parent/Subsidiary Directive[37] or of the list of foreign entity classifications used for UK tax purposes[38]).

The list should be implemented through an EU-wide legal arrangement or by general agreement or on a bilateral basis between any number of Member States.

VII.2 Withholding Tax Refund Claims

VII.2.1 Investors relinquish entitlement to claim withholding tax relief

Even if all states involved classify a VC fund as fully tax transparent, difficulties can arise in practice for investors in filing applications for withholding tax relief in the states of residence of portfolio companies.



All states involved classify the VC fund as fully transparent

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[37] *Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States. OJ L 225, 20.8.1990, p. 6*

[38] *http://www.hmrc.gov.uk/bulletins/tb83.htm#3*

If all states involved classify the VC fund as fully transparent, each single investor needs to apply for exemption from, or reduction in, or refunds of, withholding taxes on dividends or interest. It must do so either on the basis of the DTC concluded between its state of residence and the state of residence of the portfolio company or, if more beneficial, in accordance with the domestic law of the state of the VC fund or of the portfolio company, as the case may be.

In practice, such applications are often not filed, due to the administrative workload which their preparation and filing involves[39].

For example, the VC fund may invest its liquidity short-term, perhaps on a monthly basis, in different banks (depending on which, at the relevant time, offers the best conditions). There may then be monthly withholding taxes that are miniscule if each interest payment is considered in isolation and the respective bank may issue a separate certificate in respect of each individual interest payment. In many cases it may, realistically, be impossible for a single investor to separate out his share in the different withholding tax amounts and to assemble the required documentation in order to apply for withholding tax relief in the respective state.

Another example of the difficulties encountered is if the interest paid by a bank to a transparent VC fund in the same state is attributable to non-resident limited partners of the VC fund. The domestic tax law may prescribe the withholding of tax on interest paid to a resident taxpayer but not to a non-resident. The bank will typically withhold tax on interest paid to the VC fund. This is because the bank is not informed about the identity and residence of the limited partners in the VC fund. In this case the refund claim (to be filed by the non-resident limited partners) would not be based on a DTC but exclusively on the domestic law of the state of residence of the bank, which is very complicated for the individual non-resident limited partners to deal with.

VII.2.2 Solution: Entitlement of transparent VC funds to claim withholding tax relief on behalf of their investors

EU Member States should allow VC funds to apply for exemptions from, reductions of, or refunds of, withholding taxes on behalf of their investors. The applications would be made in accordance with the DTC which the state of the portfolio company has concluded with the state of residence of the respective investor, or, if more beneficial, in accordance with the domestic law of the state of the portfolio company. The VC fund's entitlements under the respective DTC or, as the case may be, domestic tax legislation, should be determined on the basis of the investors' commitments to the VC fund. The percentages of participation of a single investor in a particular item of the VC fund's income may vary in accordance with the profit allocation provisions of the VC fund's constitutive documents. The entitlement of the VC fund to apply for tax relief under DTCs or under domestic tax laws on behalf of the investors, as suggested here, is a separate matter to the entitlement of the VC fund to DTC benefits in its own right as a consequence of being recognised as non-transparent (see above in sections VII.1.4 and VII.1.5).

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[39] *See http://ec.europa.eu/taxation_customs/taxation/personal_tax/taxation_securities/index_en.htm for information on EU work on the simplification of withholding tax relief procedures*

VIII. Conclusions

The need for a dynamic VC industry within the EU and its important role in strengthening European economies are widely recognised. Nevertheless, there are still various obstacles to cross-border VC investments in the EU and the majority of them are considered to be in the area of taxation.

In its attempts to tackle the existing obstacles, the European Commission has taken various initiatives. With regard to taxation, it created the VC Tax Expert Group in May 2007, consisting of representatives of both the public and private sectors. In accordance with its mandate, the Expert Group identified cases of double taxation and other direct tax related obstacles encountered by cross-border VC investments and discussed a number of possible solutions, which are summarised below. Some experts of the Expert Group believe that the conclusions should be limited to VC funds and investors resident in EU Member States but the majority of the experts represented in the Group are opposed to such a limitation.

1) The optimum solution to the taxation problems identified would be for the tax authorities of the state of the portfolio company to confirm that the activities of the Manager of a VC fund in connection with the fund and its investors could be classified as activities of an independent agent, as defined in the OECD Model. The activities would not, in those circumstances, constitute a permanent establishment of the VC fund or its investors in the country where the Manager carries out its management functions. This confirmation could be achieved by clear statements from tax authorities that they agree with this treatment of VC Fund Managers.

2) However, if an investor had a permanent establishment in a jurisdiction other than its state of residence and the investment in the fund was properly attributable to that establishment, the profits arising to the investor could be taxed in that other jurisdiction.

3) The state of the portfolio company would still retain full taxing rights over any income/gains arising to the VC fund in its jurisdiction. If the VC fund is non-transparent for tax purposes, then the state of the portfolio company would apply the relevant DTC, if any, with the state of the VC fund. If the fund meets the conditions provided by the relevant article of the DTC to be considered a resident, the state of the portfolio company would apply this DTC in order to determine whether to apply tax on dividends, interest and capital gains flowing to the fund. If the VC fund is transparent, the state of the portfolio company would apply the DTCs between itself and the countries of residence of the investors in the VC fund.

4) The VC Fund Manager should be taxed on an arm's-length basis on the management fees that it earns in respect of services that it performs in each jurisdiction in which it has a presence.

5) Those Member States agreeing with the conclusions of this report should arrive at guidelines or a legally binding agreement concerning mutual recognition of the classification for tax purposes of different legal forms of VC funds. This would ensure that all Member States would recognise the tax classification and tax treatment applied by the home country of a VC fund (i.e. as transparent or non-transparent; subject to tax or not subject to tax; trading or non-trading). Where a VC fund is treated as non-transparent in its home country, Member States would, as a result of this mutual recognition, agree that the fund is resident in that country for the purposes of the application of DTCs if it meets the conditions provided by the relevant articles of these conventions to be considered a resident. This would help to increase legal certainty and reduce the risk of economic and/or juridical double taxation

6) Another solution would be that EU Member States would agree on a list for the classification as either transparent or non-transparent of certain specific legal forms which are often used for VC funds.

The above solutions proposed by the VC Tax Expert Group may provide a “toolbox” for consideration by EU Member States. The Group believes that tax systems must take account of the particular cross-border operating environment of VC funds in order to encourage such funds to continue providing early-stage equity financing to the EU's most innovative high-growth small and medium-sized enterprises. This would allow VC investment to contribute to strengthening European economies in the current economic turbulence and downturn.

Annexes

ANNEX I

GLOSSARY OF TERMS

Advisory Company

In the context of venture capital, an entity providing local advisory, and possibly investment management, expertise to the VC Fund Manager and the investors.

Agency Permanent Establishment

A permanent establishment (see below) which is constituted by an agent (in general a dependent agent – see below), as distinct from a permanent establishment which is constituted by a fixed place of business.

Alternative investment fund

Investments covering amongst others private equity and venture capital, hedge funds, real estate, infrastructure, commodities, or collateralised debt obligations (CDOs).

Arm's-length remuneration

A payment for services that would be charged by independent parties under comparable circumstances.

Asset class

A category of investment which is defined by the main characteristics of risk, liquidity and return.

Business angels

A knowledgeable private individual, usually with business experience, who directly invests part of his or her personal assets in new and growing unquoted businesses. Besides capital, business angels provide business management experience for the entrepreneur.

Capital gain

A gain realized by a taxpayer from the disposal of capital assets or investment.

Capital market

A market where debt and equity securities are traded. Both the primary market for new issues and the secondary market for existing securities are part of the capital market.

Carried interest

The profits generated in a successful VC fund that are received by the carried interest holders and which typically amount to 20% of the net profit of the fund provided a hurdle rate of return, usually 8%, has been earned by the investors.

Commentary to the OECD MTC

In an international taxation context, the term generally refers to the Commentaries published by the OECD together with the OECD MTC (see below). The Commentaries are intended to serve as a means of illustrating or interpreting the provisions of the OECD MTC.

Deal flow

The number of investment opportunities available to a private equity house.

Dependent agent

A permanent establishment (see below) which is constituted by an agent who is not an independent agent as opposed to a permanent establishment which is constituted by a fixed place of business.

Double taxation (economic and juridical)

Double taxation can be divided into economic double taxation or juridical double taxation. Economic double taxation refers to the imposition of comparable taxes by two (or more) tax jurisdictions on different taxpayers in respect of the same taxable income. Juridical double taxation could be described as the imposition of comparable taxes by two (or more) tax jurisdictions on the same taxpayer in respect of the same taxable income or capital.

Double Taxation Convention (DTC)

An agreement between two (or more) states primarily related to the avoidance of double taxation and the prevention of fiscal evasion. There are various types of double taxation conventions of which the most common are the conventions for the avoidance of double taxation of income and capital.

Early-stage financing

Financing to companies before they initiate commercial manufacturing and sales, and before they generate a profit. Includes seed and start-up financing.

Equity

The share capital of a company. Typical features of equity capital include an entitlement to profits, possibly also a share of the proceeds upon liquidation and subordination to creditors.

Equity financing

The acquisition of a holding in a company by issuing shares of common or preferred stock.

Exit

Disposal of investments by a VC investor. The most common exits are (1) trade sale to another company; (2) public offering (including an initial public offering – IPO) on a stock market; (3) sale to another investor; (4) repayment of the investment (when part of the investment agreement); or (5) the full write-off of the investment.

Fund of funds

A fund that takes equity positions in other funds.

Fundraising

The process to raise money to create an investment fund. These funds are raised from private, corporate or institutional investors, who make commitments to the fund which will be invested by the partnership.

General partner (GP)

A partner in a limited partnership, e.g. in a venture capital limited partnership, who has unlimited personal liability for the debts and obligations of the limited partnership and the right to participate in its management.

Independent agent

An independent agent is so described if the agent is independent both legally and economically from the entity for which the agent operates. As such the agent does *not* give rise to a permanent establishment (see below) for that entity.

Initial Public Offering (IPO)

The sale or distribution of a company's shares to the public for the first time. An IPO is one of the ways in which a venture capital fund can exit an investment.

Institutional investors

Refers mainly to insurance companies, pension funds, banks and investment companies collecting savings and supplying funds to the markets, but also to other types of institutional wealth (e.g. endowment funds, foundations, etc). Usually these have substantial assets and are experienced investors.

Investment fund

Generic term to refer to a wide range of vehicles used for investment purposes. Typically such funds are used to pool finance from different sources, thereby creating leverage and spreading risk.

Limited Partner (LP)

An investor in a limited partnership is someone who (in contrast to the general partner) is liable for partnership obligations only to the extent of his or her committed capital. Limited partners are usually restricted from taking an active part in the management of the partnership's business.

Limited Partnership

A legal structure that is used by most venture capital funds. A partnership is usually formed for a fixed period of time between the investors in a venture capital fund (limited partners) and the general partner making the investments in the underlying portfolio companies. Details concerning management policy and profit-sharing are negotiated by the limited partners and set out in a partnership agreement. There may be a separate entity which actually carries on the transparent role instead of the general partner (see Management Company).

Lisbon Strategy

Launched by the European Council in Lisbon (March 2000). Its objectives include making the European Union the most dynamic and competitive economy in the world and achieving full employment by 2010.

Management Company

An entity, separate from the General Partner, who carries on the management of a limited partnership. A separate Management Company may be used because the General Partner has unlimited liability for the liabilities of the limited partnership and/or because the management entity requires authorisation by regulatory authorities so it is easier to have one such entity for a number of funds.

Mutual Agreement Procedure

Administration procedures provided for in double taxation conventions for resolving difficulties (arising out of their application) between the signatory states of the conventions.

Mutual recognition (in the context of this report)

The tax classification (transparent/non-transparent, resident/non-resident, subject to tax/not subject to tax, trading/non-trading) in the state of establishment of a Venture Capital Fund is recognised by the states where the investors and the portfolio companies reside.

Non-resident

A non-resident is defined as one who does not satisfy the criteria for residence (see below) in a particular country.

Non-transparent

The term describes an organizational form or entity which is treated as a separate unit, distinct from its members, owners or other associates, for tax purposes. In this context the expression opaque is also used.

OECD Model Tax Convention on Income and Capital (OECD Model)

The OECD Model Tax Convention on Income and Capital is intended to provide Member countries with a standard text to be used in concluding double taxation conventions with other countries.

Opaque

See non-transparent.

Participation exemption

Tax relief accorded to a company in respect of distributions it receives from, or (in some cases) capital gains it realizes on certain shareholdings in another company, typically where the shareholding exceeds a certain minimum percentage or acquisition cost.

Partnership

In general, a partnership may be said to consist of an association of two or more persons (individuals, or other legal persons) established for the purpose of making a profit, the profit (or loss) being shared among the partners.

Pension fund

A managed fund of money required to meet pension liabilities and administer pension benefits.

Permanent establishment

A permanent establishment is, according to the OECD Model definition, a fixed place of business through which the business of an enterprise is wholly or partly carried on in another jurisdiction. It can take a structural form, such as a branch, or it can just be created by the activities of the enterprise in that other jurisdiction. This concept also applies to the cases where an enterprise carries on its activities in a foreign state through a person acting on its behalf, provided that that person is not an agent of independent status acting in the ordinary course of his/her business.

Placing memorandum

Brochure presented by a general partner in the process of raising funds. This document is issued to potential investors (limited partners), and usually contains (amongst other information) a presentation of the market for investments, the management team's track record, the terms and conditions and investment strategies.

Portfolio company

In the context of Venture capital, the company or entity into which a venture capital fund invests directly.

Private equity

Investment by private investors taking an equity stake in companies not listed on a stock market. Venture capital is strictly speaking a subset of private equity, which also includes replacement capital and buyouts.

Public equity

Equity invested in a public company. A public company is a company that has issued securities through an offering, and which are now traded on the open market.

Resident

Refers to a person who satisfies the requirements of any particular jurisdiction to be resident in that country for tax purposes.

Risk capital

Equity financing to a company during its early growth stages (start-up and development) which might include various types of financing, such as: (1) informal investment by business angels; (2) venture capital; (3) stock markets specialising in SMEs and high growth companies.

Seed capital

Financing provided to study, assess and develop an initial concept. The seed phase precedes the start-up phase. The two phases together are called the early stage.

SME – Small and medium-sized enterprise

Under European rules an SME should have less than 250 employees, an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 m.

Start-up capital

Provided to companies for product development and initial marketing. Firms may be in the process of being set up or may exist but have not sold their product or service commercially.

State aid

State aid means action by a (national, regional or local) public authority, using public resources, to favour certain undertakings or the production of certain goods. A business that benefits from such aid thus enjoys an advantage over its competitors. Control of state aids thus reflects the need to maintain free and fair competition within the European Union

Tax transparency

Tax (fiscal) transparency is a term used to describe the situation where an organisational form or entity is not treated as a separate unit, distinct from its members, owners or other associates, for tax purposes. Where this is the case the entity may be referred to as fiscally transparent. Income of a fiscally transparent entity is generally treated, for tax purposes, as accruing to the members, etc. as it arises, i.e. irrespective of an actual distribution. However, the concept varies from country to country. A non-fiscally transparent entity may be referred to as "opaque".

Venture capital (VC)

Investment in unquoted companies by venture capital firms who, acting as principals, manage individual, institutional or in-house money. In Europe, the main financing stages included in venture capital are: early-stage, covering seed and start-up, and expansion. Strictly defined, venture capital is a subset of private equity. Venture capital is thus professional equity co-invested with the entrepreneur to fund an early-stage (seed and start-up) or expansion venture. Offsetting the high risk the investor takes is the expectation of higher than average return on the investment.

Venture Capital Management Company/ VC Fund Manager

Manages the funds of the investors and makes VC investments with those funds.

Venture Capital fund

An investment fund that manages money from professional investors seeking private equity and securities (such as quasi-equity) in small and medium-sized firms (portfolio companies) with strong growth potential. The Venture Capital fund is usually an unincorporated arrangement such as a limited partnership. A management company that usually has several funds under its control may be a limited company, a partnership (or other entity having the characteristics of a partnership under its domestic laws) or a company quoted on a stock market.

Withholding tax

A tax on income imposed at source, i.e. a third party is charged with the task of deducting the tax from certain kinds of payments and remitting that amount to the government. Relief from withholding tax may be available through domestic law provisions, double tax conventions, and through an international treaty or similar instruments (e.g. within the EU, by way of the Parent-Subsidiary Directive).

ANNEX II

COMPARISON OF ROLES OF MANAGERS OF PUBLIC EQUITY AND PRIVATE EQUITY AND PRIVATE EQUITY FUNDS

1. Investors in public equity/ private equity

For the purposes of this paper, an 'Investor' means a pension fund for a large corporation, a foundation, a state-owned pension fund, an insurance company, or any other institution investing in a 'fund', which then invests in underlying assets.

The Investor first defines the aim of its asset management activities. The simplest way to express this is that the Investor seeks to achieve maximum returns for a minimum of risk in the light of its (long-term) mandate.

In line with this objective, the Investor constructs a 'standard' portfolio, consisting of assets such as equities, bonds and real estate (based on the long-term view). This standard portfolio will, within each of the selected asset classes, contain sub-areas that can be based on, for example, different indexes, geographies, industries, market caps etc. The standard portfolio will, for example, include determinations as to how much will be invested in public and private equity. The standard portfolio can thereafter be adjusted based on the mid-term view so as to achieve what can be referred to as a strategic portfolio.

Thereafter the Investor seeks to find managers to manage the portfolio (hereafter the external managers), unless it can manage such investments itself (which is not often the case).

The external managers will be given a mandate to invest certain amounts with a certain focus. The process of selecting external managers is a process which aims to find the manager best suited to execute the investment policy for the Investor on the best possible terms. Normally, such managers serve a number of institutional investors (often more than ten) due to economies of scale, or the mere fact that capital from several investors is required to execute the investment policy. The managers' offer can be in the form of a discretionary account or investment in a (private equity) fund, or a number of other structures or entities.

The terms under which the managers are appointed will depend on the nature of the services that they are to perform, and each market has its particular features. As an example, the term for a private equity manager is normally 10 years, whereas the term of assignments for a manager of public equity is considerably shorter. The primary reason for this is that private equity investment is not liquid and cannot be realized within a short timeframe, which is normally the case for marketable securities.

2. Investment process

The following is a comparison of the roles of managers managing investments in public equity and those managing investments in private equity.

Managers of public equity have public information at their disposal. They analyze this public information and make their decisions as to which companies/shares to invest in, and execute the acquisition. This can be done from virtually anywhere.

Managers of private equity face a different situation. They have to more actively seek out potential investment opportunities, and owing to the nature of private equity investments in privately held companies through processes such as due diligence, often have more and different information at their disposal when analyzing a company. In addition, they face the fact that when they have decided to make the investment, there is no liquid market where they can easily dispose of the investment, and therefore the holding period for the investment could be lengthy. In addition, private equity managers can expect to exercise a greater degree of influence on their underlying investments (investee companies) than the managers of public equity, owing to the mandates allocated to them.

3. Decision-making process

Managers of both public equity and private equity are expected to deliver returns to their Investors within their investment focus, and the boundaries provided by their Investors. Within such boundaries they have discretionary decision-making power.

4. Alignment of interest

A general principle applicable to virtually all kinds of business is that alignment of interests is important for success. Rewards should follow from the achievement of goals. However, as stated above, private equity managers invest their monies on a long-term basis offering not only a selection of investments, but also a value creation process during the holding period. If the managers decide to renounce their management roles, there is normally no one to take care of the investments and no market where they can be sold.

5. Comparison

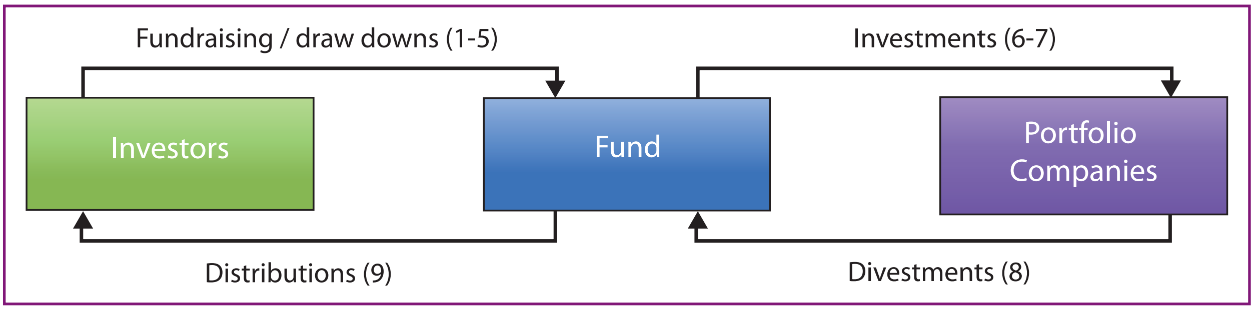
As is apparent from the above, there are a number of similarities between managers of public equity and private equity:

- Both approach several institutional investors;
- Both perform a service consisting of creating returns through buying and selling investments in companies for their Investors;
- Both have discretionary mandates;
- The only real difference is that private equity requires a more hands-on approach and greater proximity to the business, in order to generate deal-flow, evaluate investments, make acquisitions and plan exit strategies.

ANNEX III

FLOWS OF CAPITAL IN A VENTURE CAPITAL INVESTMENT

Figure 1 describes the stages in the typical flow of capital for a VC investment.



1. Venture capital firms (VC (fund) management companies) set up Venture Capital funds to pool money from sophisticated investors in order to invest in privately held companies within a 'portfolio'.

2. Before investors commit any money to a fund, a detailed Limited Partnership Agreement (LPA) (or equivalent documentation) is negotiated between the managers of the fund and the investors. The LPA defines the legal framework, the fund's focus and the terms and conditions for capital committed into the fund.

3. The investors (Limited Partners or equivalent passive participants if a limited partnership is not used) commit a certain amount to the fund. Often there is a minimum amount that limits the investors to professional and institutional investors.

4. The VC fund usually has a contractually limited life of ten years. Often there is a provision for an extension of the fund life for two to three years.

5. Upon identifying investment opportunities, the VC Fund Managers make capital calls, i.e. they draw down from the pool of committed capital. The main part of the capital is typically drawn down during the first five years of the fund's life (called fund investment period).

6. Venture Capital funds invest primarily in unquoted companies. Investments are made in rounds and are typically syndicated: one venture capital firm (lead investor) puts together a syndicate and leads an investment round. The syndicate for a VC investment round usually comprises some or all of the existing investors from previous rounds and some new ones. The total investment amount is not usually invested at once. Instead it is split into tranches and is conditional on various technical and/or commercial targets (milestones) being met by the portfolio company. This process attracts amounts to be invested in the company from other sources than VC funds.

7. The typical period during which the venture capital-backed company is held in the VC funds portfolio (holding period) is between 3 and 7 years. The company's management is responsible for the day-to-day operations. Venture Capital Fund Managers are generally far more actively involved in the activities of their portfolio companies than the owners of publicly quoted companies.

8. Fund Managers try to exit from the companies within the portfolio during the fund's life. Divestments of portfolio companies are typically made through an IPO or a trade sale.

9. Upon realisation, the proceeds (net of agreed management fees and carried interest) are distributed back to investors.

10. During the fund's life, venture capital firms operate clear disclosure and communication of relevant and material information to their investors. There is regular reporting to investors in accordance with the established industry standards - Reporting Guidelines and Valuation Guidelines, including substantial details about each of the portfolio companies and valuation of the fund's portfolio at fair value.

ANNEX IV

This report refers extensively to the OECD model double tax convention. The relevant articles in the Model and in its Commentary are, therefore, set out below[40].

1. RELEVANT ARTICLES OF THE OECD MODEL TAX CONVENTION ON INCOME AND ON CAPITAL

ARTICLE 3 GENERAL DEFINITIONS

2. *As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.*

ARTICLE 5 PERMANENT ESTABLISHMENT

1. *For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.*

2. *The term "permanent establishment" includes especially:*
   - *a) a place of management;*
   - *b) a branch;*
   - *c) an office;*
   - *d) a factory;*
   - *e) a workshop, and*
   - *f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.*

…………

4. *Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:*
   - *a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;*
   - *b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;*
   - *c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;*
   - *d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;*
   - *e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;*
   - *f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.*

[40] *OECD (2008), Model Tax Convention on Income and on Capital 2008: Condensed Version – July, 2008*

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

2. COMMENTARIES ON THE RELEVANT ARTICLES OF THE MODEL TAX CONVENTION

COMMENTARY ON ARTICLE 1 CONCERNING THE PERSONS COVERED BY THE CONVENTION

Application of the Convention to partnerships

6.3 The results described in the preceding paragraph should obtain even if, as a matter of the domestic law of the State of source, the partnership would not be regarded as transparent for tax purposes but as a separate taxable entity to which the income would be attributed, provided that the partnership is not actually considered as a resident of the State of source. This conclusion is founded upon the principle that the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.

COMMENTARY ON ARTICLE 4 CONCERNING THE DEFINITION OF RESIDENT

I. Preliminary remarks

4. Conventions for the avoidance of double taxation do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as "resident" and, consequently, is fully liable to tax in that State. They do not lay down standards which the provisions of the domestic laws on "residence" have to fulfil in order that claims for full tax liability can be accepted between the Contracting States. In this respect the States take their stand entirely on the domestic laws.

COMMENTARY ON ARTICLE 5 CONCERNING THE DEFINITION OF PERMANENT ESTABLISHMENT

Paragraph 5

*31. **It is a generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2.** This provision intends to give that State the right to tax in such cases.*

Thus paragraph 5 stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of any activity of a person acting for it. ***The paragraph was redrafted in the 1977 Model Convention to clarify the intention of the corresponding provision of the 1963 Draft Convention without altering its substance apart from an extension of the excepted activities of the person.***

32. ***Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether or not employees of the enterprise, who are not independent agents falling under paragraph 6.*** *Such persons may be either individuals or companies and need not be residents of, nor have a place of business in, the State in which they act for the enterprise. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, paragraph 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activity in the State concerned.*

    The use of the term "permanent establishment" in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases.

32.1 *Also, the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.*

33. *The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only. Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation.* ***A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation. The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise.*** *Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.*

33.1 The requirement that an agent must "habitually" exercise an authority to conclude contracts reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. ***The extent and frequency of activity necessary to conclude that the agent is "habitually exercising" contracting authority will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in paragraph 6 would be relevant in making that determination.***

34. Where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person acts for the latter, i.e. not only to the extent that such a person exercises the authority to conclude contracts in the name of the enterprise.

35. Under paragraph 5, only those persons who meet the specific conditions may create a permanent establishment; all other persons are excluded. It should be borne in mind, however, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5.

Paragraph 6

36. Where an enterprise of a Contracting State carries on business dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business (cf. paragraph 32 above). Although it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the Article for the sake of clarity and emphasis.

37. ***A person will come within the scope of paragraph 6, i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if***

a) he is independent of the enterprise both legally and economically, and
b) he acts in the ordinary course of his business when acting on behalf of the enterprise.

38. ***Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents.***

38.1. In relation to the test of legal dependence, it should be noted that the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5. But, as paragraph 41 of the Commentary indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies.

38.2. The following considerations should be borne in mind when determining whether an agent may be considered to be independent.

38.3. An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.

38.4. Limitations on the scale of business which may be conducted by the agent clearly affect the scope of the agent's authority. However such limitations are not relevant to dependency which is determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement.

38.5. It may be a feature of the operation of an agreement that an agent will provide substantial information to a principal in connection with the business conducted under the agreement. This is not in itself a sufficient criterion for determination that the agent is dependent unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted. The provision of information which is simply intended to ensure the smooth running of the agreement and continued good relations with the principal is not a sign of dependence.

*38.6. **Another factor to be considered in determining independent status is the number of principals represented by the agent.** Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. **Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.***

38.7. Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.

38.8. In deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one would examine the business activities customarily carried out within the agent's trade as a broker, commission agent or other independent agent rather than the other business activities carried out by that agent. Whilst the comparison normally should be made with the activities customary to the agent's trade, other complementary tests may in certain circumstances be used concurrently or alternatively, for example where the agent's activities do not relate to a common trade.

ANNEX V

THE APPROACH OF ITALY AND FINLAND TO PERMANENT ESTABLISHMENT ISSUES – LEGISLATIVE EXPERIENCE AND "CASE STUDY" EXAMPLES

Italy

There is very little case law in Europe on applying the permanent establishment wording in DTCs but the most notable is an Italian case involving Philip Morris which although not specific to the venture capital industry raises some general concerns which are applicable in principle also to venture capital. This is particularly the case in regard to the concept of agency permanent establishment and the relevance given to the attendance or participation in negotiations.

The Italian Supreme Court's decision in the well-known Philip Morris case can be considered to be a landmark one, as it led to the stating of several general principles (which can be considered as guidelines in the interpretation of cases of "agency" permanent establishments in Italy). These principles generated debate in a wider international context.[41] Significantly, Italy has expressly stated that its jurisprudence is not to be ignored in the interpretation of cases regarding the "agency" permanent establishment and the group of companies.[42] The relevance of these decisions should also be seen in the light of the fact that the 2005 amendments to the Commentary on Article 5 MC were aimed at clarifying the OECD position on the issues raised by the Italian Supreme Court with specific reference to multinational groups.

As a general remark, it should be noted that the Italian Supreme Court, when considering whether the agent could qualify as an independent agent or not, argued that as an Italian subsidiary of a multinational group was performing activities in favour of the company of the group, such a situation had to be seen unitarily for these purposes. (Basically it had to be considered as if the Italian company had only one principal that could be identified in the multinational group). It could therefore be deduced that the independent status would be more likely to be recognised in the event that the agents constituted several unrelated principals.

The first general rule formally stated by the Italian Supreme Court is that an Italian company may constitute a multiple permanent establishment of foreign companies belonging to the same group and pursuing a common strategy. In such cases, the question of whether the activities carried out by the Italian subsidiary are of an auxiliary or preparatory nature should be considered having regard to the whole group. It should be noted that the OECD did not deny the new concept of "multiple permanent establishment" but it took care to clarify and limit the existence of a multiple permanent establishment.

On the one hand, a parent company may be found to have a permanent establishment under the rules of paragraph 1 (fixed place of business) or paragraph 5 ("agency" permanent establishment) of Article 5 MC where a subsidiary has its place of business[43], also recognising that this rule also applies to multinational groups.

On the other hand, the OECD explained that the existence of a permanent establishment for one company of a group does not have any relevance to whether any other company of the same group has or not a permanent establishment in that State.[44]

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[41] *Decisions No. 3367 of 7 March 2002, No. 3368 of 7 March 2002 and No. 7682 of 25 May 2002.*
[42] *See paragraph 45.10 of the Commentary on Article 5 MC.*
[43] *See paragraph 41 of the Commentary on Article 5 MC.*
[44] *See paragraph 41.1 of the Commentary on Article 5 MC.*

The Italian Supreme Court also noted that the supervision or control of the performance of a contract between a resident entity and a non-resident entity cannot be considered, in principle, to be an activity of preparatory or auxiliary nature.

One of the most delicate aspects treated by the Italian Supreme Court is the participation in negotiations. In this respect, the attendance or participation in the negotiations (even a single phase) between a foreign company and a resident entity may fall within the concept of authority to conclude contracts in the name of foreign company, even in the lack of an express representation power. For these purposes, a determination regarding the authority to conclude contracts must have regard to the real economic situation of the company (a substance over form approach).

As mentioned above, the issue at hand has been considered by the Italian legislator. Under the current domestic law, it is not necessary, in order for the agency permanent establishment to exist, that the agent has the formal power to conclude contracts. It is sufficient if the agent exercises such power. In reaction to the approach taken by the Italian Supreme Court, and with the 2005 amendments to the Commentary on Article 5 MTC, the OECD took a more flexible position. It recognised that the mere fact that a person attended the negotiations is not sufficient to conclude that the person has exercised an authority to conclude contracts in the name of the non resident enterprise. However, in the OECD's opinion, such a fact should be evaluated in determining the exact functions performed by that person on behalf of the non-resident enterprise.[45]

It should be further noted that the Italian Supreme Court stated that where a resident entity manages business operations on behalf of a non-resident company, even if this management is restricted to a certain area, this implies the qualification of the former as a permanent establishment. However, the 2005 amendments to the Commentary on Article 5 MTC states that no permanent establishment exists where a company of a group provides services to a company of the same group as part of its own business carried on in premises that are not those of the recipient of the services and using its own personnel. Moreover, the fact that a company's own activities provide an economic benefit to another company of the group does not mean that the latter carries on its business through the former.[46]

Finally, the Italian Supreme Court specified that the requirements for the existence of a permanent establishment, including the dependent status and the authority to conclude contracts, have to be determined according to both a formal and a substance over form approach.

Finland

The vast majority of Finnish venture capital funds are structured as Finnish limited partnerships[47] (in Finnish: *kommandiittiyhtiö*). Finnish limited partnerships are governed by the Act on General and Limited Partnerships[48] and are basically treated as flow-through entities for taxation purposes.

Except for certain mandatory elements, the provisions of the Partnership Act may be set aside by agreement between the contracting partners. There are no other specific corporate law regulations governing venture capital funds structured as limited partnerships. More importantly,

[45] *See paragraph 31 of the Commentary on Article 5 MC.*
[46] *See paragraph 42 of the Commentary on Article 5 MC.*
[47] *The same applies to private equity and real estate funds.*
[48] *Law Nr 389/1988 of 29 April 1988.*

Finnish tax legislation for the most part does not recognize the special characteristics of the private equity industry, something which also applies to venture capital funds. Furthermore, case law and legal literature provide few guidelines concerning the industry. Thus, it is fair to say that the fund environment is still substantially subject to a 'light-touch' regulatory regime in Finland.

Previously the Finnish Income Tax Act ("ITA")[49] was interpreted so that investments made through a Finnish limited partnership created a permanent establishment for the foreign investor under Finnish taxation. This resulted in a liability to pay tax in Finland for investment activities based solely on a partnership interest in a Finnish limited partnership fund.

This problem was removed through adding a new paragraph 5 to section 9 of the ITA that came into force from the beginning of 2006.[50] According to the new regulations, income from a limited partnership received by a foreign partner residing in a country with which Finland has concluded a DTC, having a limited tax liability status in Finland, and acting as a limited partner in a Finnish limited partnership engaged in venture capital business, is taxable in Finland only on the part of the income that would have been taxable in Finland had the partner received it directly. In practice, this means that only dividends and income from real estate are subject to withholding tax according to the new regime. Hence, venture capital investments made through a limited partnership are mainly treated under Finnish taxation on an equal basis as direct investments.

It should be noted that the law does not define the concept of venture capital business. However, based on preliminary rulings given by the Supreme Administrative Court it is now clear that investing in real estate or other funds as well as investing into foreign targets by using international holding structures are deemed to be venture capital business as referred to in the ITA.

The Finnish government programme of 19 April 2007 set out the aim to enhance venture capital activities especially concentrating on companies under growth and internationalisation. Tax incentives are also being considered, as well as increasing use of governmental based risk financing.

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[49] *Law Nr 1535/1992 of 30 December 1992.*
[50] *Law Nr 564/2005 of 15 July 2005, applicable as of taxation year 2006.*

ANNEX VI

DIFFERENCE IN TREATMENT

Executive summary

This Expert Group, comprising business and governments, has as its purpose the identification of direct tax related obstacles to cross-border investment in order to bring about an improvement the operation of the EU venture capital market and narrow the gap between Europe and international competitors. In an EU/EEA context there are also legal requirements upon EU/EEA Member States to comply with the Articles of the EC Treaty as they have been interpreted by the European Court of Justice (ECJ). This chapter attempts to explore the relationship between EU law and venture capital, an area of taxation that, so far, has been largely by-passed in terms of the ECJ, although cases are now starting to appear such as the judgment dated 18 June 2009 in *Aberdeen Property Fininvest Alpha Oy* (C-303/07).

Business can challenge a Member State's laws in the national court, which can make a reference to the ECJ, or the Commission can take action against any Member State where it believes that national legislation is incompatible with the Treaty. But this is a costly and lengthy process for both sides. The Expert Group's Report seeks to identify obstacles to cross-border venture capital investment. The objective of this Annex is to analyse the context and some guiding principles of European law against which these obstacles may be assessed. It is not the purpose of this Annex or of the Expert Group to speculate whether the tax law in each Member State as it applies to venture capital is or is not compatible with the EC Treaty. However, if obstacles to cross-border venture capital investment are identified, then irrespective of a Member State's desire to tackle them on their own merits, it will want to consider the European law context and whether any changes may be necessary without or before engaging in the legal process.

The Freedoms

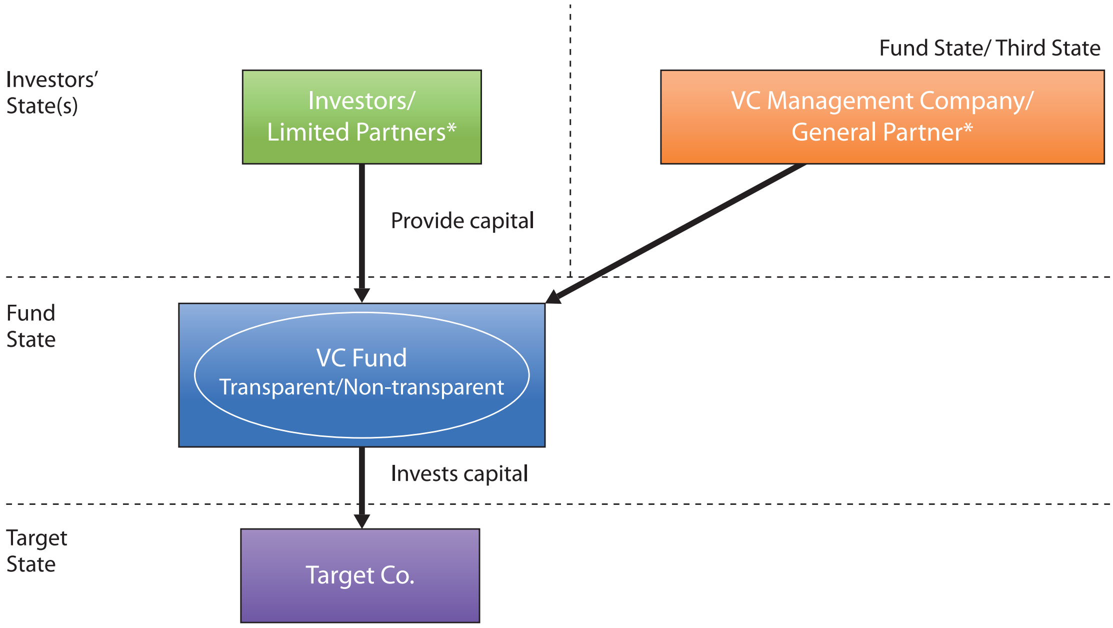
When considering EU law we are mainly concerned with two freedoms, the Freedom of Establishment (Article 49) and the Free Movement of Capital (Article 63) of the Treaty on the Functioning of the European Union (TFEU) (previously Articles 43 and 56 of the Treaty establishing the European Community). In relation to venture capital we are not so concerned with the other Freedoms (Services and goods) or with State Aids. State Aids can impact on Venture Capital regimes but the extent to which this constitutes an obstacle is a debate not considered by this Group, but may be an issue to consider in any further phase of this process.

The following pages set out the Freedoms and the interpretative case-law in more detail. But the general guiding principles as they might apply to venture capital are the "national treatment" principle and the "non-restriction" principle, namely:

- where someone from outside a Member State exercises a relevant freedom (inward establishment/inward movement of capital) he/she is entitled to broadly the same treatment as nationals of the host state - to the extent that his/her circumstances are objectively comparable;

- where a national of a Member State exercises a freedom by establishing in, or moving capital to, another Member State, the state of origin must not impose unjustified restrictions on account of his having done so unless those restrictions can be justified and provided that they are proportionate.

For venture capital we need to consider these freedoms as they apply to taxation of capital gains (including exit charges) and taxable income (dividends and interest). The impact arises at all three tiers of a typical venture capital fund, the investors, the fund and the target companies.



** In case of a transparent fund*

Typically cross-border venture capital fund structures will be more complex. But using this simplified structure, the issues can be summarised as:

For a non-transparent venture capital fund

- Investors – we are concerned with the law on capital gains and their receipt of inbound dividends and interest;

- Venture capital fund – as it is non-transparent, the assumption is that it is taxed in its home state so the law on capital gains and inbound/outbound dividends apply.

- Portfolio companies – we are solely concerned with outbound dividends and capital gains taxation of the non-transparent fund.

For a transparent venture capital fund

- Investors – we are concerned with the law on capital gains and their receipt of inbound dividends and interest;

- Venture capital fund – assuming there are no permanent establishment issues, the entity is not taxed either on capital gains or on dividends in its state of residence.

- Portfolio companies - we are solely concerned with outbound dividends and capital gains taxation of the investors.

So despite the many permutations of structure (and as we note this is only a simplified version), the issues in relation to taxation and the freedoms come down to three key issues, the taxation of capital gains and the taxation of inbound and outbound dividends/interest. We will take each in turn.

Cases on capital gains

The cases concerning capital considered so far by the ECJ have been on wealth or inheritance taxes as well as capital gains. They usually involve free movement of capital but where they impose a charge on a non-resident in circumstances where the charge would not also be imposed on a resident, the freedom of establishment is also involved. For example, the exemption for shareholdings limited to shares in domestic companies was examined in C-251/98, Baars, and the limitation to residents of an exemption from tax levied on capital value of immovable property holdings of legal persons in C-451/05, *ELISA*.

Rules for the transfer of shares to non-residents, where such transfers are taxed more heavily than transfers to residents, have been found to be in breach of the freedom of establishment or the freedom to move capital, depending on whether a majority shareholding (establishment) or portfolio investment (capital) was involved: see *C-436/00, X and Y*.

An exit charge will be in breach of the freedom of establishment unless justified and proportionate: C-9/02, *de Lasteyrie* (French charge: justified on ground of tax avoidance, but disproportionate in scope); C-470/04, N v *Inspecteur van de Belastingdienst Oost* (Dutch charge: justified on ground of preservation of allocation of power to tax, but disproportionate due to obligation to provide guarantee as *quid pro quo* of deferment). A charge based on deemed residence for a specified period following an exit is not a restriction since the mere transfer of residence does not involve any movement of capital: C-513/03, *Van Hilten*.

Dividends

Most developed countries impose tax on residents on the basis of their world-wide income and also on non-residents in relation to income having its source in that country. Therefore, a person who has foreign income may suffer tax in the country of source (taxation of a non-resident) as well as tax in his residence state. By charging tax in this way each country is exercising its sovereign right to impose taxation.

Double taxation commonly occurs when two countries want to tax the same income received by the same taxpayer. International tax practice calls this 'juridical' double taxation. "Economic" double taxation occurs where a company's profits are taxed at the company level and then taxed on the shareholder when dividends are paid (out of those profits). Unlike juridical double taxation, economic double taxation can occur within a single Member State as well as across borders. Juridical and economic double taxation can also occur simultaneously; e.g. a host state taxes company profits and also dividends paid to non-residents and the shareholder's state of residence also taxes the dividends.

The ECJ has focused on ensuring no less favourable treatment where a Member State has taxing jurisdiction over dividends paid to, or received from, non-residents. The obligations of the *source* Member State are to be distinguished from those of the Member State of *resident recipient.*

- In the source State, that Member State has to avoid discriminating i.e. treating differently a domestic dividend paid within the Member State and one paid cross- border but only to the extent it exercises tax jurisdiction over the outgoing dividend.

- In the Member State of residence, the obligation is to ensure shareholders are in substantially the same position and should be treated no less favourably whether the dividends arise from domestic concerns or foreign ones.

Outgoing dividends from source State

Where a source state does not tax a dividend paid to non-residents, there is no obligation on it to give non-residents a tax credit that is granted to residents: Case-374/04, *ACT Class IV GLO*. Tax credits are given to alleviate economic double taxation in the state that grants them.

A withholding tax levied only on dividends paid to non-residents may give rise to a breach of Community law and the source state may consequently be required to extend to non-residents tax benefits equivalent to those granted to residents. However, a restriction by the source state may be neutralised by a credit provided by the residence state under a double taxation convention, as opposed to the granting of unilateral relief: C-170/05, *Denkavit*; C-379/05, *Amurta*; E-1/04 *Fokus Bank*.

The judgement in *Aberdeen Property Fininvest Alpha Oy* (Case C-303/07) has shed useful light on the area. In this case the European Court of Justice followed the opinion of the Advocate General in pronouncing on the tax treatment of dividends in a source state (in this case Finland). The court ruled that a source state contravenes the freedom of establishment if it exempts domestic dividends, regardless of the legal form of the parent company, but levies tax on dividends paid to a non-resident company that has a legal form not known in the source state and that does not fall under the scope of Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States. The Court explicitly confirmed that a Luxembourg SICAV is comparable to a Finnish company, because Finland imposes a tax charge on the Luxembourg SICAV in respect of the dividends received. It noted that i) legal differences between domestic and foreign entities and ii) non-taxation of the dividends in the home State (Luxembourg) are not relevant for the question of comparability (paragraph 43, 50-56). Thus, as a general rule, as soon as a Member State imposes a tax charge on a foreign entity (e.g. a venture capital fund or investor) for dividends received, such foreign entity may be considered comparable to a domestic entity. Under such circumstances, cross-border dividends may not be treated less favourably than domestic dividends, because a difference in treatment of comparable entities is in breach of EU law.

Incoming dividends in resident's State

Member States cannot refuse to extend to incoming dividends economic double tax relief measures applied to domestic dividends: C-35/98, *Verkooijen*, C 315/02 *Lenz*, and case C 319/02 *Manninen*. However, a Member State may apply an exemption system for domestic dividends and a credit system for foreign dividends. The key requirement is that the incoming dividends must not be treated less favourably than domestic dividends taking account of nominal tax rates and the availability of tax credits: Case-446/04, *FIIGLO.*

An investor receiving dividend income from another Member State may bear a foreign withholding tax burden plus domestic income tax on the dividend in the Member State in which he is resident, whereas the same investor receiving domestic dividends will only bear domestic income tax, resulting in a higher net dividend. This does not necessarily result in less favourable treatment. Case C-513/04, *Kerckhaert-Morres*, explained that the difference in post-tax yield was caused by two Member States exercising their taxing rights in parallel. Belgium did not treat foreign dividends less favourably even though the combined effects of the two tax systems might result in foreign shares being less attractive to a Belgian investor. In the case at issue, foreign dividends were even treated more favourably than domestic dividends due to the fact that France provided a credit to eliminate double economic taxation (*avoir fiscal*). The ECJ in another Belgian case - Case C-128/08 *Damseaux V Belgium* - confirmed the judgement in the Kerckhaert-Morres case, ruling that that when two Member States exercise their tax competencies and do so in a manner that is not discriminatory, they are not obliged under the EC treaty in their capacity of residence state of the shareholder to grant relief from juridical double taxation. The relevant Belgian rules are also the subject of a pending case (C-307/08 *Commission v. Belgium*) which should shed further light on the compatibility of these rules in a situation where the less favourable treatment in Belgium is not compensated by an imputation credit in the state of source.

In C-194/06 *Orange European Smallcap Fund NV*, the Member State at issue compensated resident investment funds for the tax on incoming dividends deducted at source in other Member States. The aim of this concession was to render the tax burden on the proceeds from investments made through investment funds the same as that on direct investments made by individuals. The concession was, however, reduced in proportion to the interest in the investment fund held by shareholders resident in other Member States. Thus the Member State at issue treated differently investment funds whose shareholders were resident in that Member State and investment funds some of whose shareholders were established in another Member State. The Court considered this to be a restriction. Moreover, it found that in the circumstances where a Member State has chosen to tax dividends distributed to both resident and non-resident shareholders, an enterprise whose shares are partly held by non-resident shareholders cannot be regarded as being in a different position from that of an enterprise whose shareholders are all resident in that Member State. Therefore, the Member State at issue had to extend the benefit of the concession to investment funds which included non-resident shareholders.

Double Taxation Conventions

To alleviate or eliminate double taxation, countries enter into bilateral agreements (called Double Taxation Conventions, Treaties or Agreements (DTAs)) whereby they agree not to charge all the tax their sovereignties would otherwise permit. There is an agreed model double tax convention drawn up by the OECD which recommends that the source state should not charge tax of more than 15% on outbound dividends.

The state of residence can eliminate double taxation either by exempting the dividend from tax altogether (exemption method) or by taxing the dividend but allowing credit for the foreign withholding tax (credit method). Sometimes, a third method (the deduction method) is used which involves the state of residence imposing its own rate of tax on the net amount received after deducting the foreign tax. This does not eliminate all the double taxation that is created whereas the exemption and credit methods do.

Member States are competent to negotiate and enter into DTCs and are free to determine the connecting factors – residence, place of employment, source of income etc *Gilly* (C-336/96). Nevertheless, that allocation of the power of taxation does not mean that the Member States are entitled to impose measures that contravene the freedoms of movement guaranteed by the EC Treaty: *Renneberg* (C-527/06).

Non-resident taxation

Non-resident investors or a non-resident non transparent venture capital fund might be subject to non-resident taxation in respect of dividends or capital gains in the Member State where the target company is established. If, however, resident investors or a resident non transparent venture capital fund is exempt from taxation in respect of the same type of dividends or capital gains, a difference in treatment is present. According to case C-386/04, *Stauffer*, such difference in treatment is not allowed.

Conclusions

Venture capital is no different from any other area of taxation. Most of the issues are ones of direct taxation, and as such are competencies reserved for Member States. But the Member States must exercise that competence in accordance with the EC Treaty, Directives and case-law.

It is not the place of this Report to identify whether any tax provisions in any particular Member State are incompatible with the EC Treaty. But on the basis of the work of this venture capital expert group in considering the tax obstacles to cross border-investment, it appears that there may be tax regimes in Member States where there may be some indication of potential restrictive rules and would merit further analysis in relation to their compatibility with the Treaty.

But as discussed, it may be that any restrictions arising out of differences in treatment, taking account of the various authorities, may be capable of being justified and may also be proportionate to ensure the attainment of legitimate objectives compatible with the Treaty and the restrictive measure does not go beyond what is necessary to attain those objectives.

The picture is complicated by the number of permutations of source state and state of residence and by the flow through of income and gains. But in summary for each tier of the simplified venture capital structure:

- The State of residence of the **investors** should apply no less favourable treatment to income and gains received from the fund (whether transparent or non-transparent) irrespective of whether the fund or the target companies are situated in the same Member State or in another Member State. This does not mean, though, that the post tax returns of investors should all be the same where that difference is the result of the Member States exercising their taxing rights in parallel.

- In relation to the **venture capital** fund, it is inescapable that receipts, whether income or gains, should not be taxed differently depending on their provenance (i.e. from domestic or foreign sources). As regards outgoing dividends the fund state should extend to non-residents tax benefits equivalent to those granted to residents, if it levies tax on such dividends. To the extent that it has not been clarified in *Class IV of the ACT GLO* (C-374/04), the question of the difference in treatment of outgoing dividends has been clarified in *Aberdeen Property Fininvest Alpha Oy* (C-303/07). Simultaneously, a gain realized by a non-resident investor in a non-transparent or transparent venture capital fund, should be eligible for the same tax benefits as those granted to investors which are resident of the fund state.

- When considering the **target company**, the Member State of residence of the company is entitled to levy tax upon the income arising, and gains on disposals, from that company in accordance with the rules of that Member State. Gains and dividends payable to non-residents can, in certain circumstances, legitimately be taxed differently from gains/dividends arising to residents. This is a consequence of the Member State exercising its right to tax its citizens and entities. However, the source state is required to extend to non-residents tax benefits equivalent to those granted to residents and must follow the rules laid down in *Aberdeen Property Fininvest Alpha Oy (C-303/07)*.

The Treaty on the Functioning of the European Union (formerly the EC Treaty)

No article of the Treaty ***specifically*** prescribes that "national laws are invalid if they are inconsistent with EU law…". But at an early stage the ECJ found[51] that EC law has primacy over national law, and that where there is a conflict between a national rule and an EC rule, the EC rule will always prevail. As a result national rules may be unenforceable and the Member State concerned will have to amend its law, while taxpayers may be entitled to redress.

However, the ECJ also recognizes that Member States are competent in matters of direct tax, accepting that there is nothing in the Treaty that confers exclusive competence to the Community in this area. In the absence of any harmonising Community measures, it is for each Member State to organise its system for taxing income and capital gains, to define its tax base and tax rates. Member States retain the power to define and the criteria for allocating their powers of taxation, including those aimed at eliminating double taxation. Nevertheless, the Member States, when exercising their competence, are obliged to do so in accordance with EU law.

As it applies to direct taxes, EU law is largely then about the application of internal market rules. The Community has potential competence, in particular under Article 115 TFEU (ex Article 94 EC Treaty) (unanimity). That competence has rarely been exercised[52].

The fundamental freedoms

The EU rules most commonly encountered in the field of direct tax are the "fundamental freedoms". These relate to cross-border movement between Member States. There are situations where the freedoms have no application. EU law is not concerned with situations with no cross-border element so a Member State may treat its own nationals less favourably without breaching EU law, although, where those disadvantages relate to business tax, then there may be other factors to consider such as whether they may be "harmful" tax measures that would fall within the mandate of the EU Code of Conduct for business taxation. Also, when it comes to tax, the current state of case-law is that the freedoms do not extend to disadvantages that flow from the operation of the different national tax rules ("disparities"). To fall within the scope of the freedoms, disadvantageous tax treatment must flow from the application of the rules of one tax jurisdiction.

Where one (or more) of the fundamental freedoms applies, it is relevant to consider the overall balance of advantage or disadvantage to the taxpayer but a breach of a freedom still arises irrespective of the existence of some concomitant advantage to the taxpayer of equivalent (or greater) economic value.[53]

The freedom of establishment

Establishment involves the right of a person to national treatment (no discrimination) in a host state, and not to suffer an impediment (no restriction) by a state of origin. The TFEU describes the freedom of establishment in Article 49 (ex Article 43 EC) prohibiting *"restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State"* going on to say: *"Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms… under the conditions laid down for its own nationals by the law of the country where such establishment is effected".*

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[51] Declaration 17 annexed to the Treaty of Lisbon refers to the jurisprudence thus: *"The Conference recalls that, in accordance with well-settled case law of the Court of Justice of the European Union, the Treaties and the law adopted by the Union on the basis of the Treaties have primacy over the law of the Member States, under the conditions laid down by the said case law."*

[52] There are only a handful of directives in the field, specifically those concerning capital duties, parent and subsidiary, mergers, the taxation of savings, and mutual assistance.

[53] C-385/00, De Groot; C-182/06, Lakebrink.

So Article 49 prescribes the freedom of establishment in terms both of a prohibition on restrictions (generally applicable to a state of origin) and prohibition on discrimination against nationals of other Member States (by a host state); the effect of the latter is sometimes described as ensuring "national treatment". In its early case-law the ECJ tended to focus on the existence (or otherwise) of discrimination. Subsequently the Court[54] has been concerned with the existence of a *restriction* on the freedom of establishment. It is possible this is because the concept of *discrimination*[55], involves finding comparables, typically a resident and a non-resident but comparing whether the difference in treatment amounts to indirect discrimination can be difficult. However, the decision in C-298/05, *Columbus* concluded that in the absence of discrimination, the German legislation at issue in the case was not a restriction.

The free movement of capital

The free movement of capital is the other fundamental freedom most likely to be engaged by direct taxes. Article 63 TFEU (ex Article 56 EC) prohibits *"all restrictions on the movement of capital between Member States and between Member States and third countries."* So the freedom is not confined to the EU, but applies *'erga omnes'* (worldwide), the limits of which concept are still being explored. In C-101/05, A the term "restriction" has the same meaning in third country cases as in intra-Community cases, but it might be easier to justify a breach of the freedom where third countries are involved.

Establishment not infrequently involves capital transactions. The way the ECJ has dealt with such cases involving a breach of both freedoms is that where a shareholding permits a definite influence over a company's decisions and allows an investor to determine its activities, for example a substantial shareholding (See C-251/98, *Baars* and C-436/00, *X and Y.*) freedom of establishment is engaged and there is no need to consider free movement of capital separately. Having a lesser investment such as a portfolio holding involves a movement of capital, not establishment: C-436/00, *X & Y*. This is the case even where the shareholding in question is in a company incorporated in a third country: C-492/04, *Lasertec*. See also C-102/05, *A and B;* C-415/06, *Stahlwerk*.

From C-157/05, *Holböck*, it follows that one should review the nature of the restrictive domestic rule. If the domestic rule covers both establishment and capital movement, then both Treaty Freedoms apply. In such case, the restrictive legislation must be reviewed in the context of both the freedom of establishment and the free movement of capital.

Similarly, the freedom to provide services may also involve capital movements, e.g. if the business is the provision of financial services. Where the relevant domestic tax rule impedes access to a financial market, the Court seems to characterize the issue as involving the freedom to provide services, even though capital movements may be restricted by the operation of the rule[56] (and see C-294/97, *Eurowings*).

Justifications for breaches of the Treaty

So can infringements of the freedoms be justified? And if so, where does one draw the line? This question becomes more important the more the ECJ analyses cases before it. It was not until 1986 that it was realised that the freedoms might apply to direct tax[57]. Since then the focus of the jurisprudence has in general moved away the question of whether there is a restriction, rather particularly more recent cases have turned on whether the restriction is justified.

[54] *C-264/96, ICI in 1998*
[55] *See the opinion of Advocate-General Geelhoed in C-374/04, ACT Class IV at paras 35.*
[56] *C-452/04, Fidium Finanz*
[57] *C-270/83, Commission v France.*

Justifications for breach - Fiscal cohesion

In a few cases only, "fiscal cohesion" has been held to be a justification (C-204/90, *Bachmann*, C-157/07 *Krankenheim Wannsee* and C-418/07 and *Société Papillon*; in the latter case, however, the measures in question failed the proportionality test). What underlies fiscal cohesion is the notion of symmetry: most simply that a tax deduction is balanced by a subsequent tax charge. Arguably, fiscal cohesion is an early formulation of the potentially wider justification of maintaining a balanced allocation of taxing jurisdiction.

National tax authorities often pleaded fiscal cohesion in subsequent cases, but with little success. The ECJ has in the main been unsympathetic, requiring a direct link between the disadvantages imposed by a restriction and the claimed advantages. There were indications in C-319/02, *Manninen* that, in a suitable case, fiscal cohesion might be important and in the recent judgment in C-157/07 *Krankenheim Wannsee* the reasoning of the Court was that fiscal cohesion, in appropriate circumstances, was very much a relevant justification.

Justifications for breach - Fiscal supervision

The need to secure effective fiscal supervision is often cited - again with little success.[58] The ECJ usually relies on the existence of the mutual assistance directive[59] for not accepting this justification. And even where the directive is shown to be inadequate to yield the necessary information, the Court has looked to other means, e.g. asking the taxpayer to provide it directly.[60]

Justifications for breach - Tax avoidance

In a number of cases[61] the need to counter tax avoidance and evasion has been accepted as a possible justification. The Court has used the phrase "wholly artificial arrangements" to define its view of what might constitute tax avoidance where the justification would apply without indicating precisely what these words mean. In particular, the word "wholly" seems to be capable of wide interpretation. As it stands "wholly" means whole, complete, 100% but even the "letterbox companies" cited by the ECJ in *Cadbury-Schweppes*, have some substance – they are not wholly artificial even though that is how they were described. A definition of establishment might therefore be, *"intended to allow a Community national to participate, on a stable and continuing basis, in the economic life of a Member State other than his State of origin and to profit therefrom".* Once we have this definition then, the creation of a "brass plate" company is a wholly artificial arrangement as found by the Court because it does not seek to participate in the economic life of the host state.

In *Cadbury Schweppes* the Court deduced that justifiable anti-avoidance measures have to be targeted at arrangements to obtain a tax advantage when they do not "reflect economic reality". The Court said:

"As suggested by the United Kingdom Government and the Commission at the hearing, that finding must be based on objective factors which are ascertainable by third parties with regard, in particular[62], to the extent to which the CFC (controlled foreign company) physically exists in terms of premises, staff and equipment."

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58 *A rare (partial) exception is C-250/95, Futura Participations. See also C-406/04, De Cuyper (breach of Art 18 justified by need to exercise supervision over entitlement to unemployment benefit).*

59 *Council Directive 77/799*

60 *As in C-451/05, ELISA*

61 *C-264/96, ICI v Colmer, C-324/00, Lankhorst-Hohorst; C-196/04, Cadbury-Schweppes; C-524/04, Thin Cap GLO. See also C-450/03, Marks & Spencer.*

62 *Other indicators of economic reality were: the genuine nature of the services provided by the subsidiary - eg are the staff competent, and at what level are decisions taken? – and the value added by the activities of the subsidiary. The Court's use of the term "in particular" suggests these are potentially relevant to an assessment of economic reality.*

In the *ThinCap GLO* the ECJ came close to saying that non-arm's length arrangements are wholly artificial where borrowing is concerned:

"The fact that a resident company has been granted a loan by a non resident company on terms which do not correspond to those which would have been agreed upon at arm's length constitutes, for the Member State in which the borrowing company is resident, an objective element which can be independently verified in order to determine whether the transaction in question represents, in whole or in part, a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of that Member State. In that regard, the question is whether, had there been an arm's-length relationship between the companies concerned, the loan would not have been granted or would have been granted for a different amount or at a different rate of interest.

The Court was probably influenced also that there was already established international practice, (the OECD Model) that addressed the issues of thin capitalization. As the decisions in both *ThinCap GLO* and *Cadbury-Schweppes* demonstrate, tax avoidance and *abus de droit* where the taxpayer's conduct in seeking to minimize liability to tax can be said to involve abuse of the freedom claimed[63] are related.

Justifications for breach - Loss of revenue

The need to prevent loss of revenue is not accepted as a possible justification, though it remains a critical factor for tax authorities. On the other hand the Court has been receptive to the argument that *withholding tax* is a legitimate mechanism for ensuring tax is paid by non-residents.[64]

Justifications for breach - Preserving a balanced allocation of taxing rights

This justification made its first appearance in Marks & Spencer. In that case the ECJ found the UK rules on group loss relief being restricted to UK companies was, in principle, justified. The justifications it relied on, the need to preserve a balanced allocation of taxing rights to prevent losses from being used twice and to counter tax avoidance, taken together, were sufficient to justify the UK restriction to domestic situations in group loss relief.

Balanced allocation of taxing jurisdiction is derived from the principle in C-336/96, *Gilly*, that Member States retain the power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation. The justification recognizes the right (freedom) of Member States to prevent conduct capable of jeopardizing their right to exercise their taxing powers in relation to activities carried on in their territory. It helps if they exercise the power in a way which is consistent with international practice, e.g. under the OECD Model.

In the subsequent decision in C-470/04, *N* and C-347/04, *Rewe Zentralfinanz* the ECJ seems to still be reflecting on whether preserving a balanced allocation of taxing rights is a free-standing ground of justification. In C-231/05, *Oy AA*, it was sufficient that the restriction in the Finnish intra-group transfer regime preserved a balanced allocation of the power to tax and was needed to counter tax avoidance. The Court's jurisprudence in this area is still evolving as we have seen in the recent decisions in both C-414/06 *Lidl (Belgium)* and C-157/07 *Krankenheim Wannsee*.

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[63] *See, for example, C-212/97, Centros; C-436/00, X and Y. See also C-255/02, Halifax plc v Commissioners of Customs & Excise and C-425/06, Part Service (VAT cases). For a less enterprising approach to the relevance of the concept of abuse, see the timorous decision in C-321/05, Kofoed.*

[64] *C-243/01, Gerritse; C-294/04, Scorpio; C-345/04, Centro Equestre da Leziria Grande.*

Justifications for breach must be proportional

Proportionality is a general requirement that any justification must satisfy. The Member State rule in question must go no further than necessary to achieve its aims. For example in *Marks & Spencer,* the Court held that the freedom of establishment does not preclude a Member State from generally prohibiting a resident company from deducting losses incurred by a subsidiary established in another Member State, but that it was disproportionate to deny such a deduction when the latter has exhausted all possibilities for loss relief in its state of residence. See also C-293/06, *Deutsche Shell.*

Temporal limitation

In line with considerations of costs for Member States is the scope of temporal limitation (i.e. the length of time that taxpayers are allowed to go back, following a finding of incompatibility with the Treaty). AG Jacobs in C-475/03, *Banca Popolare di Cremona* suggested that the ECJ might be prepared to limit the temporal effect of its decisions in tax cases. But this has not been endorsed by the Court which has either not addressed the issue (C-446/04, *FIIGLO*), albeit the point was raised at the hearing, or has criticised the basis of the plea (C-524/04, *ThinCapGLO*), or has made the relief the subject of conditions that are difficult to meet in practice (C-292/04, *Meilicke*).

Double tax agreements and EU law

An international agreement entered into by a Member State – whether on a multilateral or a bilateral basis – is a sovereign act which engages the responsibility of that state under EC law in much the same way as the enactment and implementation of domestic legislation.

It follows that when giving effect to commitments assumed under international agreements, Member States are required to comply with the obligations that EC law imposes on them: C-55/00, *Gottardo* (in that case, the principle of equal treatment under Article 45 TFEU (ex Article 39 EC).

Therefore entering into, or giving effect to, a DTA may infringe one or more of the fundamental freedoms:

- For example, though the general rule is that Member States are free, when they agree DTAs, to determine the connecting factors by reference to which they allocate powers of taxation as between themselves, but their exercise, after allocation is subject to EU law; thus in the case of a DTA with a third country the principle of national treatment requires that when exercising its taxing powers, the Member State which is party to the treaty must grant to permanent establishments of non-resident companies the advantages provided for by that treaty on the same conditions as those which apply to resident companies: C-307/97, *Saint-Gobain*;

- Likewise, when giving effect to rules agreed as part of a DTA with other Member States, a Member State cannot be allowed to disadvantage a national who has exercised his freedom of movement to work in those other Member States as compared with a national who has remained in the Member State concerned: C-385/00, *de Groot* (partial loss of personal allowances);

- But the fundamental freedoms do not require the Member States, when negotiating DTAs, to afford MFN (most favoured nation treatment) to nationals of a third Member State: C-376/03, *D v Inspecteur van de Belastingdienst.*

In the exercise of their competence to conclude DTAs Member States must abide by EU law. In particular:

- A member state may not subordinate its compliance with the fundamental freedoms to the provisions of a DTA with another Member State.

- Adverse fiscal treatment in breach of one of the fundamental freedoms may not be justified by the existence of other, extraneous benefits.

Subject to these two points, the court though must assess whether the freedoms have been complied with on the basis of all the applicable rules, and include, where relevant, the applicable DTA: C-265/04, *Bouanich*.

ANNEX VII

TYPES OF VC VEHICLES AND SPECIAL TAX REGIMES IN EU MEMBER STATES[65]

AUSTRIA

Local vehicles for Venture Capital investments

Austrian tax law provides for a specific tax regime for intermediaries investing in European non-listed SMEs ("Small and Medium Sized Enterprises"). Entities qualifying as intermediaries have to be organized as corporations. These intermediaries may invest in partnerships or corporate entities.

The intermediary corporations that qualify for treatment under the regime are treated as opaque entities for tax purposes. In cases where the investment requirements are met, income from participations (current profits and profits from alienation and the ordinary dividend exemption which also applies to intermediary corporations) as well as interest from loans to entities in which they also hold a participation are tax exempt.

Corporations that make contributions to an intermediary are subject to corporate income tax ("CIT"), real estate transfer tax, value added tax ("VAT") and other taxes. They are exempt from capital duty on equity contributions to the intermediary corporation. Furthermore, they are exempt from capital duty and stamp duty on capital contributed to their target investments (SMEs). Although Austria does not have thin-capitalisation rules explicitly laid down in tax law, other (similar) rules also apply to intermediary corporations (and their investments).

Dividends paid by the intermediary corporation to its shareholders are subject to withholding tax according to standard tax law rules. Dividends received by other corporations will be exempt from tax at the level of the recipient (in Austria) according to the standard regime for Austrian dividends received by corporations. Furthermore, the Individual Income Tax Act ("IITA") provides for tax exemption for dividends paid by these intermediary corporations to individuals (up to a shareholding of EUR 25,000).

The goal of these intermediary corporations is to bundle equity and invest it in SMEs. It is unlikely that the intermediary is allowed to raise capital via loans. Thus, the application of the European Savings (Tax) Directive should not be an issue.

The intermediary should be treated as resident in Austria for treaty purposes and should have unlimited Double Tax treaty access.

Mutual Recognition Approach and Treaty Application

Austria will qualify foreign bodies as transparent partnerships or opaque corporations depending on whether they are comparable to Austrian partnerships or corporations from

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[65] *This information has been provided by Ernst & Young offices in various Member States, in cooperation with the Experts in the Group. The group finished the main part of its work in June 2009. The report therefore mainly reflects the situation prevailing at that data, including in particular the tax legislation in force in EU Member States at that time. Although all due care has been taken in the compilation of this material, it should be noted that neither the European Commission nor the Experts can assume any legal liability or responsibility with regard to its content which is of a general nature only and is not intended to address the specific circumstances of any particular individual or entity and should not be substituted for professional or legal advice.*

a corporate law perspective ("Typenvergleich"). According to general opinion, the tax rate (applied to the foreign body) abroad should be irrelevant. However, there has been one dissenting decision by the (Austrian) High Court. Furthermore, it is noted that Austria also applies anti-abuse provisions. Therefore, for the further explanations set out below we assume that no abuse is at hand.

In case the foreign Venture Capital ("VC") fund is transparent, normally the tax treaty with the country of the fund's investor(s) should be applicable. Austrian tax law does not clarify which documents have to be provided to treat the fund as transparent, and this is always dependent on the individual 'facts and circumstances'.

In case investors in foreign VC funds are resident in Austria, Austria should also apply relief according to the treaty with the state of residence of the fund (if the fund is opaque), or with the target state (if the fund is transparent). No specific tax relief concerning income distributed by the fund is applicable.

BELGIUM

Local vehicles – eligible for Venture Capital investments

Belgian tax law provides for a specific tax regime for public and private PRICAF / PRIVAK (closed ended investment funds in corporate form) and public PRIFONDS (closed ended transparent fund investment fund: fonds commun de placement, "FCP"). They are often used for cross-border investments, specifically in pan-European context.

Investment companies

Specifically the PRICAF (both public and private) is designed for venture capital investments. A PRICAF is incorporated as a company (Société Anonyme, Société en Commandite par Actions, Société en commandite simple).

For tax purposes, a PRICAF is treated as opaque. Recognized investment companies, such as a PRICAF (public or private), are subject to a special tax regime. This establishes that they are only taxable on a notional basis, composed of disallowed expenses, abnormal or benevolent advantages received and indemnities paid for "missing coupons" in case of stock lending. This reduced tax basis is subject to the normal corporate tax rate of 33.99%. A private PRICAF may however renounce the special treatment and opt, on a year-by-year basis, for the application of the normal corporate tax regime.

A partial exemption of dividend withholding tax also applies, i.e. in as much as the dividend distribution relates to capital gains realized by the investment company on shares. The exemption is applicable irrespective of the shareholder. No withholding tax (normally 10%) is applicable upon liquidation or redemption of shares. To the extent that distributions made by the investment company are in the form of dividends the EU Savings (Tax) Directive is not applicable. The same is applicable for realized capital gains on shares. No Belgian withholding tax is applicable on investment income earned by the PRICAF, except for dividends received from Belgian resident companies. However any Belgian withholding tax levied is creditable and refundable to the investment company.

Value added tax ("VAT") is not recoverable where there is a lack of activities of the PRICAF against which the VAT can be set off.

As a rule, investment companies are subject to a yearly tax on investment institutions. However this tax does not apply to a Private PRICAF.

The Belgian participation exemption (dividend received deduction) is not applicable to qualifying investment companies, which have indeed a restricted taxable basis which do not include dividends, received or realized capital gains on shares. The dividend received deduction may apply in the hands of the corporate shareholder of the investment company. Thin capitalization rules are not relevant given the restricted taxable basis.

The fund, if incorporated (as either a private or public PRICAF) is entitled to the benefits of tax treaties concluded by Belgium. It does not act on behalf of the investors.

Tax transparent funds

A PRIFONDS is an FCP and thus transparent for tax purposes. Provided the hypothesis that the venture capital fund is a transparent entity (fond commun de placement, such as a PRIFONDS) established in Belgium is fulfilled, the question is whether the foreign investor is entitled to the benefits of the tax treaty concluded between its country of residence and Belgium (i.e. the country where the target is established). In principle the answer is yes, provided the foreign investor proves that it has received income qualifying for tax treaty benefits. Normally an investor will be able to provide this evidence through the breakdown of the distribution they should receive from the FCP/PRIFONDS. However, since the distributions will in most cases be composed of realized capital gains on shares, there will be no Belgian withholding tax. In the case of a Belgian resident investor, if any withholding tax would be applied by the Belgian resident target upon e.g. dividend distributions to the FCP, this tax is final for the Belgian resident investor.

There is no Belgian withholding tax on distributions coming from a transparent fund (FCP/ PRIFONDS). In the event of a Belgian investor investing in a non-Belgian fund that is treated as transparent in the foreign country, but opaque for Belgian purposes, there is no relief. The distributed net income (i.e. after foreign tax) is taxable as dividend income.

Mutual Recognition Approach and treaty application

Provided the foreign legislation acknowledges the concept of legal personality, a non-Belgian investment vehicle will be considered as opaque if it has legal personality according to the foreign legislation, irrespective of its tax treatment (transparent or not) in the foreign country.

The partial only - or non-application - of the mutual recognition approach by the jurisdiction of the target company is not the main reason for the existence of double taxation of income from Venture Capital Investments. The same problem also exists where the foreign "institution" is treated as opaque on both sides of the border. This problem could be solved by applying the E.U. principles of freedom of establishment, free movement of capital and the prohibition of discrimination. In this respect, the reasoned opinion sent by the EU Commission to Belgium on 20 July 2006 with respect to double taxation on inbound dividends should be noted. However, ECJ decisions seem to imply that there is no discrimination where a "Belgian" dividend and an inbound dividend are taxed in the same way (i.e. on its net amount, after tax) and that the circumstance that there may be a foreign withholding tax is not relevant in this respect. The ECJ (Denkavit/ Test Claimants cases/ Kerckhaert-Morres[66]) seems to imply that the source state should remedy the double taxation only if such a relief exists for "internal" dividends (e.g. by providing for an exemption of withholding tax).

BULGARIA

There are no special vehicles regulated under Bulgarian law for Venture Capital investments; consequently, no specific tax regime is provided under Bulgarian tax law for Venture Capital investment funds (venture capital being defined as investment in securities of unlisted companies).

CYPRUS

Local vehicles for Venture Capital investments

Cypriot law contains legislation enabling the establishment and regulation of International Collective Investment Schemes ("ICIS") which are also used for cross-border Venture Capital investments. Under these schemes four legal types of vehicles may be licensed as an International Collective Investment Scheme ("ICIS"):

- International Fixed Capital Company ("IFCC")
- International Variable Capital Company ("IVCC")
- International Unit Trust Scheme ("IUTS")
- International Investment Limited Partnership ("IILP")

For ICIS's founded as corporate entities (IFCC / IVCC), dividends and capital gains from the sale of securities are exempt from tax in Cyprus, provided certain requirements are met. Income Tax, special Contribution for the Defence of the Republic (Defence Tax), Capital Gains Tax, Value Added Tax ("VAT"), Transactional taxes (registration fees & stamp duty) may be applicable at the level of the ICIS founded as corporate entities. As indicated, the participation exemption is applicable. In Cyprus, there are no thin capitalization rules.

There is no withholding tax levied on income distributed by the ICIS (whether founded as a corporate or a transparent entity), except for a 15% withholding tax on dividends in case the investor/shareholder is a tax resident individual of Cyprus. The EU Savings Directive is applicable on interest payments. Provided that the fund vehicle is structured as a tax resident legal entity (company), it has double tax treaty access.

Mutual Recognition Approach

Whether Cypriot jurisdiction applies a mutual recognition approach depends on the circumstances. In the absence of withholding taxes in Cyprus and the absence of Income Tax/ capital gains tax on non resident investors (except in the case of immovable property situated in Cyprus or shares of companies owning immovable property situated in Cyprus), it is irrelevant whether Cyprus would apply the double tax treaty with the non resident investor in a resident transparent ICIS. In the case of immovable property situated in Cyprus or shares of companies owning immovable property situated in Cyprus, a tax residence certificate would be required to confirm that all investors are resident for tax purposes in the treaty country claiming treaty protection.

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[66] *Reference*

CZECH REPUBLIC

Local vehicles for Venture Capital investments

Czech law provides for a Qualified Investors' Fund ("QIF") which allows for direct or indirect investments in Venture Capital. Eligible investors are qualified investors, meaning any entity or natural person which confirms its qualification as an eligible investor. Cross-border investments are generally possible and investment by foreign investors is also common. Foreign investment by the Czech QIF is less common, as careful implementation is required from a tax perspective.

There are two principal forms of a QIF:

- QIF as an Investment Company ("IC", legal entity, Joint Stock Company, separate taxpayer);
- QIF as a Unit trust ("UT", not a legal entity, nevertheless separate taxpayer).

For a QIF whether founded as IC or as UT there are no specific tax exemptions. However, compared to the standard corporate income tax rate (currently 21%), a favourable 5% corporate income tax rate is applicable. For a QIF founded as an IC, all tax laws are applicable as for other corporations (typically Corporate Income Tax, Value Added Tax, possibly Real Estate Tax, Real Estate Transfer Tax). This also applies to a QIF founded as a UT, except that the applicability of Value Added Tax to UT is unclear (the "supervising" joint stock company likely being the VAT-payer). There are no stamp duties, capital duties or net wealth taxes for a QIF, whether founded as an IC or UT.

The Czech participation exemption is likely to be applicable to a QIF founded as an IC. It is not applicable to a QIF founded as a UT.

Czech thin capitalization rules are applicable to both forms of QIF, but the actual mechanisms are rather unclear for a UT. According to the applicable thin capitalization rules, a ratio of 2:1 for related party loans and of 4:1 for total loans (the latter to be abolished as of 2009) is required.

Outbound dividends are subject to a 15% withholding tax, unless an exemption under the Parent Subsidiary Directive or double tax treaty applies. In addition, the standard rules of the EU Savings Directive are applicable to interest payments.

For tax purposes, a QIF whether founded as an IC or as a UT is treated as opaque, as it is a separate taxpayer. Thus, a QIF is generally entitled from a Czech tax perspective to double tax treaties.

Mutual Recognition Approach

The approach regarding the recognition of tax transparency of foreign entities is in general unclear and not yet settled. There are practical examples of cases in which the tax status for Czech tax purposes (transparent vs. opaque) has been set based on both (i.) legal classification and (ii.) foreign tax classification. Under the prevailing interpretations of Ministry of Finance officials, tax treatment of the entity in its state of residence should be followed. Nevertheless, in practice, there are cases of such transparent vehicles being treated as non-transparent for Czech tax purposes. There is no practical experience with determining tax transparency and residency of investors in the fund.

DENMARK

Local vehicles for Venture Capital investments

There are no specific vehicles for Venture Capital investments established in Denmark. Instead, ordinary limited liability companies (A/S or ApS), or unlimited liability partnerships, e.g. K/S, I/S or P/S etc. are used for investments in Venture Capital.

It is possible to set-up Venture Capital funds either as a transparent entity or a limited liability company.

There are no specific tax-exemptions for Venture Capital investments in Denmark. In principle, the following taxes could all be applicable at the level of the Venture Capital fund founded as a corporate entity: corporate income tax, capital gains tax, value added tax/payroll tax etc.

Inbound dividends

The participation exemption for received dividends is applicable if certain conditions are met, namely: a limited liability company owns a shareholding of 10 % in the dividend distributing company (the threshold is 15% in 2008) within an uninterrupted period of 12 months (may be met subsequent to the distribution), and at least one of the following conditions are met:

- The subsidiary is resident in Denmark, a foreign country within the EU, EEA, the Faroe Islands, Greenland or a state with whom Denmark has concluded a double tax treaty, or
- The subsidiary is part of an international joint taxation, or
- The parent company (i.e. the Venture Capital Fund organised as a limited liability company in this case) has a controlling interest in the subsidiary (i.e. is able to control the subsidiary by holding more than 50% of the voting rights or by other means is able to control the subsidiary directly or indirectly)

If the Venture Capital Fund holds less than 10% of the share capital or does not own the shares for at least 12 months, 66% of the dividend received must be included in the income of the Venture Capital Fund. The 66% inclusion is only applied if at least one of the following conditions are met:

- The subsidiary is resident in Denmark, a foreign country within the EU, EEA, The Faroe Islands, Greenland or country, which has concluded a double tax treaty with Denmark, or
- The subsidiary is part of an international joint taxation with the Venture Capital Fund

If none of the two conditions are met, the entire dividend received must be included in the income of the Venture Capital Fund.

If the distributing entity can claim a deduction for the dividend paid, the entire dividend will be taxable on the Venture Capital Fund, unless the dividend is covered by the parent-subsidiary directive 90/435/EEC.

Outbound dividends

In general, dividends paid from Danish companies to non-residents are subject to withholding tax at a rate of 28%. However, tax treaties may reduce this rate for dividends paid to non-residents. Furthermore, Danish domestic tax law provides for exemption if the following conditions are met

- The dividend is paid to a company owning at least 10% of the share capital for a consecutive period of at least 12 months within which period the dividend is paid
- The dividend should be reduced according to the parent-subsidiary directive 90/435/EEC or a double tax treaty

This means that if these conditions are met, the withholding tax is reduced to zero according to internal Danish tax rules.

In case the recipient does not own at least 10% of the share capital directly or together with affiliated parties, the withholding tax may be reduced to 15%. This is only the case if the recipient is resident in a country which exchanges information with the Danish tax authorities according to a double tax treaty, international agreement or another concluded agreement.

Interest expenses are as a main rule deductible for tax purposes in Denmark.

A Venture Capital fund founded as a corporate entity (i.e. a corporation, A/S, ApS, etc.) has unlimited access to double tax treaties, but it does not have access to the double tax treaties on behalf of its investors. However, if a small group of investors is considered to have similar interest etc., they may be regarded for Danish tax purposes as one unit, which in theory could have access to double tax treaties.

Mutual Recognition Approach

As a general rule, Danish tax regulations do not respect classification of an entity as being opaque or transparent made by a foreign jurisdiction. According to Danish tax regulations, a specific assessment of whether the foreign entity's characteristics are similar to those of a Danish limited liability company must be made. Denmark applies the approach articulated in Par. 6.5 of the Commentary on Art. 1 of the OECD MTC as a main rule, but in each situation it will rely on the double tax treaties between the state of residence of the partner, the state of the partnership and the state of the source. If the Danish authorities consider the company as being a transparent entity, the investors may be considered as the beneficial owners. If this is the case, it will be the double tax treaty between Denmark and the country of the investors that will be applicable on dividends/interest paid.

A Danish investor which invests in a foreign company and therefore receives dividend payments subject to withholding tax may as a general rule be granted a credit relief. The credit relief depends on whether the foreign taxed dividend payment is regarded as taxable in Denmark; and furthermore, whether the Danish investor has any positive income in which the tax paid can be set off against.

Qualification as an investment company

New Danish rules on "investment companies" have just been implemented. In certain cases, a Danish or foreign company may be qualified as an investment company, which can have both advantageous and adverse Danish tax consequences at the company and investor level.

A company which primarily owns securities and has at least 8 different investors may be covered by these rules and be considered an investment company, if the investments relate to portfolio shares (less than 10% ownership) and securities.

If a company is covered by the new rules, the company should be treated as a tax exempt entity for Danish tax purposes. On the other hand, the Danish investors will make up their income at the balance sheet date (market to market principle) instead of according to the realisation principle.

Certain exemptions apply for not having a company re-qualified as an investment company, e.g. if more than 15% of the company's accounting assets consist of other assets than securities.

ESTONIA

Local vehicles for Venture Capital investments

In Estonia, the vehicle that allows for direct or indirect investments in Venture Capital is the Venture Capital Fund founded either as a common fund or as a public limited company for collective investment. These Venture Capital Funds are used for cross-border investments.

The shares in the Venture Capital Fund are rendered only to professional investors under the meaning of the Securities Market Acts or to a person who meets at least two of the following criteria:

- The minimum amount of the investor's initial investment is at least EUR 10,000 and it has previously confirmed in writing its knowledge of investing, restricted risks and the distinctive risk level of a Venture Capital Fund;
- The investor works or has previously worked at least a year in a job requiring knowledge of investing in securities;
- The investor has made in the securities market at least five considerable transactions in one quarter during the previous four quarters;
- The investor's securities portfolio(s) capacity exceeds EUR 100,000.

Opaque funds

An Estonian Venture Capital fund founded as a public limited company acts as a legal person and is treated as opaque for tax purposes. No tax exemptions are applicable at the level of the fund. The Income Tax Act and Value Added Tax Act are applicable. No Net Wealth Tax, Capital Duty or Subscription Tax is applicable.

Where the participation exemption is applicable, capital gains derived from resident companies are exempt from corporate income tax. Capital gains are always subject to income tax for individuals and non-residents. There are no thin capitalization rules in Estonia.

A 21% withholding tax ("WHT") is imposed on dividends paid to a non-resident legal person holding less than 15% of the share capital of the Estonian Venture Capital fund founded as a public limited company paying dividends, and on dividends paid to non-residents from low-tax rate jurisdictions. In the case of a tax treaty, the treaty withholding tax rate is applicable. WHT is also imposed on interest paid to resident individuals. WHT is imposed on interest to the portion of interest paid to non-resident individuals and to non-resident entities that is exceeding the market interest rate. All other interest payments are exempt from WHT.

The EU Savings Directive is applicable. If the Venture Capital Fund is established as a public limited company, it has access to double tax treaties.

Transparent funds

If the Venture Capital Fund is a common fund, the fund is not considered to be a legal entity, but a pool of assets. A common fund is considered to be transparent as the shareholders of the fund are subject to taxation. As the Estonian common fund is not considered to be a legal entity, the distributions made by common fund can not be treated as dividends in the meaning of the Income Tax Act. Therefore the distributions of the common fund are treated and taxed as interest. As the common fund is not a legal person, it has no access to double tax treaties. Instead, double tax treaty ("DTT") is applicable on investors of the common fund depending on their state of residence.

Mutual Recognition Approach

The status of the fund as being transparent for tax purposes is clarified by the fund establishment documents. In order to have DTT access, foreign investors should submit the certificate issued by the appropriate competent authority proving that they are a resident of the appropriate country. Under the Income Tax Act if the residency prescribed on the basis of an international agreement differs from the residency prescribed pursuant to law, or if the international agreement prescribes more favourable conditions for taxation of income than those provided by domestic law, the provisions of the international agreement apply. A non-resident is a natural or legal person, which means that the non-resident legal person is a person and taxpayer for Estonian tax purposes regardless of whether in a foreign country this legal person is transparent for tax purposes in that country. Estonian Income Tax Act tries to avoid cases of double taxation and is in many cases more favourable than DTT.

FINLAND

Local vehicles for Venture Capital investments

In Finland, real estate funds as well as private equity funds may be used as a Venture Capital investment vehicle.

A real estate fund may be either a listed limited liability company or a limited partnership. Currently there is no specific tax regime applicable for real estate funds in general. However, a specific tax regime concerning real estate funds investing solely in rental apartments has been recently approved by the national parliament. Please note that the entry into force of the tax regime in question is subject to the European Commission's approval for State Aid notification.

The private equity funds may be founded either as limited liability companies or limited partnerships, but due to tax considerations limited liability companies are seldom used.

The tax treatment of a fund depends on its legal form. Limited liability companies have a separate legal personality and qualify as opaque for tax purposes. Finnish limited partnerships are treated, with some exceptions, as transparent for income and business income tax purposes.

Income tax, business income tax, Value Added Tax ("VAT"), transfer tax (on transfer of shares and real estate) are applicable tax laws at the level of the fund founded as a company. The Finnish participation exemption regarding capital gains does not apply for the benefit of resident venture capital investment companies or real estate companies. There is currently no specific legislation on thin capitalization in Finland. The general anti-avoidance rules are applicable, but usually they are not applied. There are a few old court cases concerning the issue. In practice, e.g. a debt-equity ratio of 1:15 has been accepted.

There are no withholding taxes on capital gains from the disposal of shares by a non-resident. However, by way of exception, when shares in a Finnish real estate company are sold by a non-resident, the sale is subject to tax in Finland and a tax return needs to be filed with the Finnish tax authorities, unless an applicable tax treaty prevents Finland from taxing the capital gain. Dividends paid to a non-resident company are exempt from withholding tax provided that the company falls under the scope of application of the European parent-subsidiary directive and the recipient company owns at least 10 % of the share capital of the distributing company. All dividends paid to a non-resident company are tax exempt if such dividends are tax exempt when paid to a resident company and the non-resident company cannot credit the Finnish tax in the country of residence provided that the non-resident company is resident in an EEA Member State and the Mutual Assistance Directive (77/799/EEC) or any agreement regarding mutual assistance and exchange of information in tax matters applies. A tax rate of 19,5 % applies to dividends received by virtue of shares belonging to company's investment assets or if the distributing company is publicly listed and the recipient is not publicly listed provided that the non resident company falls under the scope of application of the European parent-subsidiary directive but the company owns less than 10% of shares. In other cases and in the absence of an applicable tax treaty the domestic withholding tax rate of 28% may apply.

Finnish limited partnerships are not Finnish residents for the purposes of most of the tax treaties, because they are not separate tax subjects in Finland. Consequently, a Finnish limited partnership is generally not a tax treaty subject. However, the partners of a Finnish limited partnership may be eligible for tax treaty benefits depending on the applicable tax treaty between the source state of income and the residence state of the partner. A Finnish limited partnership may be a tax treaty subject only if another treaty state regards it to be liable to tax for its global income.

The tax treatment of non-resident limited partners of Finnish capital funds taking the form of a Finnish limited partnership differs from the tax treatment of other partners in partnerships. The special treatment applies provided that there is an applicable tax treaty between Finland and the partner's state of residence. If the Finnish limited partnership is engaged only in capital investment, the limited non-resident partner is taxed for his share of the profits of the partnership in Finland only to the extent that the income would be taxed in Finland if the partner received it directly. In a non-treaty situation a Finnish partnership may constitute a permanent establishment for its non-resident limited partners.

Mutual Recognition Approach

According to the Ministry of Finance, Finland does not apply a Mutual Recognition Approach, but the classification by the jurisdiction of the entity is taken into account and may influence the Finnish classification.

FRANCE

Local vehicles for Venture Capital investments

An FCPR can be used in a cross-border context, both for French and foreign investments, i.e., both from an inbound and outbound perspective.

An FCPR is essentially a specific form of Unitary Collective Investment Trust - Organisme de placement collectif en valeurs mobilières ("OPCVM"), i.e., a vehicle with no legal personality that is regulated and managed by an independent management company. There are several forms of FCPRs that are configured for various types of activities and that give rise to different tax incentives, where French resident investors are concerned. The two main types of FCPRs, in addition to the standard FCPR, are the fonds commun de placement dans l'innovation ("FCPI") and the fonds d'investissement de proximité ("FIP"). Apart from FCPRs, it also happens that inbound VC investments are made in France through foreign partnerships, essentially when made by UK/US investors. There are still other French vehicles for VC investments in France: the 'société de capital risque' (most commonly referred to as an "SCR"), the 'société unipersonnelle d'investissement à risques/régional' ("SUIR"), and to a lesser extent the 'jeune entreprise innovante' ("JEI") usually have a legal personality and are considered as opaque for tax purposes.

French law grants a corporate income tax ("CIT") exemption for SCRs (and SUIRs[67]) due to specific rules. Except in particular situations where SCRs are considered to render services for their own purpose, SCRs are subject to value added tax ("VAT") as these vehicles do not benefit from the general VAT exemption applicable to OPCVMs management. Regarding registration duties, the creation of an SCR is exempted. SCRs should be out of scope of French thin capitalization rules, as these rules apply to companies or entities that are liable for CIT, whereas SCRs benefit from a CIT exemption. SCRs cannot contract loans for a proportion exceeding 10% of their net asset value. Foreign investors in SCRs benefit, in principle, from a similar income tax relief enjoyed by French residents. Therefore, a withholding tax exemption applies if commitments prescribed for such tax relief are met both at the level of the investor and the SCR (e.g. holding period, mandatory reinvestments or respect of the investment ratio). Otherwise, taxation is levied at either 18% or 25% (no social charges are levied).

Given the lack of any taxation as regards income tax, VAT and capital duty would be considered as the main feature of the VC vehicle. FCPRs are not liable to taxes as they are void of any tax personality: taxation of income and capital gains is effected through its investors. Furthermore, French VC vehicles normally do not have any VAT issues either because they have no tax personality, or due to the fact that no services are invoiced. Indeed, in the case of an FCPR run by a management company, only services provided by the management company may be subject to VAT. FCPRs are out of scope of French registration duties. Legislation regarding wealth tax has recently been subject to amendment in order to promote private equity investments. The value of participations in FCPRs, FCPIs and FIPs held by wealth tax payers is not taken into account in the wealth tax basis provided that the French vehicle invests in specific companies (small and mid-sized companies) meeting certain conditions. In addition, wealth tax payers can claim a tax credit for an amount equal to 50% of their participation in French vehicles (FIPs, FCPRs and FCPIs) on the same conditions. A tax ruling also allows the combination of these tax incentives, to a certain extent, with a tax reduction on personal income tax.

It is not possible to access the standard participation exemption regime regarding the dividends and capital gains realized by the FCPRs. However, French resident corporate investors enjoy a specific tax regime that enables them to benefit from tax treatment that is similar to the participation exemption. Provided that certain conditions are respected, both at the level of the investors and the FCPR, it is possible for the investors to be exempted from French corporate income tax on all or part of the capital gains realized through the FCPR. Furthermore, a participation exemption does not apply either when an investment is realized through a foreign partnership. Whereas on one hand the French parent subsidiary regime does not apply, on the other there is no specific tax regime allowing to reach tax exemption from French corporate income tax on dividends and capital gains realized through a foreign partnership.

French FCPRs are not subject to standard French thin-capitalization rules. However, from a French legal standpoint, and depending on how they are organized (whether the FCPR is open to the public or reserved for qualified investors), they have to respect certain 'risk-division'

[67] *CIT exemption for SUIRs ceases as from 1 July 2008*

ratios. In essence, this means that in some cases it is not possible for French FCPRs (or FCPIs and FIPs) to be financed via debt for more than 10% of their assets.

There is no withholding tax on dividends distributed by the FCPR (if received from foreign portfolio companies), or on capital gains realized from their redemption or disposal. As regards capital gains tax, it is important that non-resident investors be treaty-protected if their participation in the FCPR indirectly represents more than 25% of the share capital of the underlying participation at the origin of the capital gain realized by the FCPR. Otherwise, the capital gain may be taxable in France at a rate of 18% (provided that a disposal threshold of EUR 25,000 is exceeded). The EU Savings Directive was transposed into French law in 2003. As a result, these entities can be subject to a twofold information commitment:

- French UCITs exceeding a specific 40% investment threshold must keep the paying agents informed of their status related to this 40% threshold (i.e. the direct or indirect investments in fixed-income products realized by the UCIT must represent more than 40% of its assets) ;

- as a paying agent, the French UCITS must fill in the French IFU forms.

Mutual Recognition Approach

What is probably the most commonly-used vehicle in France is the *fonds communs de placement à risques* ("FCPR"). The French tax authorities agree to consider that an FCPR is fiscally transparent. This is a notable exception to the French tax rules, as they almost never accept to grant full tax transparency to French or foreign vehicles, even when they are devoid of any legal personality. The fiscal transparency granted to French FCPRs allows French source income realized by FCPRs to flow through FCPRs to the investors with the possible application of the tax treaty(ies), if existing, between France and the country of residence of such investors. In the cases where the income flowing through the FCPR is not from a French source, the tax treatment is more complex, as it is essentially a matter of 'facts and circumstances'. In other words, the tax treatment applicable in the source country, as well as in the investor's country of residence, must be checked each time with local advisors to confirm whether the source and residence countries recognize the tax transparency of vehicles such as FCPRs.

Unless specific tax treaty provisions exist, France will apply tax transparency to foreign funds similar to French funds and will deny tax residence. Due to its tax transparency, foreign-source income received by a French fund and redistributed to non-residents retains its original classification and source, so that no tax is withheld in France on its redistribution to the non-resident investor. With respect to foreign taxes imposed on such income, the non-resident investor may wish to claim the application of the treaty between his country of residence and the source country. Such treaty application presupposes that each country concerned accepts the tax transparency of the French fund. However, as the income transits through a French fund, the French tax authorities indicate that, in principle, the fund is not required to intervene in the treaty procedures or claims. The only way for the French FCPR to be qualified as transparent would be to effect a settlement based on the mutual- agreement procedure.

Foreign partnerships (in particular, limited partnerships) are generally not considered to be tax transparent. Moreover, since they are not subject to tax, they are not entitled to treaty benefits (i.e., double tax treaties are not applicable to these entities), unless the relevant treaty provides otherwise (e.g. the France-US and France-UK tax treaties). French-source investment income flowing through foreign partnerships, when derived by non-French tax resident investors, is subject to French withholding tax on interest (18%) and dividends (25% or 18%), while capital gains can be tax exempt, subject to certain conditions. Further to recent case law, the French tax authorities are now inclined to analyze the tax transparency of foreign partnerships based on intrinsic characteristics according to the applicable foreign law, thus allowing the application of look-through treatment and leading to the improvement of the French tax treatment of income flowing through foreign partnerships.

Double taxation of income from Venture Capital

Double taxation of income from Venture Capital ("VC") investments will remain an issue for as long as tax treaties do not contain provisions concerning a unique approach for both contracting states in respect of tax treatment for partnerships or funds. At this stage, it is understood that some initiatives to improve the situation are being undertaken at a local level (France) and at a conventional level (France-UK new tax treaty) regarding the look-through treatment. However, for the moment such progress concerns partnerships which in some countries are not the main vehicle used for venture capital. Furthermore, the improvements noted above are limited to specific situations and may not cover all situations concerned by VC investments. Moreover, difficulties can arise from the fact that numerous countries apply different tax treatments depending on various local criteria. The precision made by the new France-UK tax treaty (i.e. that the qualification of the shareholder state of residence prevails) could overcome these issues.

GERMANY

Local Vehicles for Venture Capital Investments

In Germany, a new law has recently been introduced with regard to Venture Capital (Wagniskapital-Beteiligungsgesetz). In principle the law became effective on August 19, 2008. However, the enactment of the tax provisions depend on the confirmation by the EU Commission that the new tax provisions are in line with EU (in particular: subsidy) law.

Venture Capital holding companies or partnerships which fall under this new law ("Wagniskapitalbeteiligungsgesellschaften", hereafter called "Regulated VC Fund Vehicles"), i.e. which apply for registration as such with the German Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht; "BaFin"), are subject to permanent regulatory supervision by the BaFin. They are not restricted to a certain legal form. The registered office and place of management of the VC Fund Vehicle have to be in Germany and the target companies have to be non-listed EU / EEA companies. Certain investment restrictions apply (e.g., a Regulated VC Fund Vehicle may only invest in target companies which have been founded within the last ten years, and whose equity - at the time when the investment is made – does not exceed EUR 20m).

Depending on the legal form of the Regulated VC Fund Vehicle, it is treated as either transparent (partnership) or opaque (corporation) for tax purposes.

In general, Regulated VC Fund Vehicles are subject to the same tax rules as ordinary partnerships and ordinary corporate entities (Körperschaften). One of the ordinary rules to be mentioned is the corporate income tax exemption of in principle 95% of dividends and capital gains which a corporate entity derives from a corporate target company (the present German corporate income tax rate plus solidarity surcharge is 15.825%). The 95% exemption also applies to trade tax as far as capital gains are concerned, and to dividends if the Regulated VC Fund Vehicle holds at least 15% (or in the case of corporate Regulated VC Fund Vehicles and corresponding applicable double taxation conventions: 10%) of the shares in the distributing target company at the beginning of the respective calendar year. Otherwise the dividend is fully subject to trade tax, the rate of which depends on the municipality in which the Regulated VC Fund Vehicle is located. Trade tax rates presently vary between 7% and 17.15%.

There are, however, some special tax rules which have to be applied to Regulated VC Fund Vehicles, inter alia the following:

- If the activity of a Regulated VC Fund Vehicle which is set up as a partnership is in principle limited to the administration of shares (which must not include short-term sales) and other permissible assets and if the target companies are solely corporate entities, the partnership is qualified as non-commercial (merely asset-managing, "vermögensverwaltend") for tax purposes (it is then, in particular, not subject to trade tax);

- There are certain allowances in respect of capital gains taxation.

The new law with regard to venture capital (Wagniskapital-Beteiligungsgesetz) has not been received with much enthusiasm by the German VC industry, mainly due to the restrictions on permissible activities of Regulated VC Fund Vehicles and the minimal-only tax advantages offered by this new law, and also due to the regulatory supervision which Regulated VC Fund Vehicles are subjected to. It is therefore doubtful whether the new Regulated VC Fund Vehicle as designed by the new law will be utilised much in practice. The general expectation is that the VC industry will use the local vehicles (legal forms) which have already been used in the past (in the following called **"Unregulated VC Fund Vehicles"**):

– GmbH & Co. KG (*Kommanditgesellschaft*), which is the German legal form of limited partnership, whose sole general partner is a GmbH:

German VC Fund GmbH & Co. KGs usually have a so-called managing limited partner, i.e. the partnership agreement constituting the VC Fund limited partnership endows one of the limited partners with (co-)management authorities. The purpose of this is to avoid application of the so-called deemed commercial partnership-concept ("Konzept der gewerblich geprägten Personengesellschaft"). In addition, German VC Fund GmbH & Co. KGs normally strive at complying with the criteria for non-commercial-partnership-classification as described in the decree by the Federal Ministry of Finance dated 16 December 2003. Only in the case of non-commercial-partnership-classification is the VC Fund GmbH & Co. KG fully transparent for tax purposes, i.e. the investors are in principle taxed as if the investors had made the investments directly.

– GbR (Gesellschaft bürgerlichen Rechts), which is the German legal form of simple partnership. Due to the principle absence of limitation of liability of all partners, this legal from is only rarely used for VC Fund Vehicles in practice.

– GmbH, which is the German legal form of company with limited liability. This legal form is used rather rarely, because it does not achieve tax transparency, i.e. there is an additional layer of tax and the investors are not taxed as if they had made investments directly.

Mutual Recognition Approach and treaty application

Due to the fact that the registered office and place of management of a Regulated VC Fund Vehicle have to be located in Germany, Regulated VC Fund Vehicles should normally have German legal forms. However, if a (Regulated or Unregulated) VC Fund Vehicle is set up as a foreign legal vehicle having its registered office and place of management in Germany, the foreign legal vehicle could be qualified either as a (transparent) partnership or a (opaque) corporate entity from the German tax point of view. The result of the qualification depends on the comparability of the foreign legal form to a German partnership or German corporate entity from a German tax point of view (*"Rechtstypenvergleich"*). The tax classification by the state under whose laws the (Regulated or Unregulated) VC Fund Vehicle has been set up and is governed is in principle irrelevant.

If the German tax authorities consider the foreign VC Fund Vehicle as an opaque company, the VC Fund Vehicle is subject to corporate income tax and trade tax in Germany. In case the investors are resident in a third state and there is an existing double taxation convention (DTC) between Germany and this third state, the latter will not be applied by the German tax authorities. If the target company is resident in Germany, the German tax authorities will in principle apply the DTC which Germany has concluded with the state of residence of the opaque VC Fund Vehicle.

If the German tax authorities treat the foreign VC Fund Vehicle as transparent, there is a different treatment depending on whether the VC Fund Vehicle carries out commercial activities or not. The DTC between Germany and the third state (state in which the investors are resident) will usually only be relevant in case of commercial activities of the VC Fund Vehicle. In this case the branch principle (*"Betriebsstättenprinzip"*) is applicable.

In case the VC Fund Vehicle is non-commercial and therefore not qualified as a branch (the VC Fund Vehicle would then be considered as *"vermögensverwaltend"*), the DTC between the state of the target company and the state of the investors should be applicable.

In general, there are no specific documents mentioned in German tax law which are needed in order to classify the VC Fund Vehicle as transparent or opaque. This classification will normally depend on the material contents of the laws governing the respective legal form, and of the constituting documents of the vehicle.

It is currently uncertain in which way the German tax authorities deal with classification conflicts which could arise if the state of residence of the (Regulated or Unregulated) VC Fund Vehicle e.g. treats it as transparent, whereas the country of residence of the investor (or of a target company) considers it as opaque, unless the applicable DTC concluded between Germany and the other state provides for special provisions in respect of this issue. The German Federal Ministry of Finance published a draft decree on the application of DTCs on partnerships in May 2007. Due to criticism against that draft, and recent new decisions by the German Federal Fiscal Court contradicting some of the principles of the draft, the final version of this decree has not yet been published.

GREECE

Local vehicles for Venture Capital investments

Mutual Recognition Approach and treaty application

To the extent that a foreign entity provides the Greek tax authorities with a valid tax residence certificate issued by the tax authorities of the State where it is established and which entitles the said foreign entity to claim DTT protection, the Greek tax authorities would not in principle dispute it. In the case of a transparent foreign entity, that is not considered to be a resident according to the provisions of the DTCDTT, the investors thereof would be required to provide tax residence certificates, fully filled in, signed and stamped by the foreign tax authorities and according to the provisions of the corresponding DTCDTT, whenever DTC is applied.

In Greece, Venture Capital Holding Companies ("EKES") are used for direct or indirect investments in Venture Capital. These engage in participating in the capital of business entities that are located in Greece and that are not listed in the stock market as well as in providing security for loan grant to entities, in which they participate. EKES can also invest in convertible bonds issued by non listed companies, they can invest its floating assets in deposits and short term quoted securities or UCITS in Greece or abroad and they can provide services to the companies in which they invest regarding market research, analyzing investment plans etc. They may also invest in companies having shares floating in a Stock exchange market under certain conditions.

An EKES is considered as opaque for tax purposes. A tax withholding at the rate of 10% is imposed on dividends distributed to EKES, exhausting any further liability of the beneficiary, according to the provisions of the recent tax law 3697/2008. It is not clear whether this 10% withholding tax may be offset with the EKES total tax liability. A formal query to the Ministry of Finance should be considered if needed. Income tax for an EKES applies on the dividends distributed in any form after their conversion to a gross amount by adding the tax corresponding to them, excluding the part of the dividends deriving: a) from dividends of a domestic S.A. in general or from profits arising from participation in domestic limited liability companies, which according to the provisions of L.2238/1994 are taxed in the name of the latter companies and b) from profits from the exploitation of ships under the Greek flag, which are subject to shipping taxation. The income tax rate is 20% (25% applicable for a Greek S.A.).
With regard to the application of thin capitalization rules, the liabilities of an EKES cannot exceed its owners equity and if so, the company must proceed to a share capital increase within 6 months.

Dividends distributed by an EKES seem not to be subject to a withholding tax. As this issue is unclear, a formal query to the Ministry of Finance should be considered if needed.

As a Greek tax resident, an EKES may benefit from the protection of double tax treaties ("DTT") to which Greece is a signatory.

Mutual Recognition Approach and treaty application

To the extent that a foreign entity provides the Greek tax authorities with a valid tax residence certificate issued by the tax authorities of the State where it is established and which entitles the said foreign entity to claim DTT protection, the Greek tax authorities would not in principle dispute it. In the case of a transparent foreign entity, that is not considered to be a resident according to the provisions of the DTC, the investors thereof would be required to provide tax residence certificates, fully filled in, signed and stamped by the foreign tax authorities and according to the provisions of the corresponding DTC, whenever DTC is applied.

HUNGARY

Local vehicles for venture capital investments

As a special form of investment fund, the investor's capital can also be collected in Venture Capital funds ("VC funds") which are governed by the provisions of the Hungarian Act on Capital Markets ("ACM").

Under the provisions of the ACM, the VC fund is a legal entity that issues public or private investment units (venture capital notes), managed by an investment Fund Manager by investing the capital collected from the investors on behalf and for the benefit of the investors in accordance with predetermined investment principles.

VC funds are registered and supervised by the Hungarian Financial Services Authority, which approves the status of the funds prior to their establishment. Under the ACM, the Fund Manager company must operate as a company limited by shares or a branch of a foreign company.

On the basis of the law, VC funds are not subject to corporate taxation in Hungary (They do not fall under the personal scope of corporate income tax and solidarity surtax, either. The Act on solidarity tax is going to be repealed as from 1 January 2010). On the other hand, the company or the branch managing the VC fund is subject to corporate taxation according to the normal rules. The income derived from the venture capital activities is taxed at the level of the investors.

Under the Hungarian Act on Local Taxes ("ALT"), an entrepreneur conducting business activity in the jurisdiction of the municipality falls under the personal scope of the ALT and is subject to local business tax. Local business tax is a local tax that can be levied by the Hungarian municipalities on corporate taxpayers that have their legal seats or permanent establishments within the municipalities' jurisdiction. The business activity should be conducted in the entrepreneur's own name and on its own risk. Because, under the "ACM", the VC fund is seen as a group of assets, and as such cannot act in its own name and on its own risk, it does not, therefore, fall within the scope of the ALT.

In the case of VC funds, the investment is embodied in venture capital notes issued by the VC fund and all income derived as dividends, exchange gains or interests from the shares and debt securities of the Hungarian VC fund's portfolio is embodied in the output yields of the venture capital notes. The venture capital note itself represents an ownership interest, but the income derived from that should be treated as interest for Hungarian accounting purposes.

As Hungarian legislation does not levy any withholding tax on payments to legal entities, interest payments made by the VC fund to legal entities are not subject to withholding tax. Should there be, however, any Hungarian or foreign resident individuals receiving distributions from the Hungarian VC fund, personal income tax must be withheld by the Fund Manager of the VC fund.

Application of double tax treaties

As regards the double taxation of income earned by the VC funds from portfolio companies, we note that treaty protection is only available for entities that are residents of a contracting state. (The term 'resident' is defined by the OECD model treaty as any person that is liable to tax in the given state by reason of domicile, residence, place of management, etc).

Based on the above, the treaty protection is not applicable to VC funds in Hungary. Notwithstanding this, as noted above, Hungary does not levy any withholding on any payments made to foreign legal entities (unless they qualify as CFC). Therefore, making payments from Hungary does not trigger such withholding tax concerns.

IRELAND

Local vehicles for Venture Capital investments

Depending on the investor type there are a number of Irish vehicles which can be used also for cross-border investments:

Regulated Investment Funds:

- Unit Trust (collective investment fund);
- VCC (variable capital investment company)
- Investment Limited partnerships
- Common Contractual Funds
- Typically Professional Investor or Qualifying Investor Funds

Non Regulated Vehicles:

- Unlimited Company
- Irish Holding Company
- Irish Limited Partnership

Irish Holding Companies are exempt from capital gains tax on gains arising from disposals if they meet certain conditions including minimum equity holding, ownership and trading criteria.

Dividends are subject to tax at 12.5%/25% but with the ability to pool foreign tax credits and eliminate any Irish tax. Where the holding company regime does not apply then it is likely that a capital gains tax rate of 20% is applicable on disposals. There is no subscription tax, no Net Wealth Tax, no Capital Duty. Holding Companies qualify as a taxable person for Value Added Tax ("VAT") purposes, but there is a tax exemption on management services. No thin capitalization rules are applicable. A tax of 0% is withheld on dividends/interest to treaty countries otherwise a tax of 20% is withheld. Capital gains are not subject to any WHT unless the gains relate to certain Irish assets. The EU Savings Directive is not applicable. Holding companies are treated as opaque and have unlimited access to all double tax treaties ("DTT").

Professional Investor and Qualifying Investor Funds are tax exempt. There is no subscription tax, no Net Wealth Tax, no Capital Duty. The PIF/QIF qualifies as a taxable person for VAT purposes, but there is a tax exemption on management services. No thin capitalization rules are applicable. No tax is withheld at source. PIF and QIF are potentially in scope for the EU Savings Directive but unlikely in a venture capital arrangement. Regulated PIF / QIF have limited access to some double tax treaties.

A partnership qualifies as a taxable person for VAT purposes, but there is a tax exemption on management services. There is no subscription tax, no Net Wealth Tax ("NWT"), no Capital Duty. No thin capitalization rules are applicable. There is no withholding tax levied except in certain limited cases on interest and capital gains. The EU Savings Directive is not applicable as well. In case of transparent entities there may be access to some DTT at the level of the partners.

Mutual Recognition Approach

The classification given to an entity by the jurisdiction in which it is established is partially recognized. If it is an entity which is listed in Art. 2 of the Parent Subsidiary Directive or in a

Double Tax treaty, the original classification will be accepted. Otherwise, the legal features of the foreign entity will be compared to an equivalent Irish entity. Where a foreign Venture Capital fund is regarded as tax transparent the tax treaty between Ireland and the investors should be applicable. It is a matter of fact in comparing the Venture Capital fund with an equivalent Irish entity to assess whether it is transparent or not. The payer of dividends and interest will need to confirm that the investors are tax resident in a treaty country. This is normally proved by receipt of a certificate of tax residency from the investor who wishes to apply the DTT between Ireland as the state of residence of the target company and the investor's state of residence.

ITALY

Local vehicles for Venture Capital investments

The most commonly used vehicle for Venture Capital in Italy is the "*Fondo Chiuso*" (closed-end fund), although in principle structures with corporate entities may be adopted.

The Fondo Chiuso is a separate pool of assets with no legal personality that is managed by a regulated management company on behalf of the investors.

Formally, the Fondo Chiuso is not regarded as tax transparent (as the income is not allocated to the investors) and it is subject to an annual 12.5% tax on the yearly yield, that substitutes for the standard income taxes (the "Substitutive Tax"). However, as described below, the Fondo Chiuso may under certain circumstances achieve tax transparency in the sense that the fund itself is not subject to taxation and the investor is taxed in its country of residence only when the fund distributes gains and revenues.

The Substitutive Tax rate is lowered to 5% if (i) the management rules of the fund explicitly state that at least two thirds of the investments have to be employed in shares of small and medium companies (i.e. companies that have a market capitalization of no more than Euro 800 million) listed on a stock exchange in the EU and (ii) the value of the investments in the above mentioned companies is not lower, during the calendar year, than two thirds of the total value of the assets for a period longer than two months. However, the European Commission (Decision IP/05/1103 of the European Commission) considered that the 5% rate constitutes State aid and requested Italy to abolish such advantage with retroactive effect; the EU Court of First Instance ruled in favour of the Commission (case T-424/05 decided on 4 March 2009).

If the Fondo Chiuso has less than 100 investors, the Substitutive Tax applies at a rate of 27% on the part of the yield deriving from participations beyond certain thresholds. The 27% rate does not apply if more than 50% of the units of the Fondo Chiuso are held by "qualified" investors.

The Fondo Chiuso is fully exempt from the Substitutive Tax if all the investors are "qualified" foreign investors. For these purposes a foreign investor is "qualified" if resident in a country that allows an adequate exchange of information with Italy (White List countries). Moreover, the following investors are in any case deemed to be "qualified" investors: (i) entities and international bodies established according to international treaties implemented in Italy; (ii) institutional investors, even if not subject to tax, established in a White List country; and (iii) central banks and bodies that manage the official reserves of a country.

Distributions from the Fondo Chiuso to foreign investors are not subject to any further taxation (in particular, no withholding tax applies). Moreover, "qualified" foreign investors are entitled to the refund of the Substitutive Tax for an amount equal to 15% of the profits received. The refund is paid by the management company (and not by the Italian tax authorities) out of the Substitutive Tax to be paid. Eventually, as a matter of fact, "qualified" foreign investors receive the profits from the fund gross of the Substitutive Tax.

It is not certain whether the Fondo Chiuso is entitled to treaty benefits.

Mutual Recognition Approach and treaty application

As a general rule, under domestic law, foreign entities are not treated as tax transparent.

However, under applicable tax treaties, Italy may recognise the tax transparency of foreign investors. In this respect, Italy does not follow a mutual recognition approach and therefore regards a foreign entity as tax transparent on the basis of the domestic rules. In particular, an entity can be regarded as tax transparent if the income of the entity is allocated to the partners and taxed in their hands regardless of actual distribution.

In general, if the foreign VC fund is transparent under Italian law, the treaty with the country of the investors may apply provided that the investors are considered as "residents" of their country according to the treaty. Moreover, if the foreign VC fund vehicle is considered as a "resident" of its country of establishment, the treaty with the latter country may apply.

LATVIA

Local vehicles for Venture Capital investments

No specific vehicles are provided by Latvian law concerning investments in Venture Capital ("VC").

Investments in Venture Capital can for example be made through an investment fund, a limited liability company ("LLC"), a joint-stock company ("JSC") or a partnership.

An investment fund may be established under the Investment Management Companies Law as a contractual joint ownership having no legal personality. The fund is managed by a management company that must be a joint stock company holding an appropriate licence issued by the Finance and Capital Market Commission, or a fund management company from other EU/EEA Member State. An investment fund may be created as an open or closed investment fund. An open fund may invest its assets in transferrable securities, money market instruments, deposits in credit institutions and other financial instruments subject to the investment limits set by the Investment Management Companies Law. In addition a closed investment fund may invest its assets in immovable property. It is important that most of the investment limitations set by the Investment Management Companies Law are not applicable to closed investment funds, thus a closed investment fund is more appropriate for investments in Venture Capital.

An investment fund is not opaque for tax purposes as it has no legal personality. However, it also may not be regarded as transparent, since neither the fund's income nor expenses are attributed to the holders of funds shares, units or certificates of investment. The income received from the fund, or from the alienation of its shares, units or certificates is taxable at the level of a recipient of such income. The income distributed by a fund is not considered a dividend and accordingly is not subject to WHT, and the fund itself has no access to tax treaties concluded by Latvia.

Both the LLC and JSC are regarded as opaque entities for tax purposes. Venture Capital vehicles registered in the form of an LLC or JSC are subject to corporate income tax ('CIT') at the rate of 15% on their worldwide income. In addition, the Law on Value Added Tax ('VAT') shall be applicable to VC vehicles registered in Latvia. VC vehicles in the form of an LLC or JSC may receive tax-free dividends from their resident subsidiaries and from qualifying non-resident subsidiaries. To qualify for participation exemption, a holding company must hold at least 25% of voting shares in the non-resident subsidiary, which must not be incorporated in any of the tax havens blacklisted by the Latvian Government. Additionally Latvia has implemented provisions of the Parent/Subsidiary Directive, i.e. the participation exemption applies to subsidiaries that are resident in, and have been established under, the laws of an EU Member State or EEA country.

According to Latvian law interest payments can be deducted from the VC vehicle's taxable income. The Latvian law sets no restrictions with respect to deduction of interest if paid to a Latvian, EU or Tax Treaty state registered credit institution. However, the deductible amount is restricted if paid to other Latvian residents and to non-residents.

According to the thin capitalization rules, two calculations for determining the deductible amount of interest must be made. The calculation of deductible interest must be done on an annual basis. Under the first calculation, the principal amount upon which interest was paid during the year is multiplied by 1.2 times the average short-term interest rate for the last month of the taxation period as determined by the Central Statistical Bureau of Latvia. If the interest payment for the tax year exceeds this amount the excess is not deductible for taxation purposes. Under the second calculation an amount of interest paid is disallowed proportionally to the amount by which the average amount of the principal outstanding during the year exceeds a multiple of four times the company's equity as stated in its annual accounts at the beginning of the year, reduced by any amounts that are long term investment revaluation reserves or other reserves that have not been reflected in the profit and loss statement. If the non deductible interest amounts are calculated under both calculations, only the largest amount is disallowed as deduction at determination of taxable income.

Non-deducted interest payments cannot be carried forward for deduction in future taxation years. That means that if in a taxation period a taxpayer incurs non-deductable interest payments following the thin cap calculation, non-deducted amount of interest payments cannot be recognised as expenses for CIT purposes in future taxation periods.

Generally, a 10% withholding tax ("WHT") is applicable on dividends which are distributed from a company registered in Latvia to non-Latvian residents. However, a 0% rate can be applied if the company receiving dividends is a resident of another EU Member State or resident of European Economic Area ("EEA"). For a 0% WHT on dividends to apply, the EU or EEA company receiving dividends must not be subject to a corporate income tax ("CIT") exemption in the country of its residence or have the possibility to choose the CIT exemption. The WHT on dividends paid out by a VC vehicle to a resident of a tax treaty state in most cases can be reduced to 5%, provided that a residence certificate (approved by both the Latvian and the recipient's resident tax authorities), is held by the Latvian resident paying dividends at the moment of payment. For the reduced WHT to apply the beneficial owner of dividends shall be regarded as a resident of the respective State, i.e., subject to tax under the laws of that State as well as subject to other conditions stated in the respective treaty.

A Latvian partnership is regarded as a transparent entity. A VC vehicle registered as partnership does not pay tax itself. Each partner is liable for the payment of corporate income tax or personal income tax respectively on the share of taxable income attributable to them. An income, which is acquired from participation in a partnership distributed to non-Latvian resident shall be subject to 15% WHT (if partner is a legal person) or 23% personal income tax (if partner is an individual).

In case of an LLC or JSC the double tax treaty is applicable to the VC fund vehicle, whereas in case of a partnership investors of the VC vehicle should have the right to benefit from the respective treaty.

Mutual Recognition Approach

Latvian laws do not provide for any specific rules regarding treaty application in respect of partnerships. Thus, since treaties are generally based on the provisions of the OECD Model Tax Convention on Income and on Capital, the Latvian tax authorities tend to use the OECD Commentary on Model Convention for the interpretation and application of the respective treaty, notwithstanding the fact that the Republic of Latvia is not an OECD Member State. However, as no considerable experience has been developed with respect to this issue, written clarification from the Latvian tax authorities would be recommended. If the target company and fiscally transparent VC vehicle (partnership) would both be registered in Latvia, no double taxation convention will be applicable as concerns the distribution of income, i.e., dividends distributed from the target company to the partnership are usually tax exempt at the level of partnership.

LITHUANIA

Local vehicles for Venture Capital investments

Lithuanian legislation provides for two types of special investment vehicles that allow investments in Venture Capital:

- Private Capital Collective Investment Undertakings (hereinafter – the Private CIU);
- Hedge Collective Investment Undertakings (hereinafter – the Hedge CIU).

According to the Law on Collective Investment Undertakings as of 1 March 2008 (hereinafter – the Law on CIU), types of Venture Capital investment vehicles mentioned above (hereinafter – VCIVs) may have a form of either (1) a joint stock company incorporated under the Lithuanian Law on Companies or (2) an investment fund managed by a management company. The Law on CIU does not provide any restriction on investment objects of the abovementioned VCIV and therefore cross-border investments in Venture Capital are allowed. However, since the abovementioned forms of the collective investment undertakings are not harmonized with Council Directive 85/611/EEC as of 20 December 1985, their units or shares may not be distributed in other Member States if this is not allowed in the national legislation of the respective state. This rule does not restrict the acquisition of shares or units of the VCIV directly from Lithuania.

VCIVs in the form of a joint stock company are always considered as opaque. According to the provisions of the Law on Corporate Income Tax (hereinafter – the CIT), except for dividend income or any other income from distributed profits, investment income of VCIVs is treated as non taxable income. Other types of business income (if any) are subject to 15% CIT.

Dividends received by the VCIV in form of a joint stock company are subject to 15% CIT and may be reduced to 0% in case of qualified participation (not less than 10% of the shares for not less than 12 consecutive months, including the month dividends are paid). Capital gains upon disposal of investments would not be subject to CIT in Lithuania.

Returns of capital distributions due to the redemption of shares are treated as follows:

- a part exceeding the shareholder's contributions is treated as dividends and taxed accordingly.
- a part not exceeding the shareholder's contributions is not taxed.

Net wealth tax, Value Added Tax (although some exceptions may apply i.e. operating income is a subject to general VAT taxation), Capital Duty, and Subscription Tax are not applicable to VCIVs. Under the participation exemption, dividends paid by the Lithuanian resident to a VCIV are not subject to CIT if the recipient is a company (not located in a tax haven) that holds more than 10% of the shares of the payer of the dividends for a period of at least 12 months. According to the "Thin capitalization" rule, interest and foreign exchange loss on controlled debt are not classified as allowed deductions. Controlled debt is a company's interest bearing debt to controlling persons at the end of the respective tax year, the ratio of which in relation to the company's equity (excluding results for the year) exceeds the ratio of 4:1.

Dividends paid to foreign corporate shareholders are subject to 15% withholding tax. Under the domestic Law on CIT the withholding tax may be reduced to 0% in case of distribution to qualified participation held by a corporation (no less than 10% of the shares for no less than 12 months, including the month the dividends are paid on). The withholding tax rate can be also reduced by applying a Double Tax Treaty (hereinafter – the DTT). Dividends paid to foreign individual shareholders are subject to 15% withholding tax. The EU Savings Directive 2003/48/EC has been incorporated in Lithuanian legislation since 2005; however it will only come fully into force in 2011.

There is no clear legislation regarding transparency status of the VCIV in a form of a fund. The classical concept of transparency when all income and expenses of the entity are attributed to the share-/unit- holders of the entity is not applicable to the fund. However, it should be noted that the fund has some features of transparency described below. Though no practice on taxation of dividends distributed by a VCIV exist, it should not be taxable at source (at the level of a fund), as the fund does not represent a legal entity (and therefore a tax payer) in Lithuania. However it should be taxed at the level the recipient. Moreover, dividends paid by a Lithuanian entity to the VCIV in a form of a fund would not be taxed at the level of the paying entity.

The double tax treaty application depends on the transparency of the fund. Transparent funds would trigger application of the treaty with the investor's state; otherwise the treaty with a state where the fund is registered shall be applied. According to the Lithuanian Law on CIT, a foreign entity is treated as opaque from Lithuanian taxation perspective where the foreign entity has the status of a legal entity. If the entity does not have the status of a legal entity it would be considered as transparent and, therefore, the DTT of the investors' jurisdictions would be triggered, provided that the transparent entity discloses information on the investors.

Mutual Recognition Approach

From a DTT perspective, in general practice Lithuania applies a mutual recognition approach, i.e. in case foreign tax authorities provide a certificate of residence of the entity, it would be treated as opaque from a Lithuanian tax perspective. In case the fund proves its transparency, the DTT between Lithuania and the country of each investor would be applied. The transparency of the fund should be verified by the documents proving that the fund is not treated as a legal person.

Registration documents should be appropriate. The residency of the investor should be verified by a tax administrator's written certificate of residence. If the fund is transparent in Lithuania, in general payments to foreign investors would be taxed at source. If the fund is not a legal entity in Lithuania it would not be taxed with the CIT and it would not be able to use a withholding tax credit. Later payments at the level of the fund to the investors would not be taxable. Therefore the investor would not be entitled to a withholding tax reduction under a DTT, since there was no withholding a tax paid at the level of the fund. In this case double taxation exists. Lithuanian legislation does not provide for a tax relief in respect of income distributed by the Venture Capital fund to the investor.

LUXEMBOURG

The Luxembourg investment vehicles commonly used for Venture Capital ("VC") for cross-border investments can be divided into two regulated vehicles (the SICAR and SIF) and an unregulated vehicle (SOPARFI).

Unregulated local vehicles for Venture Capital investments

The SOPARFI (société de participations financiers) is a commercial corporate entity. It can be set up as a corporate vehicle - i.e. an S.C.A. (comparable to a corporate partnership limited by shares), an S.A. (similar to a public limited company), an S.à r.l. (similar to a private limited company) – or as a tax transparent partnership – i.e. as an S.C.S. (comparable to a limited partnership), an SNC (similar to an unlimited partnership) or a Société Civile (similar to a civil partnership).

The SOPARFI, founded as a corporate vehicle, is governed by the Law of 1915 on commercial companies and aims at investments in qualifying financial participations. It is not subject to the risk-spreading principle nor is it restricted to any specific type of investment.

The SOPARFI founded as corporate entity (S.A., Sarl or SCA) is subject to corporate income taxes (max. 28,59% for Luxembourg city), but there is a potential exemption for dividends, liquidation surplus and capital gains deriving from qualifying participations if certain conditions are met (Participation exemption, transforming the Parent Subsidiary Directive in national law). In Luxembourg no explicit thin capitalization rules exist, but as a general practice, a debt equity ratio of 85:15 is accepted by the tax authorities in the case of a corporate entity. There is no subscription tax, but the SOPARFI is subject to Net wealth Tax ("NWT") of 0.5% on the net assets as at 1st January of each calendar year. However, if certain conditions are met, an exemption for qualifying participations is available.

In addition, there is a possibility to reduce NWT by creating a special reserve.
The company is subject to a fixed registration duty of EUR 75 upon incorporation. The holding activities of the SOPARFI are not considered as economic activities for Value Added Tax ("VAT") purposes. Only if the SOPARFI performs other activities qualifying as economic activities may it qualify as a taxable person. In case a SOPARFI grants more than one loan to another company or recharges costs, it would be considered as performing economic activities and would qualify for VAT as a taxable person in Luxembourg.

Dividend distributions of a SOPARFI are generally subject to a withholding tax ("WHT") of 15%, but there is a possible exemption if the income is distributed to qualifying parent companies (located in EU and EEA Member States, as well as in jurisdictions with which Luxembourg has concluded Double Taxation Treaties) and certain conditions are fulfilled. In case that the exemption is not applicable, reduced tax treaty rates are available for a corporate entity. There is no WHT on liquidation proceeds and capital gains deriving from liquidation, redemption or disposal of qualifying participations if certain conditions are fulfilled. There is generally no WHT on interest payments. The SOPARFI is potentially in scope of the EU Savings Directive for interest payments.

A SOPARFI founded as corporate entity has unlimited access to double tax treaties ("DTT"). In case of transparent entities there is only limited access to some DTT at the level of the partners.

Regulated local vehicles for Venture Capital investments

Among the Luxembourg regulated investment vehicles, the SICAR and the SIF are of special interest for the Venture Capital industry. The SICAR (Société d'Investissement en Capital à Risque) was introduced by the Law of 15 June 2004. In all cases where the SICAR Law does not explicitly derogate there from, the SICAR is subject to the Law of 1915 on commercial companies. It may be set up as an S.C.A., S.A., S. à r.l. or S.C.S. (with fixed capital). The SICAR aims at (either directly or indirectly) contributing assets to entities during their launch, development or listing on a stock exchange, without being subject to risk-spreading requirements.

A SICAR founded as a corporate entity (SA, Sarl or SCA) is subject to corporate income taxes at a maximum of 28,59% (as from 2009 in Luxembourg City), but with several exemptions; i.e. the income derived from transferable securities and, at least for 12 months, for income on cash held prior to its investment in risk capital. Dividends, liquidation surplus, capital gains and interest are not subject to any WHT. Interest payments are potentially in the scope of the EU Savings Directive. There is neither a subscription tax nor Net Wealth Tax. There is a fixed registration fee of EUR 75. The management of investment companies like a SICAR subject to the supervision of the CSSF is VAT exempt and, as a result, a SICAR must under Luxembourg law be regarded as a taxable person for VAT purposes. If a SICAR is founded as a corporate entity, it has unlimited access to all double tax treaties ("DTT") in the view of Luxembourg, but this may be arguable in the view of several treaty countries. Transparent entities have limited access to some DTT at the level of the partners.

The Luxembourg specialized investment fund (SIF), introduced by the Law of 13 February 2007, replaced the fund regime dedicated to institutional investors which dates back to 1991. The SIF may be set up as an S.C.A., S.A., S.à r.l., S.C.S. (with fixed capital), S.N.C. (with fixed capital), or a Société Civile (with fixed capital), with variable (SICAV) or fixed (SICAF) capital; alternatively it may be structured as a FCP (contractual form). Though not explicitly aiming at direct or indirect investment in Venture Capital and though subject to risk-spreading requirements, the SIF offers an attractive regime and is often used as Venture Capital investment fund vehicle.

An SIF is a tax exempt fund vehicle (only a fixed registration fee of EUR 75 and a subscription tax are payable; the rate of subscription tax is reduced to 0.01%). SIF are NWT exempt. However, there is a fixed registration fee of EUR 75. The management of investment companies like a SIF subject to the supervision by the Luxembourg Supervisory Authority (Commission de Surveillance du Secteur Financier – CSSF) is VAT exempt and, therefore, under Luxembourg law, SIFs have to be regarded as taxable persons for VAT purposes. Dividends, liquidation surplus, capital gains and interest are not subject to any withholding tax. An FCP-SIF is potentially in scope for the EU Savings Directive. A SIF founded as SICAV / SICAF have limited access to some DTT whereas the FCP-SIF has no access to DTTs signed by Luxembourg (however, its investors may).

Mutual Recognition Approach

The classification given to an entity by the jurisdiction in which it is established is partially recognized. If it is an entity which is listed in Art. 2 of the Parent Subsidiary Directive or in a Double Tax treaty, the original classification will be accepted. Otherwise, the legal features of the foreign entity will be compared to those of the transparent Luxembourg company. If a foreign Venture Capital fund is qualified as transparent, the tax treaty with the investors should be applicable. The Luxembourg tax law does not provide for a clarification of which documents have to be provided to treat the fund as transparent or to determine tax residency of the investor. The practice of the Luxembourg tax authorities in such a case is that if enough documentation proves the transparency of the fund, Luxembourg will treat it as transparent and otherwise it will treat the fund as opaque.

In a case where the tax transparency is recognised, the Luxembourg tax authorities will request a certificate of tax residency from the investor who wishes to apply the DTT between Luxembourg as the state of residence of the target company and the investor's state of residence.

NETHERLANDS

Local vehicles for Venture Capital investments

The Netherlands does not have any specific regulated Venture Capital fund vehicles as such, but there are three vehicles which are commonly used in Venture Capital situations for cross-border investments: the CV (limited partnership), BV (limited liability company) or a Dutch Co-operative (legal association), possibly in combination with each other. The Co-operative ("Coop") and the BV are opaque for Dutch tax purposes, whereas a CV can be either transparent or opaque for Dutch tax purposes.

Whether or not a CV is considered transparent for Dutch tax purposes depends on the articles of association. In order to guarantee the tax transparency of a CV, prior written consent of all partners, limited and general, is required with respect to the admission or substitution of a limited partner. Presently, a CV does not have full legal personality under Dutch law, however new legislation is expected to come into force enabling partnerships to elect to become a legal personality while still preserving their tax transparency characteristics.

The Co-operative ("Coop"), the BV, and the CV that is not considered tax transparent, are opaque for Dutch tax purposes, and therefore subject to Dutch corporate income tax at a rate of 25.5% on all income and capital gains. Despite the relatively high tax rate, a Dutch corporate taxpayer, without special tax status, can still be a tax-efficient vehicle for certain equity investments. Based on the Dutch participation exemption regime, income (dividends as well as capital gains) derived from qualifying participations are fully exempt from taxation in the Netherlands, provided certain requirements are met (e.g. the interest in the nominal paid up share capital must amount to at least 5%). However, all losses incurred on the shareholding in the participation are generally non-deductible (except for losses realized upon liquidation, which, subject to meeting certain requirements, are not exempt under the participation exemption).

A transparent CV is not subject to Dutch Corporate tax in the Netherlands, and distributions to its partners are not subject to Dutch withholding tax. In addition, provided that the CV is managed and controlled outside the Netherlands, or provided that the funds' (CV) investment strategy does not exceed regular asset management, no Dutch tax liability should arise for foreign investors on their investment in a CV as such. This may be different in respect of the investment held by the CV if it regards equity stake in Dutch targets.

Dutch tax law contains specific rules for foreign resident individuals/entities holding a so-called substantial interest (in short, an equity interest of at least 5%) in a Dutch resident (opaque) entity. Income derived from such interest could be subject to Dutch tax, unless the interest forms part of a business enterprise of the interest holder. The latter may be met if the VC fund is capable of influencing the business policy of the Dutch target, e.g. by having a seat in the executive board. The Dutch tax authorities are currently only prepared to confirm this by way of an Advance Tax Ruling if the Fund obtains executive board seats in the investee companies. This condition cannot be met by most VC funds. Typically, VC Funds will have substantial involvement in the management and affairs of the investee companies (as a big minority shareholder or supervisory board member), but generally do not have a controlling interest and generally cannot enforce to be represented in the executive board. Buy-out funds take controlling (or significant) interests, and can enforce board representation. This is a clear obstacle for VC Funds in attracting international investors, because investors from outside the Netherlands generally prefer to invest in a tax transparent CV. In such situation further structuring would be required to mitigate any tax inefficiencies.

If the activities carried on by the Dutch resident CV were to exceed regular asset management, this could result in a permanent establishment in the Netherlands of the investors in the transparent CV. However, for corporate foreign investors this should not have any adverse tax consequences, as income derived from equity investments (forming part of the permanent establishment) should be exempt under the Dutch participation exemption (provided certain requirements are met). The Netherlands do not levy branch withholding tax.

A Dutch BV and Coop, being Dutch corporate taxpayers, should normally be entitled to tax treaty benefits. If foreign investors invest in a Dutch target through a Dutch transparent CV (or a foreign fund that is transparent for Dutch tax purposes), then the treaty between the country of residence of the investors and the Netherlands should be applied to income derived from the Dutch target.

The Netherlands do not levy any stamp duties or other taxes upon capital contribution in an investment vehicle. In addition, no annual subscription tax or corporate net worth tax is levied in the Netherlands.

Withholding tax

Profit distributions by regular taxable Dutch resident entities are in principle subject to dividend withholding tax at the statutory rate of 15%. Based on Dutch tax law, no dividend withholding tax is in principle levied on profits distributed by Coops. If, the dividend is received by a Dutch resident entity, and at the level of the recipient the participation exemption applies to the dividend, no dividend withholding tax is due either.

Furthermore, based on Dutch tax law, there is no statutory withholding tax on interest- and royalty payments

Tax treaties concluded by the Netherlands and other countries usually reduce the dividend withholding tax in case the minimum ownership requirement is met.

A 0% dividend withholding tax rate generally (subject to certain conditions) applies in situations where the shareholder is:

- a taxable entity resident in an EU Member State holding an interest of at least 5% in the Dutch investment vehicle;
- an entity that is resident of a country with a tax treaty with the Netherlands that provides for a 0% rate, such as the United States, Switzerland, Iceland, the United Arab Emirates, Singapore or Barbados. In this case, a minimum ownership is also required (usually 25% or 10%), depending on the specific tax treaty applicable;
- a tax-exempt qualifying pension fund or non-profit organization that is resident in an EU Member State;
- a US qualifying pension fund or non-profit organization.

Mutual Recognition Approach

Dutch tax law has it own rules concerning the qualification of legal forms as either transparent or non-transparent. This means that the Netherlands does not apply a mutual recognition approach on foreign entities. The Netherlands do not apply the approach articulated in paragraph 6.5 of the Commentary on article 1 of the OECD MTC either, unless such an approach is specifically included in a tax treaty itself.

Foreign funds should, for Dutch tax purposes, be qualified as either transparent or opaque. As a result, it could be that a foreign fund that invests in the Netherlands is opaque for Dutch tax purposes, whereas it is transparent for foreign (local) tax purposes. As a result the fund may not be eligible for treaty benefits. However, in practise this can easily be avoided by appropriately structuring the investment. It is even possible to obtain certainty in advance in this respect, by way of an advance tax ruling from the Dutch tax authorities.

POLAND

Local vehicles for Venture Capital investments

There are no specific vehicles in Poland for the purpose of direct or indirect investment in Venture Capital. Usually, partnerships, corporate entities or closed investment funds are used for such investments.

Corporate entities are subject to corporate income tax ("CIT"). There are no specific CIT exemptions for vehicles used for Venture Capital investment purposes. There is no Net Wealth Tax and subscription tax in Poland. However, income tax, value added tax, transaction or capital tax, real estate tax and other taxes are applicable in relevant cases. There is no participation exemption regime established in Poland. Under the Polish thin capitalization rules, interest due on loans or credits granted to the taxpayer by the shareholders (holding directly, individually or jointly, not less than 25% of the voting rights in the loan beneficiary (parent companies)) or, by sister companies (where the same shareholder holds directly at least 25% of the voting rights in both of these companies (the borrowing company and the lending company)), may not be recognized as a tax deductible cost as regards the part by which the borrowing company's debt to equity exceeds – at the date of interest payment – the ratio of 3:1, as defined in the Polish law. There seem to be some negative developments in the practice of Polish tax authorities regarding the thin capitalization issue, as the tax authorities try to claim that an indirect holding may also trigger thin capitalization restrictions.

Provided that the following conditions are jointly met (below), generally, dividends paid from Poland to investors abroad are subject to 19% withholding tax (“WHT’) in Poland unless relevant double tax treaties (“DTT”) concluded by Poland provide otherwise. It is also possible to apply exemption from WHT in Poland with respect to dividends paid by the Polish tax resident to its EU / European Economic Area ("EEA") based shareholder, based on the Polish CIT Act provisions implementing the EU Parent - Subsidiary Directive:

- The foreign dividend recipient is subject to income tax on its worldwide income in one of the EU / EEA Member States,
- The foreign dividend recipient holds at least 15% of the Polish company's shares (10% from 2009 onward),
- The foreign dividend recipient holds the Polish company's shares for an uninterrupted period of at least 2 years (2-year holding period can be met after the dividend has been paid out; if shareholder takes advantage of the exemption prior to the expiry of that period and then loses its qualifying share in a subsidiary within 2 years counting from the date of acquisition thereof, it will be liable to file an adjusted tax return and transfer the amount of the WHT, as well as default interest accrued thereon).

In order to apply the DTT / EU Directive reduced WHT rates or the DTT / EU Directive exemption from WHT on dividends, the Polish taxpayer should obtain a certificate of residence. Failure to obtain such a certificate may trigger Polish WHT at the standard rate (19%). In the case of a company liquidation, the liquidation proceeds should, in principal, be treated in Poland as dividend income. Furthermore, income resulting from the redemption of shares should be treated as a dividend income. The sale of shares is subject to 19% taxation in Poland; however the provisions of the DTT may overlap with Polish internal regulation so that the income from the sale of the share will be taxed only in country where the income recipient is a resident. As a result, a case-by-case analysis is required. The EU Savings Directive has been implemented to the Polish tax law only with respect to the exchange of the information regarding payments made to EU residents.

In general, partnerships are transparent for corporate income tax ("CIT") purposes. This means that taxable revenues generated by the partnership, tax deductible costs, tax non-deductible costs, tax exemptions and allowances, reduced income, taxable base or tax are directly combined, in appropriate proportions, with the taxable revenues, tax deductible costs, tax non deductible costs, etc. of its partners.

Investment funds established on the basis of the Polish Act on Investment Funds[68] are exempt from CIT. This rule refers to both open-ended (including specialized funds) and closed-ended investment funds. Tax may be due however from the investors at the date of the fund’s certificate disposal – provided that the investor is subject to tax obligation in Poland.

Currently, it is understood that the Polish government is working on legislation that will allow investment funds from other European Union countries to also benefit from the corporate income tax exemption in Poland. However at this stage it is not clear if / and/or when the legislature procedure will be finalized.

Mutual Recognition Approach

Generally, only the individual or a company having unlimited tax liability in its country of residence may benefit from the protection given by the provisions of the relevant DTT. In this respect should the fund vehicle be transparent from the income tax perspective the DTT

[68] *Reference to be added/completed*

provisions will be applicable at the level of investors. In principal, Poland respects classification given to an entity by its jurisdiction. Nevertheless, a case-by-case analysis is required in each separate scenario.

PORTUGAL

In Portugal, specific vehicles that allow for direct or indirect investments in Venture Capital exist. Decree-Law 375/2007 of 8 November sets forth disciplinary provisions for the constitution and activity of the following vehicles, the activity of which is to invest and to acquire investment units in companies with high growth potential, as well as to contribute to their development and to benefit from the respective appreciation in value:

- Venture Capital Companies (so-called "Sociedades de Capital de Risco") are incorporated as joint public companies (so-called "Sociedades Anónimas"). Portuguese legislation provides for the existence of Venture Capital Companies having the management of Venture Capital Funds as their main and exclusive objective;

- Ventures Capital Investors, also known as "business angels" (so-called "Investidores em Capital de Risco") are incorporated as a sole shareholder limited liability company, which can only be held by an individual;

- Venture Capital Funds (hereinafter "VCF", so-called "Fundos de Capital de Risco) are standalone assets, without a corporate entity, belonging to the holders of investment units as a whole, formed with the purpose of being invested, for limited periods of time, in companies with high-growth potential. Each VCF is administered by a management company.

The comments set out below are confined solely to the VCF:

Despite not having a legal personality, the VCF is deemed as a Corporate Income Tax taxpayer and is not qualified as "transparent" entity for Corporate Income Tax (CIT) purposes. Consequently, investors (i.e. unit-holders) are only taxable in respect of income which is effectively distributed to them by the VCF.

A VCF, although being liable for Corporate Income Tax, is tax exempt. The VCF is a VAT taxpayer, although most of its operations would tend to fall within the scope of the VAT (partial[69]) exemption on financial operations. The VCF may be subject to Stamp Duty provided that it carries out operations that fall within the scope of the Stamp Duty General Chart and which are not subject or exempt from VAT. Stamp Duty is, for instance, levied on the granting of credit, guarantees, as well as on interest, commissions charged by financial institutions. There are no thin capitalisation rules applicable on a VCF.

In Portugal, withholding tax is generally not levied on distributions from the VCF to non-resident unit-holders. However, this exemption does not apply (and non-resident unit-holders are subject to a 10% WHT) if:

- The non-resident is resident in a 'black-listed' territory (i.e. "Tax Haven");
- Resident entities that own more than 25%, directly or indirectly, of a non-resident entity.

[69] *I.e., exemptions that do not grant the right to deduct the VAT incurred with the inputs.*

With respect to income distributed from the VCF to resident unit-holders, the following taxes are withheld:

- Individuals (not acting in the course of a business): subject to a final 10% WHT;
- Companies and Individuals acting in the course of a business: subject to a 10% WHT (as a payment on account of the final tax due); income is included in the taxable basis and subject, respectively, to the ordinary Corporate Income Tax and Individual Income Tax rates;
- Exempted taxpayers in respect of investment income, are also exempt on income distributed by the VCF.

With regard to capital gains derived from the sale of the participation units in the VCF, no withholding tax is levied for non-resident unit-holders. However, the exemption does not apply (and the positive net balance between capital gains and losses arising from the disposal of participation units is autonomously taxed at a 10% special rate) if:

- The non-resident is resident in a 'black-listed' territory (i.e. Tax Haven);
- Resident entities that own more than 25%, directly or indirectly, of a non-resident entity

With regard to capital gains derived from the sale of the participation units in the Fund, the following rules apply to resident unit-holders:

- Individuals (not acting in the course of a business): the positive net balance between capital gains and losses arising from the disposal of participation units is autonomously taxed at a 10% special rate;

- Companies and individuals acting in the course of a business: capital gains and losses are included in the taxable basis and subject, respectively, to the ordinary Corporate Income Tax and Individual Income Tax rates.

As mentioned above, VCF are deemed as "taxpayers" for Corporate Income Tax purposes. The issue relies on whether the VCF should be deemed as a "person/company" for the purposes of a Double Tax Treaty, needs be analysed on a case-by-case basis, in light of the wording of the applicable Double Tax Treaty.

ROMANIA

Although there is no special legal or tax regime, and no special vehicles in respect of Venture Capital investment, there exist similar concepts to these funds in Romania, namely the Law of the capital market, under the name of ˝types of collective investment organisations˝.

Romania does not apply tax relief to Romanian resident individual investors in foreign VC funds. They have to declare all their world wide income. (However, the foreign individuals not domiciled in Romania but whose center of vital interests is in Romania or have a presence in Romania for a period or periods that exceed in aggregate 183 days in any consecutive 12 month period ending in the calendar year concerned, become subject to tax in Romania on their world wide income starting with the fourth year of meeting such conditions; by then, only the income derived from Romania is subject to Romanian tax). For foreign investors in transparent Romanian VC fund vehicles, usually the treaty with the investor´s residence state is applied. For opaque entities, dividends paid to non-resident corporate shareholders are subject to 16% withholding tax (respectively, 10% for dividends paid to a corporation resident in other EU or

EFTA Member States; moreover no Romanian withholding tax would be due for dividends if such an EU or EFTA corporate resident holds at least 10% in the Romanian company for a period of at least two years), while foreign individual shareholders are taxed at 16%. Note that where a tax residence certificate is available the provisions of the double tax treaty between Romania and the other state could apply, and consequently the tax rates could decrease.

Mutual Recognition Approach and treaty application

There are no clear rules; Romanian authorities tend to use the OECD Model Tax Convention.

SLOVAKIA

There are no specific vehicles in Slovakia for the purpose of investment in VC. Investment in VC can be made through common vehicles allowed under Slovak legislation. These vehicles can be either transparent or opaque.

The Slovak Income Tax Act does not provide for any specific tax regimes or exemptions for investment in VC, so general tax rules are applicable in this case. As a general rule, dividends are not subject to tax, whether they are paid to any legal entity or individual, resident or non-resident.

Interest payments are generally tax deductible, in compliance with the Income Tax Act. Interest paid to non-residents is subject to a 19% WHT, unless an exemption under the EU Interest and Royalty Directive (as implemented in the Slovak tax legislation) or a DTC applies.

Mutual Recognition Approach and Treaty Application

Slovakia in general follows the mutual recognition approach from a commercial law perspective, i.e. Slovakia respects the classification given to an entity by its jurisdiction. Generally, in the case of opaque entities the DTT between Slovakia and the country of residence of the entity would apply, and in the case of transparent entities, the DTT between Slovakia and the country of residence of partners (investors).

SPAIN

Local vehicles – eligible for Venture Capital investments

In Spain there are specific vehicles that enable direct or indirect investment in Venture Capital, namely Venture Capital Companies ("VCCs") which have legal personality and Venture Capital Funds ("VCFs") which do not have legal personality. These vehicles may be used both for domestic and cross-border investments in Venture Capital. In the Basque Country other vehicles with similar characteristics called "Sociedades de Promoción de Empresas" exist; however the following comments are solely dedicated to Venture Capital Companies and Venture Capital Funds.

Spanish Venture Capital entities ("VCEs"), regardless of being Venture Capital Companies or Venture Capital Funds, are opaque for tax-purposes and are as a general rule, tax resident in Spain.

These entities are provided with a special and favourable tax regime. A special tax treatment for VCEs includes a 99% tax relief of the burden attributable to capital gains obtained through the transfer of shares and participations in the capital of companies (the targets), in the event that the transfer, computed as from the moment of the acquisition, occurs after a year and before year 15 (and exceptionally before 20 years). Given such 99% tax relief, the effective final taxation would be 0.3% of the gain arising from the transfer of the targets by the VCE (1% x 30% - i.e. standard Corporate Income Tax rate-). This special treatment will apply with certain limitations.

Venture Capital Entities may apply a tax credit to avoid Spanish double taxation on dividends received and a participation exemption to avoid international double taxation, regardless of the interest and holding period. Note that the rest of the income received by these entities will be taxed at the standard Corporate Income Tax rate of 30%, (i.e. interest, income derived from profit participating loans, etc.).

A thin-capitalisation rule applies in Spain. Any interest paid on loans from foreign related parties in excess of a 3:1 debt-to-equity ratio is treated as dividends. This ratio may be increased through an advance pricing agreement process. Thin-capitalisation rules do not apply if the lender is an EU-resident company that does not reside in a territory included in the Spanish tax haven list.

With regard to indirect taxes, the management and deposit of shares and units in VCEs are services that are exempt from value added tax. Also, operations consisting on the incorporation and capital increase of VCEs will be exempt from Stamp Duty

Among the income obtained by shareholders, one may distinguish the treatment of dividends and gains, depending on the characteristics of the taxpayer.

Dividends:

(a) When the taxpayer is a Spanish Corporate or a Non-Resident with a Spanish Permanent Establishment, a full deduction to avoid the Spanish double taxation may be applied, regardless of the interest and holding period. In the case of individuals, dividends received in excess of the amount of Euros 1,500 per year, will be subject to taxation, as any other dividend, that is, at a fixed tax rate of 18%;

(b) In the event that the taxpayer is a Non-resident without a permanent establishment, the income is not regarded as coming from a Spanish source therefore it will not be subject to Spanish taxation. However, this income characterization will not apply when the income is obtained through a territory qualified as a tax haven.

Capital gains:

(a) Spanish entities and Non-Resident with a Spanish permanent establishment may apply a full deduction for the part of the gain (derived from the transfer of the VCE's shares/units) corresponding to the non-distributed earnings, regardless of the interest and holding period;

(b) When the taxpayer is a Non-resident without a permanent establishment, the income is not regarded as coming from a Spanish source and thus it will not be subject to Spanish taxation. However, this income characterization will not apply when the income is obtained through a territory qualified as a tax haven.

In the view of Spain, VCEs are taxpayers of the Corporate Income Tax and as such it can be understood that these vehicles fit the definition of Article 3 of the Model OECD Convention and therefore should be considered "companies", having access to the Double Tax Conventions.

Mutual Recognition Approach and treaty application

Spain does not apply a mutual recognition approach. Instead, if the foreign entity is tax transparent as per the domestic regulations applicable in the foreign entity's country of origin, it will be reasonable that its shareholders/unit holders can request the application of the conventions signed by their State and Spain. It should be noted that, although the wording of Spanish Law pays attention to the legal nature of the foreign vehicle to treat it as transparent for tax purposes in Spain and to apply to it the look-through approach up to its shareholders/unit holders, the Spanish Tax Authorities go further and apply the look-through approach whenever the vehicle is transparent for tax purposes in its country of origin, regardless of whether it holds legal personality or not.

If the target company is a Spanish tax resident, the fiscally transparent venture capital entities are established in another State, and the investors are resident in another State or in the same State of the fund, the shareholders/unit holders may claim the benefits of the Convention signed between their respective State of residence and Spain. The investors must provide a tax residence certificate issued by the tax authorities of their State of residence proving their tax residence in the sense of the applicable treaty, and the fund must provide the documentation that is required by the Spanish tax authorities to determine whether or not it is transparent for Spanish tax purposes.

SWEDEN

1 Available structures

1.1. The principal structures which may be used for VC funds in Sweden are as follows:

(a) a Swedish limited partnership;

(b) a Swedish consortium; and

(c) a foreign structure:

(i) a foreign company; or
(ii) a foreign limited partnership.

In addition to the abovementioned structures, there are at present some private equity vehicles structured as limited liability companies. However, the limited liability company is normally only used for family and friends funds while the limited liability company structure has limitations which are not acceptable to professional investors.

2 The Swedish limited partnership

2.1. A limited partnership and all partners must be registered in Sweden at the Swedish Companies Registration Office. Limited partnerships consist of one or more limited partners and at least one general partner. A limited partner will not, under the provisions of the Swedish act governing limited partnerships, have any obligation for the debts or liabilities of the limited partnership in excess of the amount which it has committed to the limited partnership. The general partner will solely be responsible for the limited partnership's debts and liabilities which exceed the responsibility of the limited partners.

2.2. The limited partnership is tax-transparent and thus the limited partners will be taxed directly at the time the income arises in the limited partnership. The income (profits and losses) from the limited partnership will be taxed in the resident state of each limited partner, unless the business income is deemed to derive from a permanent establishment in Sweden. In an advance ruling, the income from a limited partnership was deemed to be derived from a permanent establishment in Sweden. It should be noted, however, that the matter has not been subject to judgement by the Supreme Administration Court.

2.3. Due to the fact that any income from the limited partnership which is taxed in Sweden will probably be deemed to be business income, this causes a less favourable tax situation for Swedish tax resident natural persons and certain other entities liable for Swedish income tax, which have favourable tax treatment for capital gains in Sweden. Discussions have been made with the government to achieve equal treatment for the investors regardless of whether they invest via a limited partnership or directly in the investee company. It is expected that the government will soon change the rules so that such equal treatment is achieved. In the meantime, some investors might invest directly and in parallel with the limited partnership in order to achieve favourable tax treatment for capital gains.

UNITED KINGDOM

Local vehicles for Venture Capital investments

In the UK the typical vehicle for making investment into Venture Capital assets is an English Limited Partnership ("ELP"). It is fiscally transparent and is subject to various confirmatory agreements between the UK tax authorities and the British Venture Capital Association ("BVCA"). In addition there are some quoted Venture Capital Trust structures. These are subject to strict regulation and are broadly aimed at channelling the investments of retail investors to very small (typically under £1million) underlying Venture Capital investments in the UK. Given their limited nature we have not discussed these further here. The ELP is often used for cross border investments.

An ELP is treated as being tax transparent in most jurisdictions. Investors are taxed on underlying investment income and capital gains as if it is their own – there are no specific exemptions.

There is no withholding tax ("WHT") levied on payments out of the fund.

The UK would apply a double tax treaty ("DTT") at the level of the investor in the transparent fund, not at the level of the fund itself. Therefore, it is necessary for investors to claim any treaty credits etc. by making their own tax filings.

The UK approach for classification of a foreign entity is generally driven by case law. The UK looks at the fundamentals of the foreign entity under the non-tax laws applicable to its legal form in its own country. Often this leads to the same analysis as the home jurisdiction, but not always. For example US LLCs are opaque for UK but normally transparent for US tax purposes.

Mutual Recognition Approach

There can be mismatches where one jurisdiction regards an entity as transparent and another as opaque, which leads to double taxation problems. The UK does not provide any specific exemption from this problem. This seems not to be a large-scale problem for the common ELP structure outlined above. In most jurisdictions the ELP is regarded as tax transparent (which is one of its attractions). Therefore there should be relatively few mismatch issues caused by non application of the mutual recognition principle, but there are some jurisdictions within the EU that do not recognise the transparency of the ELP, which does create problems (such as France and Italy).

ANNEX VIII

LIST OF THOSE MEMBERS OF THE EXPERT GROUP WHO HAVE AGREED TO HAVE THEIR NAMES PUBLISHED

COUNTRY	EXPERT	ORGANISATION
FINLAND	**Ilkka HARJU**	*Ministry of Finance* *Financial Markets Department*
FINLAND	**Jyrki TÄHTINEN**	*Borenius & Kemppinen*
GERMANY	**Stefan BEHRENS**	*Clifford Chance*
GREECE	**Fotini FANARA** **Ioannis ANASTASIOU**	*Ministry of Economics and Finance –Taxation & Customs Matters* *Ministry of Economics and Finance –Taxation & Customs Matters*
HUNGARY	**Laura FEHÉR**	*Ministry of Finance* *Department of Income Taxes*
IRELAND	**Paul RYAN**	*Irish Department of Finance – Taxation and Financial Services Division*
ITALY	**Fabio BRUNELLI**	*Di Tanno e Associati*
LUXEMBURG	**Alain KINSCH**	*Ernst & Young S.A.*
LUXEMBURG	**André PESCH**	*Ernst & Young S.A.*
NETHERLANDS	**Marco DE LIGNIE**	*Loyens & Loeff*
PORTUGAL	**Paulo CAETANO**	*APCRI – Associação Portuguesa de Capital de Risco e de Private Equity*
ROMANIA	**Diana CRACIUN**	*Ministry of Finance – Direct Tax Legislation*
SLOVAK REPUBLIC	**Radomil KURKA**	*Ministry of Finance – Taxation and Customs Section*
SPAIN	**Rodrigo OGEA**	*Baker & McKenzie*
SWEDEN	**Ulf SÖDERHOLM**	*Andulf Advokat AB*
UNITED KINGDOM	**Mark HAINSWORTH**	*SJ Berwin LLP*
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INTERNATIONAL	**Maria LEANDER**	*European Investment Fund*

http://ec.europa.eu/venture-capital/index_en.htm

European Commission