70th CONGRESS OF THE INTERNATIONAL FISCAL ASSOCIATION

25-30 SEPTEMBER 2016
MADRID · SPAIN

INTERNATIONAL FISCAL ASSOCIATION 2016

Taxation of Venture Capital:
Funds, Managers and investment structure

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Taxation of Venture Capital: Funds, Managers and investment structure

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INTRODUCTION

- Funds are groups of investors pooling their resources to invest in Business, principally in securities.
- Private equity capital means funds available to invest in private companies.
- Venture capital means funds made available for startup firms and small business with exceptional growth.
- Venture money is not long term money. The venture capitalist buys a stake in an entrepreneur’s idea, nurtures it for a short period of time and the exits.

FUND STRUCTURE

- Main categories:
  - Regulated funds (e.g. UCITS, EUVECA, RAIT, SCR).
  - Non regulated funds.
- Tax regime of the fund vehicle:
  - exempt entity or quasi exempt
  - Look-through entity
- Funds may be structured as a partnership, a corporation, a trust or as a coownership agreement

FUND STRUCTURE

- Manager
  - External manager
  - Internal management, when the legal form of the Fund permits it.
- Manager out of the scope of the AIMFD:
  - Portfolios of AIFs whose assets under management, including any assets acquired through the use of leverage, in total, do not exceed €100M.
  - Portfolios of AIFs whose assets under management, do not exceed €500M, when the portfolios of AIFs consist of AIFs that are unleveraged and have no redemption rigth exercisable during a period of 5 years following the date of the initial investment in each AIF.

FUND STRUCTURE

Investors

Investors

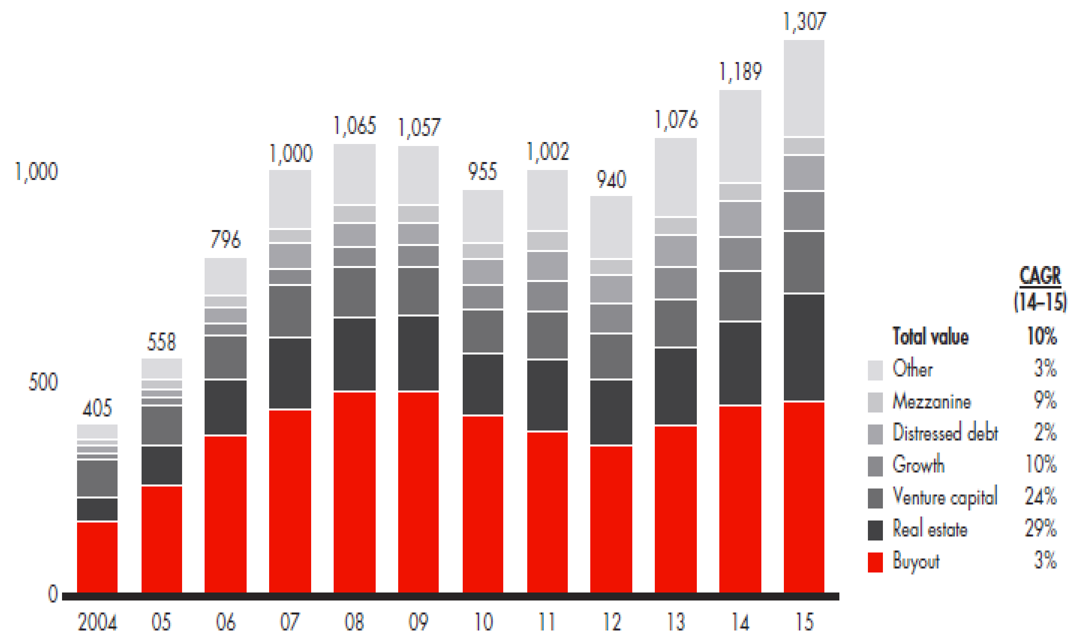
Blocker

Management company

FUND
(SICAV, Trust, Partnership)

Investments

MARKET TRENDS



MARKET TRENDS

Exits

Global buyout-backed exits

$500B

400

300

200

100

0

2011 12 13 14 15

Fund-raising

Global buyout capital raised

$500B

400

300

200

100

0

2011 12 13 14 15

Investments

Global buyout deal value

$500B

400

300

200

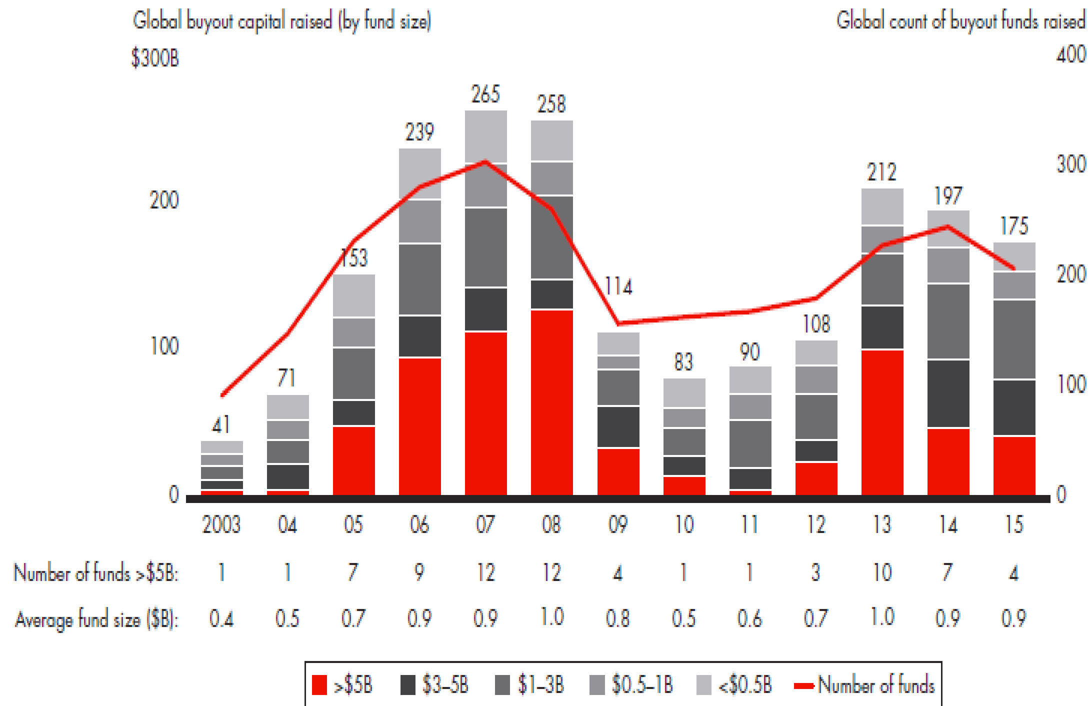
100

0

2011 12 13 14 15

Sources: Preqin; Dealogic

MARKET TRENDS



EU POLICY FRAMEWORK FOR ALTERNATIVE INVESTMENT

- The top priority is boosting jobs and economic growth in Europe.
- More difficult to get bank financing since the banking crisis.
- Market-based financing can complement bank lending to provide alternative sources of finance.
- A more diversified financial system creates a bigger range of financing options, particularly for SMEs.
- Capital market union.

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EU COMMISSION UPDATE AND VIEWS FROM THE INDUSTRY

- Venture capital market in Europe.
- Venture capital market in US and Asia.
- The EU Fund framework and the revision of the EUVECA Regulation.

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VC FUNDRAISING IN EUROPE

Funds raised by type of investor, % of total amount, 2011-15

35%
30%
25%
20%
15%
10%
5%
0%

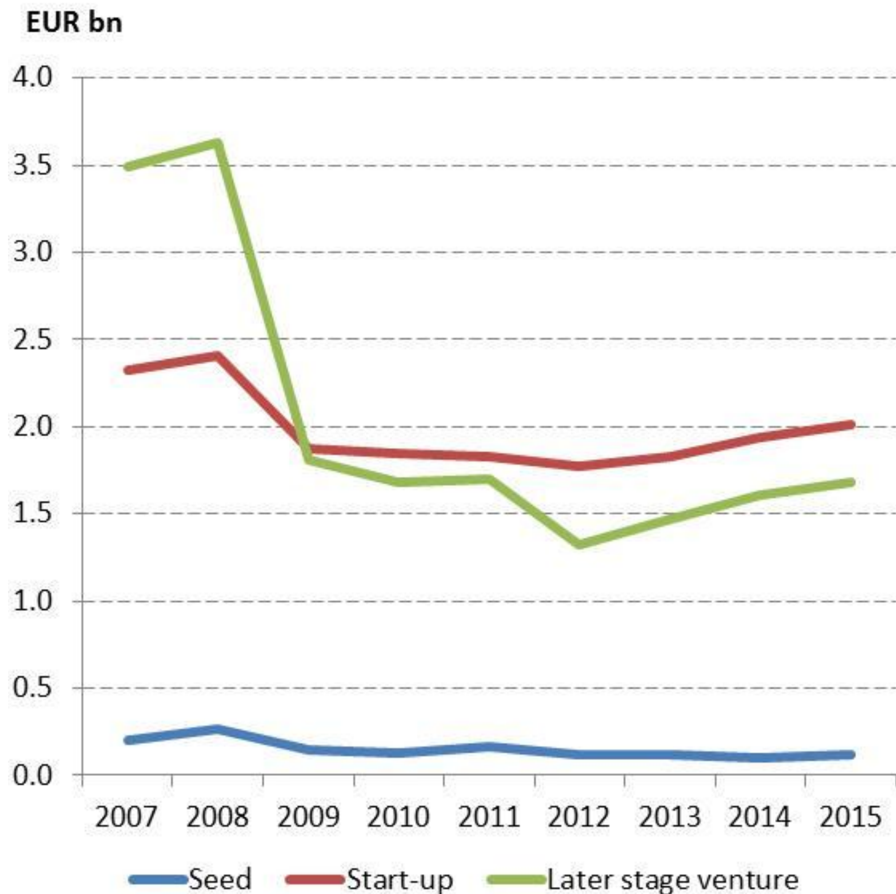
2011 2012 2013 2014 2015

- Academic institutions/Endowments/Foundations
- Banks
- Capital markets
- Corporate investors
- Family offices and private individuals
- Funds of funds and other asset managers
- Government agencies
- Insurance companies
- Pension funds
- Sovereign wealth funds

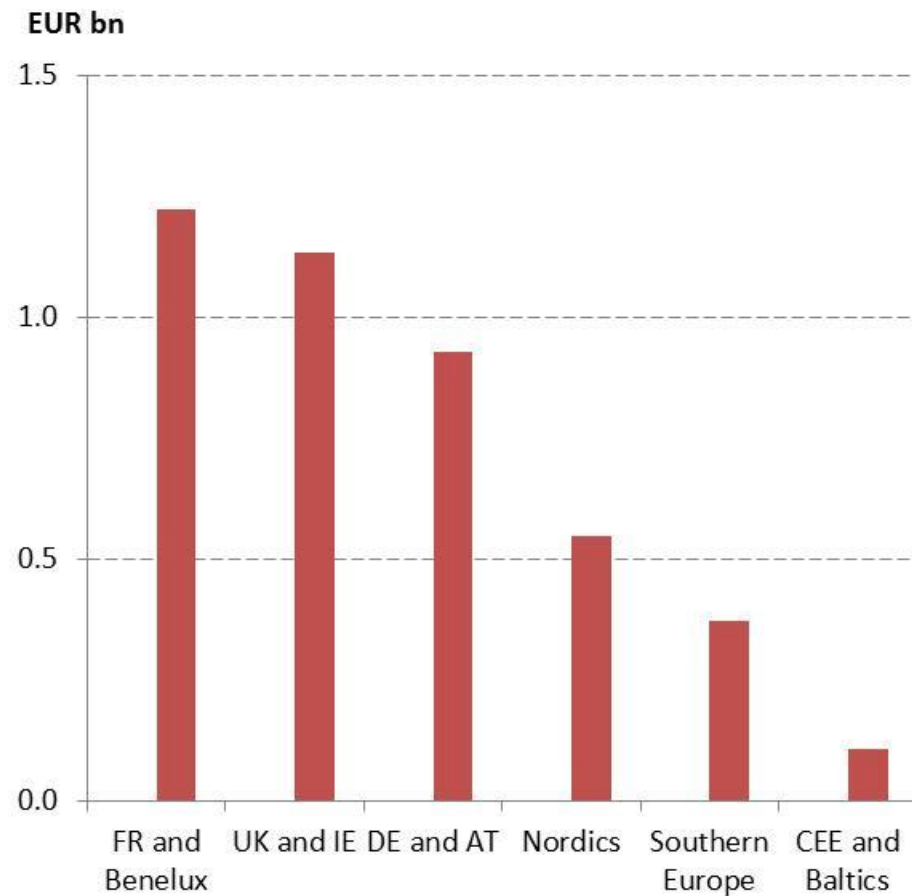
Source: InvestEurope

VC INVESTMENT IN EUROPE

VC investments by stage, 2007-15



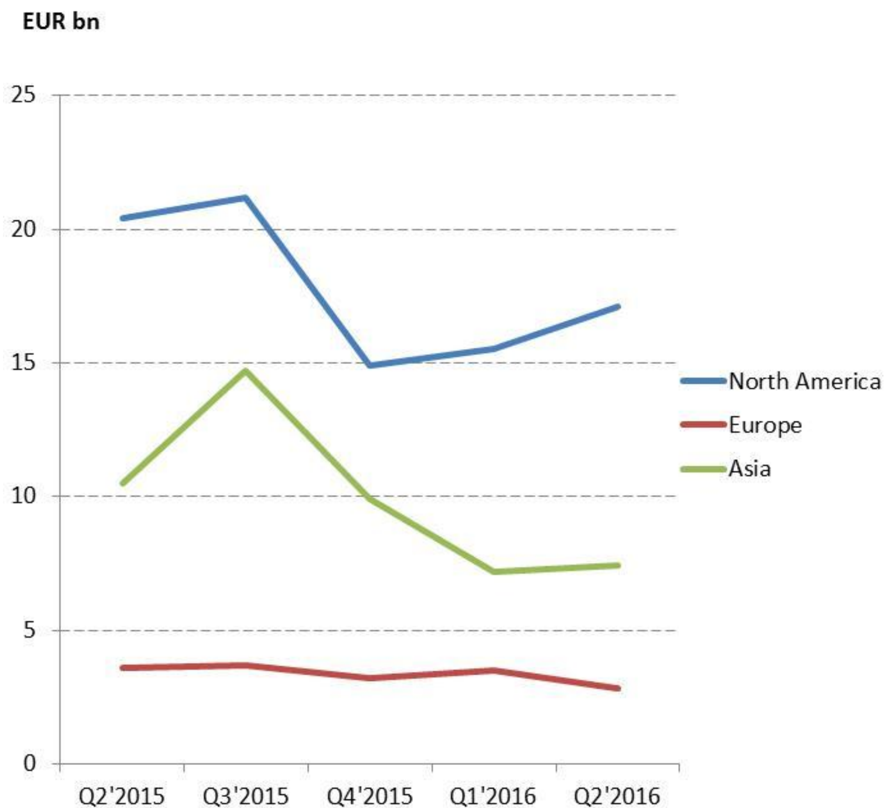
VC average yearly investments by region, 2007-15



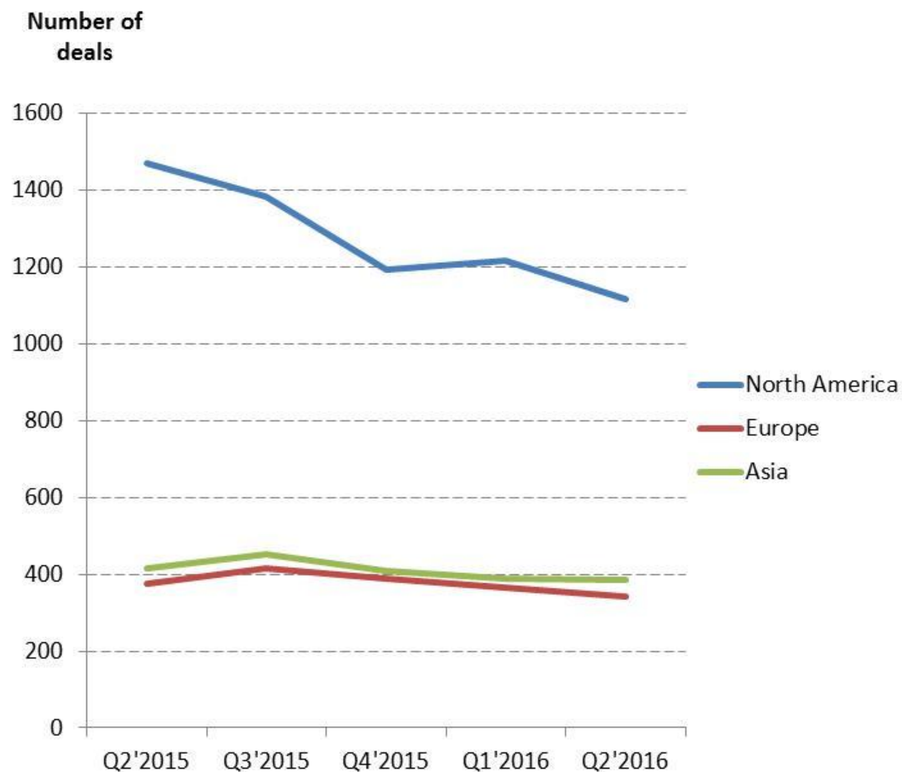
Source: InvestEurope

VC INVESTMENT IN EUROPE, NORTH AMERICA AND ASIA

Investment by continent, Q2'2014 – Q2'2015



Deal count by continent, Q2'2014 – Q2'2015



Source: KPMG and CB Insights

EU FUND FRAMEWORKS

UCITS

MMF

AIF

ELTIF

EuSEF

EuVECA

AIFM > € 500m AUM

EUROPEAN VENTURE CAPITAL FUNDS (EUVECA)
EUROPEAN SOCIAL ENTREPRENEURSHIP FUNDS (EUSEF)

WHY?

- Facilitate access to funding for SMEs / Social Entrepreneurs.
- Facilitate investing in young & innovative SMEs / Social Enterprises.
- Achieve "critical size" for venture capital / social funds.

HOW?

- Creating a recognized EU brand for venture capital / social funds.
- Improving investor protection.
- Breaking down barriers to fundraising across Europe.

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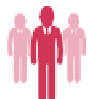
MAIN FEATURES OF EUVECA AND EUSEF

- EU-wide passport: Uniform rules for fund marketing, portfolio composition, eligible investment instruments, conduct & transparency.
- Invest at least 70% of capital in "qualifying investments‟.
- Flexibility in how they can invest e.g. equity, quasi-equity, debt, and other types of participation.
- Strict limits on borrowing & leverage.
- Open to professional investors & non-professional (min. €100.000 and state in writing they are aware of the risks).

BARRIERS



Low take-up and assets under management below expectations

- Few managers
- Few funds
- Small investors base
- Definition of SMEs (in EuVECA)

Lack of cross-border business

- Inconsistent application by Member States
- Disproportionate total costs, including own funds and supervisory fees

PROPOSED CHANGES

- Allow AIFMD-authorised managers to manage and market EuVECA and EuSEF funds.
- Expand eligible assets: small mid-caps, SMEs listed on SME Growth Markets, follow-on investments in firms exceeding qualifying portfolio criteria.
- Maintain the €100,000 minimum investment for non-professional investors.
- Explicit clarifications to avoid burdensome administrative processes and additional measures (including fees and non-proportionate requirements).

TIMELINE

- Commission legislative proposal adopted July 2016.
- Under negotiation in European Parliament and Council.

INDUSTRY VIEW - AIFMD

- Permira is a Guernsey AIFM – AIF and market in EU under article 42 private placement regime (usually 30% of our investors) and hence, partially subject to AIFMD.
- We reviewed the position last year for the launch of Permira VI and concluded that:
  1. Investors do not ask us to be EU AIFM or EU AIF – focus on returns.
  2. Private placement regime not a major issue to market in EU.
  3. Still uncertainty (at least in our case) in application of remuneration rules and regulatory capital
- Conclusion: Guernsey confirmed in particular in a competitive environment where some competitors still offshore.

INDUSTRY VIEW - AIFMD

1 **Investors mainly focused on returns** in order to get top quartile (rather than median or bottom one) - detailed due diligence before committing funds.

Buyout Net IRR (%) by quartile and vintage year

Source: Preqin as at Sep 2016. Market benchmark filtered for buyout funds only, with no restrictions on geographic focus or fund size. Total of 1,346 funds analysed from 1998 to 2013, by vintage year. Net IRR is net of management fees and carry

INDUSTRY VIEW - AIFMD

2 **Fund raising not a timing (or access to mkt) issue with private placement regime.** This is showed by high % of funds that met or exceeded target and average month to close.

Percentage of global buyout funds that met or exceeded targets (bars)

Average months to close for global buyout funds (line)

100%
80
60
40
20
0

25
20
15
10
5
0

2004 05 06 07 08 09 10 11 12 13 14 15

Note: Average months to close excludes funds closed in less than one month or more than 40 months
Source: Preqin

Source of the chart : Bain Global private equity report 2016

INDUSTRY VIEW - AIFMD

2 **Positive fund raising also with private placement regime** most likely helped by high liquidity in the LPs market due to net cash flow to investors.

US

Capital distributions and contributions by US buyout funds

$150B
100
50
0
−50
−100

	2008	09	10	11	12	13	14	H115
Ratio of distributions to contributions	0.3	0.5	0.9	1.3	1.9	2.9	2.2	2.6

Europe

Capital distributions and contributions by European buyout funds

$60B
40
20
0
−20
−40

	2008	09	10	11	12	13	14	H115
Ratio of distributions to contributions	0.4	0.2	0.6	1.5	1.5	2.3	2.0	3.1

Asia-Pacific

Capital distributions and contributions by Asia-Pacific buyout and growth funds

$30B
20
10
0
−10
−20

	2008	09	10	11	12	13	14	H115
Ratio of distributions to contributions	0.3	0.5	0.8	0.7	0.5	1.1	1.4	1.9

Distributions | Contributions | Net cash flows

Note: Europe includes developed economies only
Source: Cambridge Associates

Source of the chart : Bain Global private equity report 2016

INDUSTRY VIEW - AIFMD

3 **Remuneration rules and capital requirements still uncertain application** (at least perceived in our case)

- Remuneration rules - this could have an impact to retain/attract people if certain changes to the remuneration need to be implemented vs offshore Funds.
- Capital requirements – this could have an impact on additional amount to be invested by partners/employees in a business that already requires material co investments - more than 2% total commitment in each new LBO Fund – i.e. 5 bn Fund = 100 mil euro of personal commitment for the partners/employees.
- **Conclusion**: Guernsey confirmed in particular in a market with still some competitors (global funds) offshore.

Source: Preqin as at Aug 2016

Note: Scope of research filtered for buyout funds above USD1bn raised from 2006 to 2016 as well as currently raising. Criteria definition: US market defined as GP located in the US; Europe market defined as GP located in Europe. Regional funds selected according to geographic scope and focus; when those were targeted in the same region within a couple of countries only. Global defined as those with no specific regional imposition. Permira funds defined as global within the European market

BEPS FROM AN EU PERSPECTIVE

BACKGROUND

- Aggressive tax planning strategies undermine public finances and generate resentment among tax players. How to tackle the issue?
- Current initiatives:
  - COMMISSION – Anti-tax Avoidance Package (ATAP)
    - ✓ Proposals adopted in Jan. 2016, ATAD 1 (Directive) adopted by Council in June
  - OECD – Base Erosion and Profit Shifting (BEPS) project
    - ✓ Recommendations in BEPS report of October 2015
- BUT industry claims that BEPS could have adverse consequences for legitimate funds.

BEPS FROM AN EU PERSPECTIVE

INVESTMENT FUND INDUSTRY CONCERNS

- Impact of BEPS action 6 – "preventing the granting of treaty benefits in inappropriate circumstances"
- What is the industry claiming?
  - Some legitimate investments funds, in particular those investing in SME financing (private equity, private debt, venture capital) and real assets (infrastructure, commercial real estate) could lose access to Bilateral tax treaties benefits.
    - ✓ if confirmed, would affect cross-border investment and go against CMU objectives.
- Which categories of funds could be affected?
  - Collective Investment Vehicles (CIVs) and in particular non-CIVs.

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BEPS FROM AN EU PERSPECTIVE

POSITION OF COUNCIL AND COMMISSION

- Council conclusions on BEPS (8 Dec. 2015)
  - Supported a "coordinated implementation by the Member States of the anti-BEPS measures ".
  - Observed that "OECD BEPS conclusions often propose different options for implementing certain of its recommendations and that a common approach at EU level in favour of certain options would bring value with a view to ensure the proper functioning of the Single Market".
- European Commission
  - Closely following the discussions.
  - June 2016: Discussion with representatives of Finance Ministries.
  - Observer status in BEPS discussions – TAXUD leading, FISMA participating (last discussion on non-CIVs: 21 Sept. 2016).

OECD UPDATE AND VIEWS FROM THE INDUSTRY

- ACTION 2, on Hybrid mismatch arrangements.
- ACTION 4, on Interest deduction.
- ACTION 6, on Treaty abuse.
- ACTION 7, on Permanent establishment.

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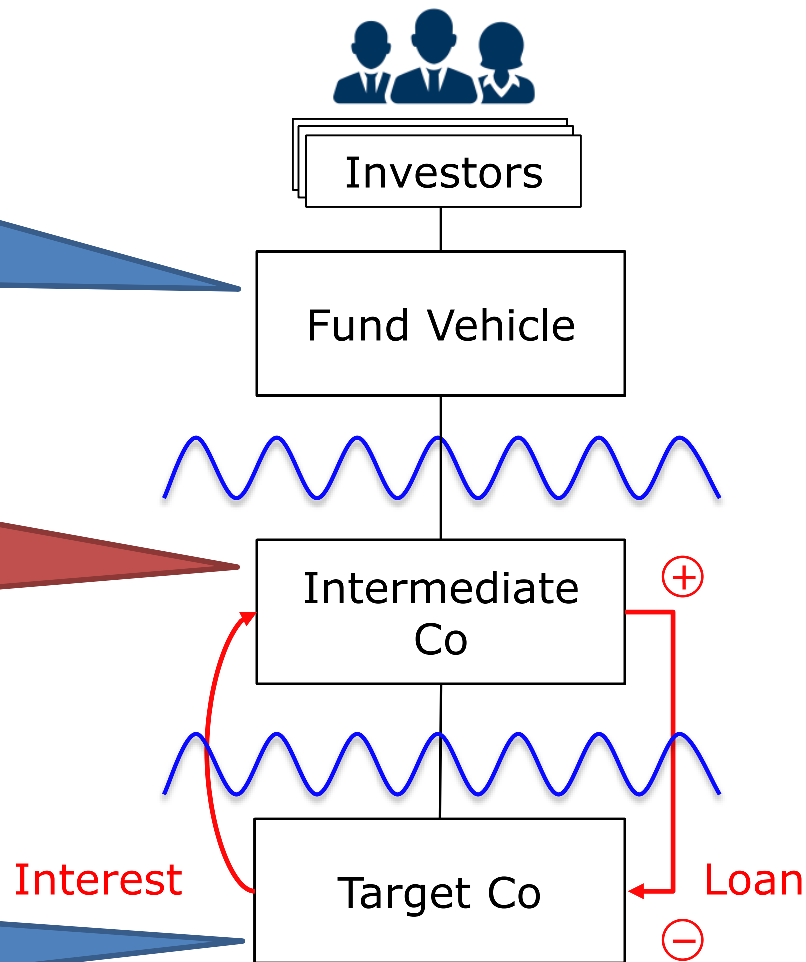
PE/VC STRUCTURES

Tax neutral (i.e exempt or transparent) vehicle – structured to avoid additional layer of taxation on investors

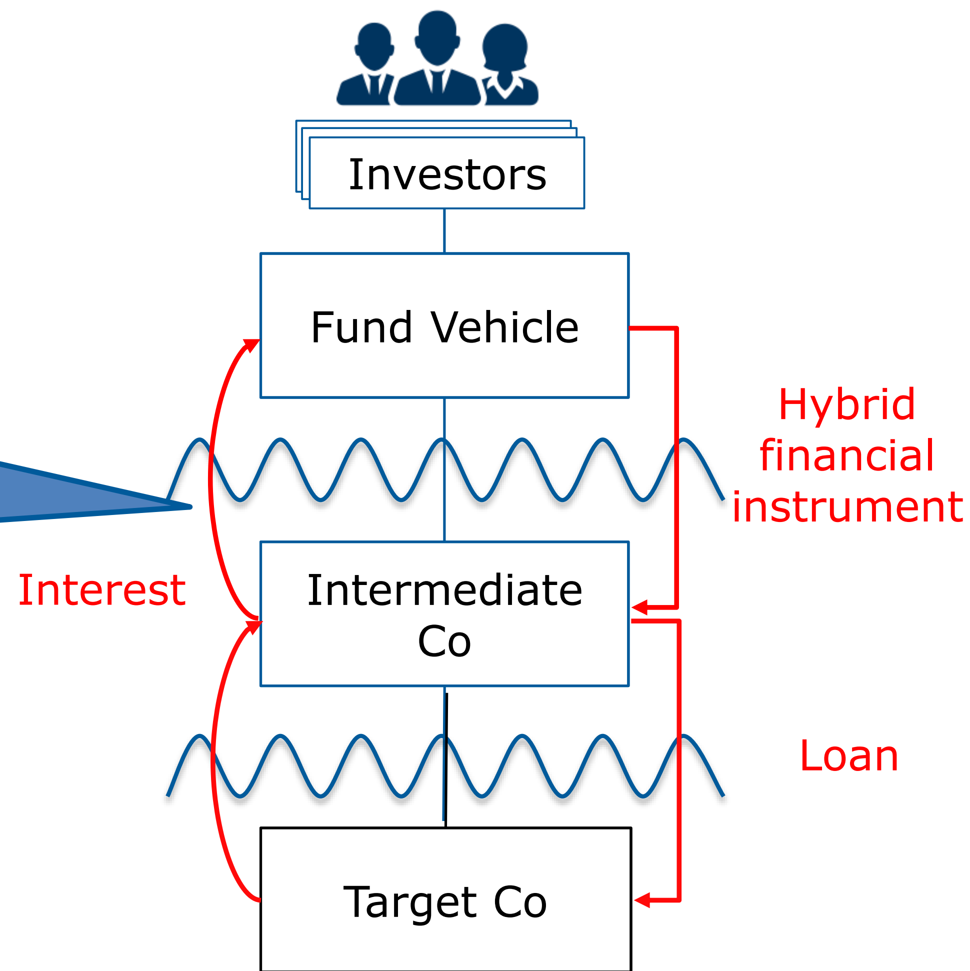
Possible focus for tax structuring – designed to mitigate withholding and other taxes on interest, dividends or gains.

Debt financing makes it easier to extract tax free profit



PE/VC STRUCTURES

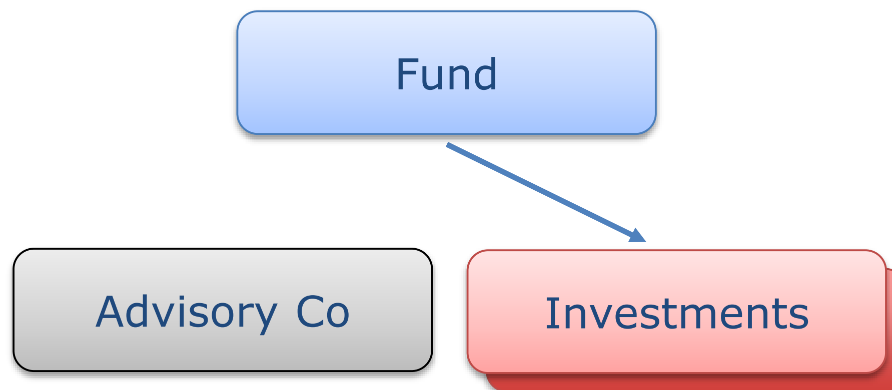
Payment under hybrid financial instrument is treated as:
- ✓ Interest expense by payer
- ✓ Exempt dividend or other excluded return by payee



IMPACT OF ACTION 2 & 6

- Does not prevent funds from achieving tax neutrality for their investors (either through tax exemption or transparency).
- But restricts the ability of funds to structure group financing arrangements that:
  - Strip the tax base of target jurisdiction through hybrid D/NI outcomes; or
  - That are used for the principal purpose of securing additional treaty benefits.
- Clarifies that treaty benefits can be claimed through transparent vehicles (but only if the income is actually included by a resident of a contracting state).

PERMANENT ESTABLISHMENT EXPOSURE



- Foreign VC Funds and PE funds with investments in a local country main also set up an "advisory Company" that will render services to the fund / management co.
- Impact of BEPS (Action 7) on some of these structures.

PERMANENT ESTABLISHMENT EXPOSURE

- "Foreign" venture capital fund structures: local advisory company to provide non-binding and non-exclusive services to the overseas management company pursuant to an advisory agreement.

- The local team sources the deal, evaluates opportunities and present their findings to the overseas manager.

- BEPS Action Plan 7 – artificial avoidance of Permanent Establishment.

  - Amendments of the Permanent Establishment definition to include commissionaire arrangements and exclude certain exceptions for the preparatory and ancillary activities.

    - Reference to Paragraph 22.6 of Commentary to article 5, under Action 7 Report ("*collection of information*").

  - Increased risk that the foreign fund / management company be regarded as having a PE.

PERMANENT ESTABLISHMENT EXPOSURE

- Importance of segmenting the roles of the foreign manager and the local advisor – avoid to the greatest possible extent overlapping of roles and functions, as well as board members and top executives.
  - Proposals by local advisor routinely executed?
  - Local advisor under exclusive relationship with foreign fund manager?
  - PE risk + withholding tax risk with regard to payment to unitholders (PE as wht agent)
- Supporting documentation – possibility to file a ruling request.
- Transfer pricing aspects of the compensation for the local advisory role (e.g., cost plus)
  - Value creation
    - ✓ Scouting and sourcing activities – what else is really left to the foreign management Company?
    - ✓ Final decisions and risks

PERMANENT ESTABLISHMENT EXPOSURE (ITALY)

- Italian Circular letter No. 21/2014 commenting the main tax ramifications of the AIFM Directive

"*The circumstance where a European investment fund manager constitutes and/or manages an Italian CIV on the basis of the passport regime, does not entail per se the existence of a permanent establishment in Italy. It is a general principle that, where the place of management of a company/entity is abroad, due to the fact that the offices, employees and contractors are located abroad and the decisions regarding the organization and the functioning of the company/entity (meetings and resolutions by the board of directors, decisions by the general directorate, etc.) are taken abroad, the tax residence of the company or entity is necessarily outside Italian territory pursuant to article 73(3) of the ITC. Obviously, where instead the foreign investment fund manager operates in Italian territory through a permanent establishment, the withholding tax on income derived from the units of the Italian CIV shall be applied by the permanent establishment.*"

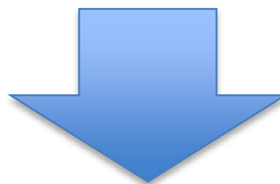
INDUSTRY VIEW – ACTION 6

1. Action 6 high risk to prevent treaty protection.
2. Impact mainly on gains at exit. The impact should be mainly on gains at exit that are the main part of the returns for an LBO Fund.
3. Impact should be material on IRR.
4. Negative impact not justified by class of investors and possibility for investors to abuse LBO Funds.

- Conclusion: if action 6 implemented need to find a solution to the issue of the treaty protection of the non CIVs.

INDUSTRY VIEW – ACTION 6

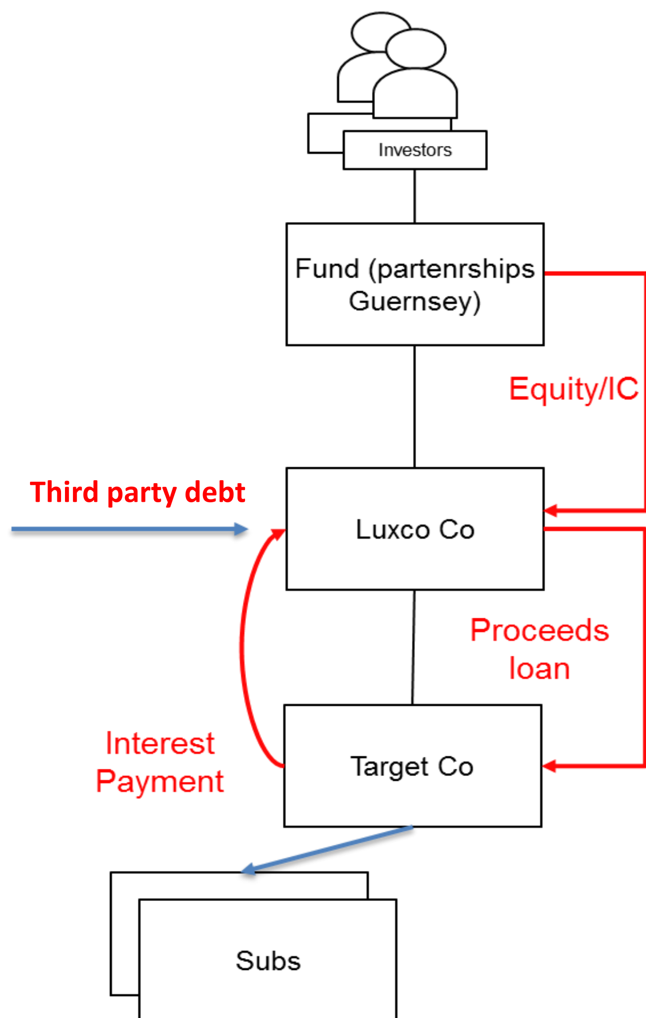
1. Action 6 (<u>if and when implemented – good to know status</u>) should have an impact on LBO transactions.



- Detailed LOB = no treaty
- PPT seems more manageable but :
  - Most reasons to interpose SPVs could not be sufficient (legal financing - difficult to support from a documental perspective or in a comparative analysis)
  - It would leave in any case high uncertainty in an industry IRR driven (prevent full distributions, no claw-back provisions, difficult to start a litigation etc..).

INDUSTRY VIEW – ACTION 6

2 Main impact on gains at exit. An example :



- Gross multiple of money on 2 times, 600 mil invested equal to 600 mil gain.
- At a tax rate of 20% 120 mil of tax to be paid.
- Dividend (withholding tax) less relevant as recaps limited by leverage.
- Interests (withholding tax) only in case of proceeds loan - if leverage 50% of investment, interests at 6%, withholding tax at 20% means an annual cost of 3.

INDUSTRY VIEW – ACTION 6

3. Impact on IRR in the range of 20% decrease in returns assuming around 5 years holding period of portfolio companies and 25% tax rate for non resident gain tax;

- Such 20% could be much higher if the same IRR and multiple of money is reached with material gains and losses on the portfolio as gain on one deal cannot be offset by loss in another deal
- Depending on quartile where the LBO Fund is present (and vintage) the impact on the IRR could be material.

The IRR decreases have been determined simulating a LBO fund on a 10 year period, in few scenarios of calls, distributions, total multiple of money and multiple of money per deal. It has also been tested with recent transaction running the base case model net of capital gain tax.

INDUSTRY VIEW – ACTION 6

3 This could materially impact the (superior) returns with consequences in terms of possible diversion of investments out of countries with non resident tax as well as unfair competition versus regional funds.

Private Equity Median Net IRR vs. Public Market Equivalents

16%
14%
12%
10%
8%
6%
4%
2%
0%
-2%

1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013

Private Equity Dow Jones Global FTSE 100 FTSE World Europe

Note: Shown by vintage years
Source: Preqin for the private equity data. PME data from Thomson Reuters (PME analysis by Cambridge Associates) at 15 Sep 2016 using latest available data. Chart shows pooled returns for vintage years. All public market indices are total return indices to determine an equivalent IRR, by treating the buying and selling of shares into the selected indices as private equity cash flows

INDUSTRY VIEW – ACTION 6

4. The negative impact on IRR is not (ultimately) justified by a treaty abuse of final investors as most should be treaty protected and with no possibility to invest directly – (P5).

Source: Permira as at Mar 2016. North America accounts for both the US and Canada

ACTION 6 INDUSTRY VIEW

4. The negative impact on IRR not justified by investors abusing LBO Funds to defer income recognition.

- Investors have no influence on GP, no exact knowledge where GP will invest
- LBO funds are measured on IRR by investors and main part of remuneration of partners employees is IRR driven
- Investors commit money for more than 5-6 years or even more, in an illiquid instrument with a high degree of risk.
- Real reason for investors is to get superior returns rather than a highly uncertain tax arbitrage.

ACTION 6 INDUSTRY VIEW

Conclusion :

- "urgent" to find a solution to the treaty protection of non CIVs in general and in particular if action 6 will be implemented.
- In particular LBO funds have limited number of investors, stable over the time of the fund, with longstanding relationships with most of them (repetitive over the various Funds) and so it should not be highly difficult to get proper documentation.
- Such solution needs to be reasonable in terms of compliance and administrative issues/costs as well as certainty in terms of application.

ONGOING WORK: TREATY ENTITLEMENT OF NON-CIV FUNDS

- Par. 14 of the Report on Action 6: further work to ensure that new treaty provisions included in Report adequately address the treaty entitlement of non-CIV funds.
- Non-CIV funds: funds that do not qualify as “collective investment vehicles” within the meaning of the 2010 OECD Report.
- Public consultation March 2016: main focus on how LOB and PPT rules might inadvertently affect non-CIVs.

TREATY ENTITLEMENT OF NON-CIV FUNDS – PRELIMINARY CONCLUSIONS & NEXT STEPS

Principle Purpose Test:

- One or more additional examples could be developed for inclusion in Commentary.

Simplified LOB:

- Derivative benefits provision should address most issues (no limit on the number of equivalent beneficiaries, no base erosion test and no requirement related to intermediate owners).
- Compliance and administrative issues related to the determination of the identity and treaty eligibility of investors are similar to those of CIVs:
  - TRACE addresses these issues in relation to CIVs and could form the basis for consideration of solutions for non CIVs.

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TREATY ENTITLEMENT OF NON-CIV FUNDS – PRELIMINARY CONCLUSIONS & NEXT STEPS

Detailed LOB:

- Will not be included in MLI.
- Fact that detailed LOB will mostly be used by the US removes pressure on OECD for changes to address negative impact on non-CIV.

EU PERSPECTIVE ON NON-CIVs

ISSUES WITH NON CIVS

- No OECD definition of non-CIVs.
- BEPS recommendation on non-CIVs:
  - OECD recognises that non-CIVs could face additional difficulties in accessing tax treaty benefits as a result of BEPS.
  - Further work to be done by OECD Committee on Fiscal Affairs Working party I , in particular on REITS and pension funds.
  - Funds that could be particularly affected: REITS, pension funds, private equity and venture capital funds, and European Long Term Investment Funds "ELTIFs�much".
  - Difficult work given the large diversity of fund structures and features in the non-CIV universe.

INDUSTRY VIEW – ACTION 2 and 4

1. Action 4 should permit tax deductibility of passive interest with present leverage and interest rates.
2. LBO Funds in any case rely more on value creation than leverage, as a consequence impact on IRR should be limited.
3. Action 2 main hybrid used (mainly in the past) equity at investors-shareholder loan at target, with action 4 little room for such hybrid, action 2 should close definitively.

ACTION 4 INDUSTRY VIEW

1. Action 4 should permit third party debt tax deductibility : present net debt/EBITDA ratio combined with low interest rates should permit full tax deductibility – 5 times net debt at a rate of 6% = 0.3 times EBITDA (30% EBITDA).

LBO Average Pro Forma Credit Statistics (Total Debt / EBITDA)

Year	Europe	US
2003	4.5x	4.7x
2007	6.6x	6.2x
2010	4.6x	4.7x
2011	4.8x	5.2x
2012	4.5x	5.3x
2013	4.9x	5.4x
2014	5.3x	5.8x
2015	5.0x	5.7x
2016 YTD	5.0x	5.5x

Source: LCD Global Review (Q2 2016). For EBITDA >US$/€50m

ACTION 4 INDUSTRY VIEW

2 Conclusion: Action 4 with the exclusion of certain situations should have limited impact on IRR, this also because in LBO transactions value creation is less dependent by the leverage.

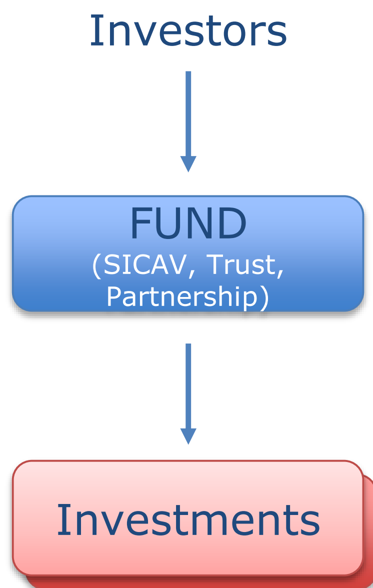
Source: Permira as at Feb 2016
Notes: The objective of the value creation analysis is to give, in Permira's opinion, a reflection of how gains have been driven in the fully realised portfolio companies in which the Permira funds invested

ACTION 2 INDUSTRY VIEW

3. Action 2 limited impact on IRR: main Hybrid instrument – equity at investors level, debt at target level.

- Mainly used in the past, Action 4 plus action 2 will close the possibility.
- In any case such type of Hybrid was already under (internal) debate due to the fact that :
  - ✓ not all investors benefit,
  - ✓ carry holders subject to higher tax rates,
  - ✓ risk of withholding and later claims from target.

ENTITLEMENT OF TAX TREATIES –WITHOLDING TAX REFUND



- Investing through a fund should not put the investor in a worse tax position, compared to a direct investment in target.
- Are funds resident for domestic tax laws or tax treaty purposes?
- Are funds entitle to tax treaty benefits?
- WHT at target level are frequently a final cost for the fund.
- Treaty relief claims for and on behalf of investors are often burdensome or even impossible.
- Fund structure try to minimize tax inefficiences arising from lack of treaty entittlement.

EU COMMISSION: WITHOLDING TAX REFUND

What is the problem?

- Procedures are often demanding, resource-intensive and costly
  - need to file claim forms with different MS' tax administrations, if investments in different countries
  - claim forms may differ radically, change periodically, be in different languages (about 56 different tax reclaim forms exist in the EU)
- Time to pay-out reclaims varies from a few weeks to several years.
- Most countries require individual investors to make claims for relief themselves rather than via a financial institution.
- In some MS, tax reclaims must be processed via a domestic financial institution.

EU COMMISSION: WITHOLDING TAX REFUND

What are the consequences?

Regular double taxation of cross-border investment despite bilateral double taxation treaties has the following consequences:

- Hinders the functioning of capital markets.
- Is a burden for investors, financial industry and tax authorities.
- Increases the cost of cross-border trading.
- Is fundamentally incompatible with a single European securities market.
- Leads to a misallocation of resources.
- Limit the scale benefits of funds in terms of diversification of risks, optimisation of return, reduced operational and management costs → reduced returns for investors and fragmentation of the asset management industry: goes against the CMU objectives.

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SUSTAINED EFFORTS TO DATE…BUT LIMITED SUCCESS

- Giovannini reports (2001, 2003).
- Fiscal Compliance Experts' Group (FISCO): fact-finding study (2006).
- FISCO: possible solutions (2007).
- **Commission's Recommendation (2009) on simplified WHT procedures → but largely ignored by MS.**
- Tax barriers Advisory Group (T-BAG) (2013).
- OECD Treaty Relief and Compliance Enhancement ("TRACE") Group (2013).

CMU: RENEWED POLITICAL MOMEMTUM

CMU Action Plan:

- Promote best practices.
- Encourage MS to adopt relief-at-source systems and establish quick and standardised refund procedures.
- Develop a Code of Conduct with MS on withholding tax relief principles (2017).

Council: a clear political mandate

Council Conclusions of 10 November strongly supported the CMU Action Plan, stressing the need for "pragmatic solutions to long standing tax obstacles such as double taxation linked to the current withholding tax arrangements" .

CVCs and VCs

- Different motivations and different expected returns
  - Financial vs. business / technical approach
- Different "acceleration rate".
- Different exit strategies
  - Timing and commitment
- Synergies in adding value and boost growth
  - License technologies / pipeline acquisitions.

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CVCs – TYPICAL STRUCTURES

- Corporate division / business unit.
- Outsourcing of personnel and functions.
- Objective: generating capital gains or access to strategic technologies for the parent?
- Specific organizational structure to ensure sufficient transfer of what the CVC has learned to the senior members of the corporate
  - Technology transfer agreements.
  - Transfer of businesses.
  - Licensing.

INVESTMENT PROCESS

- Multiple round investing.
- Each round typically with its own class / series of shares.
- ESOPs to compensate founders for the dilution deriving from new rounds of equity.
- Rounds of equity:
  - Pricing and valuation issues.
  - Risk of audits related to the valuation of management shares in the light of a subsequent round of equity dedicated to VC fund.

ITALY: THE TAX REGIME OF INVESTMENT FUNDS UNDER ITALIAN LAW

- The current tax regime for Investment funds is laid down by Law Decree No. 225/2010.

- Such regime provides that an Investment fund is:

  - Exempt from corporate income tax (IRES) – article 73(5-*quinquies*) of Legislative Decree No. 917/1986 (the *Italian Income Tax Code, IITC*);
  - Exempt from regional local tax (IRAP) – article 3(2) of Legislative Decree No. 466/1997; and
  - Not subject to withholding tax as regards income received and realized gains, albeit some exceptions apply (e.g., financial income on bonds issued by non-listed entities).

- Liability to tax under Italian tax treaties.

- Applicability of the regime only if some regulatory requirements (e.g. plurality of investors, management activity carried out by a professional entity, etc.) are met.

ITALY: THE TAX REGIME APPLICABLE TO FUND DISTRIBUTIONS

- At investor's level, two types of income:
  a. Income from capital related to proceeds deriving from distributions;
  b. Income from capital related to the disposal/redemption/liquidation of the fund units.
- Capital loss in case of disposal/redemption/liquidation of the fund units if the consideration received by the investor is lower than the weighted average cost of subscription or acquisition of the fund units.
- If the investor carries out a business activity, income/capital loss is attracted into the "business income".
- Under article 26-*quinquies* of Presidential Decree No. 600/1973, a 26% withholding tax is levied on income under a) and b). In particular:
  - The withholding tax is applied as an advance payment with regard to recipients carrying out a business activity;
  - In other cases (i.e., individuals and non-commercial entities), the withholding tax represents a "final" payment for income tax purposes.
- S.G.R. (*Società di Gestione del Risparmio* – management company) as withholding agent.

ITALY: THE SPECIAL REGIME FOR VENTURE CAPITAL FUNDS AND THEIR INVESTORS (I)

- Law Decree No. 98/2011: venture capital funds (VCFs) are defined as investment funds investing at least 75% of the total capital in companies that are in "seed, start-up or early-stage financing"
  - EU funds only?
  - EU funds distributed in Italy only?
    - ✓ Free movement of capital

- The target companies need to fulfil the following conditions:
  - Not listed;
  - Having an Italian seat;
  - Shares or quotas need to be directly held mainly by individuals;
  - Subject to corporate income tax or any equivalent tax provided for by local legislation, without any possibility of exemption (even if partial);
    - ✓ Similar (but more restrictive) than Par-Sub Directive
  - Whose business activity has started since less than 36 months;
  - Having a turnover lower than Euro 50 million;
  - Any investment in a single target cannot exceed Euro 2.5 million over a 12-month period.

ITALY: THE SPECIAL REGIME FOR VENTURE CAPITAL FUNDS AND THEIR INVESTORS (II)

- VCFs are generally subject to the tax regime provided for investment funds.
  - Investment funds vs corporate vehicles (e.g., holding companies)
    - ✓ ESMA guidance
- However, Decree No. 98/2011 sets forth a withholding tax exemption on income from capital for professional VCFs unitholders with the aim of promoting access to VC and supporting the processes of growth of new companies.
- For further info: Banca d'Italia, "*The new framework for the taxation of venture capital in Italy*", by A. Magliocco, G. Ricotti, June 2013.

ITALY: LBO PROVISIONS (I)

- On 30 March 2016, Italian Tax Authorities have issued Circular No. 6/E (the "Circular") which provides important clarifications on the tax treatment of LBO transactions and recognizes the general legitimacy of LBOs in the Italian tax system.

- Indeed, in the last few years, the Italian Tax Authorities have targeted the tax benefits arising from LBOs, primarily in order to deny the deduction of interest expenses borne by the special purpose vehicle ("BidCo") connected to the debt incurred for the purposes of the acquisition of the target company.

- When LBOs involved foreign private equity investors, the Italian Tax Authorities did not only challenge the deduction of interest, but also other tax benefits (e.g., carry-forward of losses) on the assumption that these transactions are structured with the sole purpose of obtaining a tax benefit.

ITALY: LBO PROVISIONS (II)

- More in particular, the main areas addressed by the Circular are:
  - deduction of funding costs;
  - allocation of intra-group services charges:
    a) where the foreign parent actively participates in raising funds on behalf of the Italian BidCo which then uses such funds in order to carry out the LBO, the foreign parent should be regarded as providing a service to the Italian BidCo;
    b) where the Italian BidCo directly raises funds in order to carry out the LBO, BidCo should not be regarded as providing a service;
  - treatment of transaction costs:

    with reference to costs that are charged directly to the portfolio companies by the private equity firms, the disallowance should be carried out whereas such costs are identified as a portion of the costs that the manager would ordinarily charge to the investors (such as management fees);
  - taxation of outbound flows (*i.e.*, IBLOR structures);

ITALY: LBO PROVISIONS (III)

- shareholders' loans:

  the Circular, in compliance with the OECD Transfer Pricing Guidelines, identifies some circumstances which the local tax offices should analyze on a case-by-case basis in order to re-characterise such loans as equity, thus leading to the disallowance of the relevant interest expenses;

- withholding taxes on dividends and capital gains realized upon exit:

  if the various structures involve, further to BidCo, also one or more intermediate companies and an ultimate foreign holding ("HoldCo"), the tax benefits achieved by these structures could be challenged if they constitute artificial or mere conduit arrangements.

TAXATION OF MANAGERS COMPENSATION

- Managers are remunerated for:
  - Management of the fund (annually).
  - high return of capital at exit (after investor's capital is returned) – carried interest.
- Carried interest is a contractual right that grants the general partner of a private equity fund to share in the fund's profit.
- Tax treatment as capital gains or employment income.
- Relevant factors:
  - Income expectation contingent on the individual performance.
  - Restrictions on transferability.
  - Risk in the investment.
  - Investment in the fund should have been acquired at market value.
  - Market value remuneration for the management services.

UK: TAXATION OF MANAGERS COMPENSATION

DISGUISED INVESTMENT MANAGEMENT FEE (DIMF) RULES

- Introduced w.e.f. 6 April 2015.
- Relevant to carry taxation because carried interest from "bad funds" is taxed as DIMF.
- Stated aim of rules was to ensure that fund executives pay UK income tax and NICs (47 per cent) on their share of management fee profits.
- However, achieved by treating all amounts arising from a fund to a person providing fund management services to that fund as DIMF and then excluding specific amounts.
- The excluded amounts are those amounts already taxed as employment or trading income, co-investment returns and carried interest (each as defined).
- DIMF rules look through trusts, relatives and low taxed controlled companies.
- If any work is done in the UK, no benefit of being a non-dom in relation to DIMF.
- DIMF applies to non-UK residents to the extent they do material work in the UK.

UK: TAXATION OF MANAGERS COMPENSATION

NEW CARRY RULES

- Introduced w.e.f. 8 July 2015.
- Previously carry was taxed according to the tax character of the cash flow satisfying the carried interest entitlement.
  - For UK doms, meant a blended rate of 0 per cent (to the extent satisfied by base cost), 28 per cent (capital gain), 30.55 per cent (dividends – now 38.1 per cent) and 45 per cent (interest income).
  - For non-doms, if cash wasn't remitted/was held in trust, only paid UK tax to the extent carry satisfied by UK source income.
- Cherry picking was rife but HMRC now say it doesn't work.
- New carry rules brought in a minimum 28 per cent tax for carried interest proceeds
- Essentially, the new rules increase tax on base cost shift for UK doms to 28 per cent and change source rules for non-doms.
- It is a minimum tax - the actual tax can be higher to the extent carried interest is satisfied out of income.

UK: TAXATION OF MANAGERS COMPENSATION

INCOME BASED CARRY

- Distinguish between good fund and bad funds.
- Only carried interest from good funds will benefit from CGT treatment.
- Carried interest from a bad fund will be "income based carried interest" which will be taxed as DIMF
  - 47 per cent tax
  - No pro rating for non-doms
  - Potentially applies to non-residents
- New rules will apply to carry distributions received on or after 6 April 2016, without any grandfathering.
- If rules apply to an executive, crucial to be a good fund.

UK:TAXATION OF MANAGERS COMPENSATION

WHO WILL NEW RULES APPLY TO?

- First question: do DIMF/carry rules apply to an executive?
- For any of the rules above to apply
  - There needs to be a collective investment scheme; and
  - The individual needs to have provided investment management services in relation to the fund in question. Includes:
    - ✓ Fund raising for the fund
    - ✓ Researching investments to be made by the fund
    - ✓ Managing the fund's portfolio
    - ✓ Assisting portfolio company to raise funds
- Where carried interest is an employment related security, all funds will be good funds!

UK: TAXATION OF MANAGERS COMPENSATION

WHAT IS A GOOD FUND?

- Fund must have an average holding period for its investments of at least 40 months.
- Below 36 months holding period, all carry is income.
- Between 36 months and 40 months pro rating.
- Average holding period of a fund is determined based on weighted average by cost of investment.
- Subject to special rules discussed later, holding period is determined on an investment by investment and instrument by instrument basis, ignoring intermediate holding structures.

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UK: TAXATION OF MANAGERS COMPENSATION

HOW TO APPLY RULES

- Test whenever carry proceeds are received
  - Second chance: conditionally exempt carry
- First, need to identify the fund's investment
  - Ignore intermediate holding companies
- Special rules for certain funds
  - "controlling equity stake fund"
  - Venture capital/growth capital funds
  - Real estate funds
  - Funds of funds
  - Secondary funds
  - Direct lending funds

ITALY: MANAGER COMPENSATION

- The Italian Tax Authorities have confirmed that the non-proportional grant of special shares to managers for a cash consideration lower than the fair market value of the shares granted represents effectively a form of remuneration (Resolution No. 103/E of 4 December 2012).
  - Any income then deriving from the participation in the portfolio company is qualified as income from capital in case of dividend distribution, or miscellaneous income in case of capital gains on divestment.
- Supreme Court (criminal) case law on carried interest (No. 9635/2014)
  - Co-investment in Target by Luxembourg company owned by a top executive, alongside a PE fund;
  - Luxco entitled – under the shareholders' agreement - to a higher share of the gain realized upon disposal of a shareholding in Target ("carried interest")
  - Carried interest also attributable to other individuals (in their own name) working for the top executive
  - *Luxco looked through for tax purposes (interposed entity)*
  - What the decision does not say: whether the carried interest needs to be qualified as (self-)employment income or miscellaneous income
  - still it is income subject to personal income tax at progressive rates!

INDUSTRY VIEW - CARRY

1. Carry is the most important return in Private equity/LBO industry - the best way together with Co-investment to align interests with Investors.

2. Taxation uncertain. At the same time it is also in most countries (UK and US ex) uncertain in terms of tax treatment – capital or employment income – due to terms and conditions (not always present) that render difficult the tax classification.

3. Treated usually as capital. Carry is usually treated as a financial instrument with an upfront taxation as benefit in kind at assignment and gain (dividend or interest) treatment at cash in.

INDUSTRY VIEW - CARRY

4 To treat carry as gain in nature is not always "a good deal", i.e. 2008 downturn, bad leaver, not all LBO funds reach the hurdle (see below chart), assignment of carry once value is already high etc..

Buyout Net IRR (%) by quartile and vintage year

230%
210%
190%
170%
150%
130%
110%
90%
70%
50%
30%
10%
-10%
-30%
-50%
-70%
-90%

1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013

1st quartile
2nd quartile
3rd quartile
4th quartile

HURDLE ?

Source: Preqin as at Sep 2016. Market benchmark filtered for buyout funds only, with no restrictions on geographic focus or fund size. Total of 1,346 funds analysed from 1998 to 2013, by vintage year. Net IRR is net of management fees and carry

INDUSTRY VIEW - CARRY

5. Push to move from capital to income.

- DIMF rules seems in the direction to move (slowly ?) towards an employment income approach.
- i.e. different tax rate for carry 28%,
- income if average holding period not at least 40 months (see chart following page),
- UK non domiciled subject to tax based on service provided in UK
- DIMF rules seems also to introduce complexity and uncertainty in terms of their application (until guidance ?).

FINANCIAL TIMES

'Without fear and without favour'

FRIDAY 15 JANUARY 2016

A tax break that Wall Street cannot defend

Pledges to close the carried interest 'loophole' must become a reality

INDUSTRY VIEW - CARRY

- Conclusion: private equity industry needs certainty (gain?) on tax treatment of carry given materiality of such return.

Chart 35: Median Holding Period
By Year of Exit

1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014

Average 4.4

0 1 2 3 4 5 6 7

Source: Hamilton Lane Fund Investment Database (August 2015)

ISRAEL: PRACTITIONERS' VIEW

- Standard VC/PE ruling
  - Look-through
  - Foreign investors, Israeli institutional investors – tax relief, no reporting
  - Regardless of Israeli permanent establishment
  - GP – benefitted carried interest regime
- Otherwise, general Israeli tax law applies
  - Permanent establishment
  - Management and control
  - Classification of income
- No-ruling structure
  - Foreign structure
  - Investment-management separation

TAX INCENTIVES FOR INVESTMENT IN VC AND PE (ISRAEL)

- Population: 8.4 million (annul population growth 2%).
- GDP: $302.7 billion.
- GDP per capita: $36,000.
- Inflation rate: 0.6%.
- Unemployment rate: 4.6%.
- Exports: $87.8 billion (hi-tech export $22.5 billion).
- Imports: $83.8 billion.

TAX INCENTIVES FOR INVESTMENT IN VC AND PE (ISRAEL)

Fundraising by Israeli Funds

$m	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
VC	30	900	900	600	1300	1100
PE	200	600	1200	400	1700	1500

Investments of PE Funds ($m/#Deals)

Q1/14	Q2/14	Q3/14	Q4/14	Q1/15	Q2/15	Q3/15	Q4/15
448	156	1689	996	496	1613	419	841
21	25	14	20	20	30	20	20

Investments of Israeli VC Funds ($m)

2009	2010	2011	2012	2013	2014	2015
405	451	619	489	560	568	653

TAX INCENTIVES FOR INVESTMENT IN VC AND PE (ISRAEL)

Different Incentives; different goals

- For investment in funds.
- For investment in hi-tech companies.
- For investment in early-stage companies [non-tax].

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TAX INCENTIVES FOR INVESTMENT IN VC AND PE FUNDS

- Income tax ruling for investment funds.
- VAT ruling for investment funds.

TAX INCENTIVES FOR INVESTMENT IN VC AND PE FUNDS

INCOME TAX VC/PE RULING – TAX TREATMENT

Foreign Investors		
VC*	All incomes	Tax exempt
PE	Capital Gains	Tax exempt
	Dividend/Interest	*Individuals* – 15%; *Exempt* – exempt; *Others* - 25%, (all subject to treaty)
Israeli Institutional Investors		
VC+PE	All incomes	Tax exempt
Carried Interest		
Foreign members	Related to Israeli investments – 15% Other – no tax.	
Israeli members	Tax rate = 0.25*R + 0.5*(1-R) $R = \frac{\text{Investments of foreign investors and Israeli institutional investors}}{\text{Capital commitments of the fund}}$	

*VC** = Qualified company; at least 75% of the investment is for issuance of shares

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TAX INCENTIVES FOR INVESTMENT IN VC AND PE FUNDS

INCOME TAX VC/PE RULING – CONDITIONS

- At least 10 investors.
- Minimum fund size (around $10M).
- Max holding per investor = 25%.
- Investment non-redeemable/transferrable before EOL.
- Max investment in one company – 25% of the commitments.
- Investments in Israeli/Israeli-related portfolio –via Israeli office.
- Fund has to open tax file, submit tax returns, withhold tax from investors income.

TAX INCENTIVES FOR INVESTMENT IN VC AND PE FUNDS

INCOME TAX VC/PE RULING – CONDITIONS (cont.)

- At least 50% of the commitments - invested in Israeli/Israeli-related companies, engaged in "qualified activities" in Israel.
- At least 30% of the commitments - invested in either:
  - Israeli companies that own the know-how they develop, or
  - Non-Israeli companies which Israeli subsidiaries own the developed know-how.

VAT RULING

- **Services to non-Israelis** - 0% VAT, if not involve any Israeli assets/matters.

- **Ruling for services provided by the GP to the fund** –

  - ***0% VAT*** - carried interest and management fees attributed to **foreign investors**.

    <u>Investment of foreign residents</u>
    Capital commitments of the funds

  - ***Full (17%) VAT*** - carried interest and management fees attributed to **Israeli Investors**.

TAX INCENTIVES FOR INVESTMENT IN HI TECH COMPANIES

- ***Angels Law*** *– deduction of investment amount*

  – by individuals / partnership of individuals

- ***Reduced corporate tax rate (15%/9%)*** - for R&D companies and R&D centers, in biotechnology, nanotechnology or if at least 25% of income is from export.

- ***Deduction of R&D expenses by R&D companies (20A)***.

- ***Tax-exempt restructuring*** - greater flexibility.

INCENTIVES FOR INVESTMENT IN EARLY STAGE COMPANIES (NON-TAX)

- Government **hedging** for investment of institutional investors in VC/PE funds.
- Government **incubation / R&D funding**.
- Government **employment subsidies**.

EU COMMISSION: CMU ACTION PLAN ON VC TAX INCENTIVES

- Tax incentives can be useful to support equity financing for innovative companies and start-ups.
- "The Commission will study how national tax incentives for venture capital and business angels can foster investment into SMEs and start-ups and promote best practice across Member States."
- As part of a comprehensive package of measures to support venture capital and risk capital financing in the EU.

EU COMMISSION: OBJECTIVES OF ONGOING STUDY

- Evaluate the effectiveness of existing tax incentives for VC and BA in fostering investment into SMEs and start-ups; and
- Provide best practice recommendations for the design of tax incentives for VC and BA drawn from current practice in all EU Member States and eight additional countries*.

* Australia, Canada, Japan, South Africa, South Korea, Switzerland, Turkey, and United States.

EU COMMISSION: EXPECTED OUTPUT

- Framing VC and BA investment in SMEs.
- VC and BA investment and the tax system.
- Analysis of design features of tax incentives for VC and BA investment.
- Detailed country fiches for all EU MS and selected countries.
- Benchmarking VC and BA tax incentives.

EU COMMISSION: TIMELINE

- First workshop with MS expert: 5 October; second workshop in Spring 2017.
- Final results and policy recommendations: June 2017.

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Thank you for your attention!