EC regional policies

Regional development studies

Financial engineering techniques in regions

covered by Objectives 1, 2 and 5b

of the Community regional policies.

9

European Commission

EUROPEAN COMMISSION

Directorate-General for Regional Policies

Financial engineering techniques in regions covered by Objectives 1, 2 and 5b of the Community regional policies

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- Etude prospective des régions atlantiques
- Interregional and cross-border cooperation in Europe

This study also includes three separate sections devoted to leasing, factoring, guarantee funds and mutual guarantee funds. They are not published in this volume but can be obtained by writing to the following address:

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Preface

Each year, the Directorate-General for Regional Policies of the Commission of the European Communities launches a number of studies in the field of regional policy and regional planning. These studies mainly aim at providing a basis for policy formulation internally, as well as the preparation of programmes and initiatives and a basis for analysing the impact of current or planned activities. The most interesting or innovative of these will now be published in a series entitled *Regional development studies*. With this series the Directorate-General hopes to stimulate discussion and action in a wider sphere on the research results received. The publication of the studies is addressed to politicians and decision-makers at European, regional and local level, as well as to academics and experts in the broad fields of issues covered.

It is hoped that by publicizing research results the Commission will enrich and stimulate public debate and promote a further exchange of knowledge and opinions on the issues which are considered important for the economic and social cohesion of the Community and therefore for the future of Europe.

Readers should bear in mind that the study reports do not necessarily reflect the official position of the Commission but first and foremost express the opinion of those responsible for carrying out the study.

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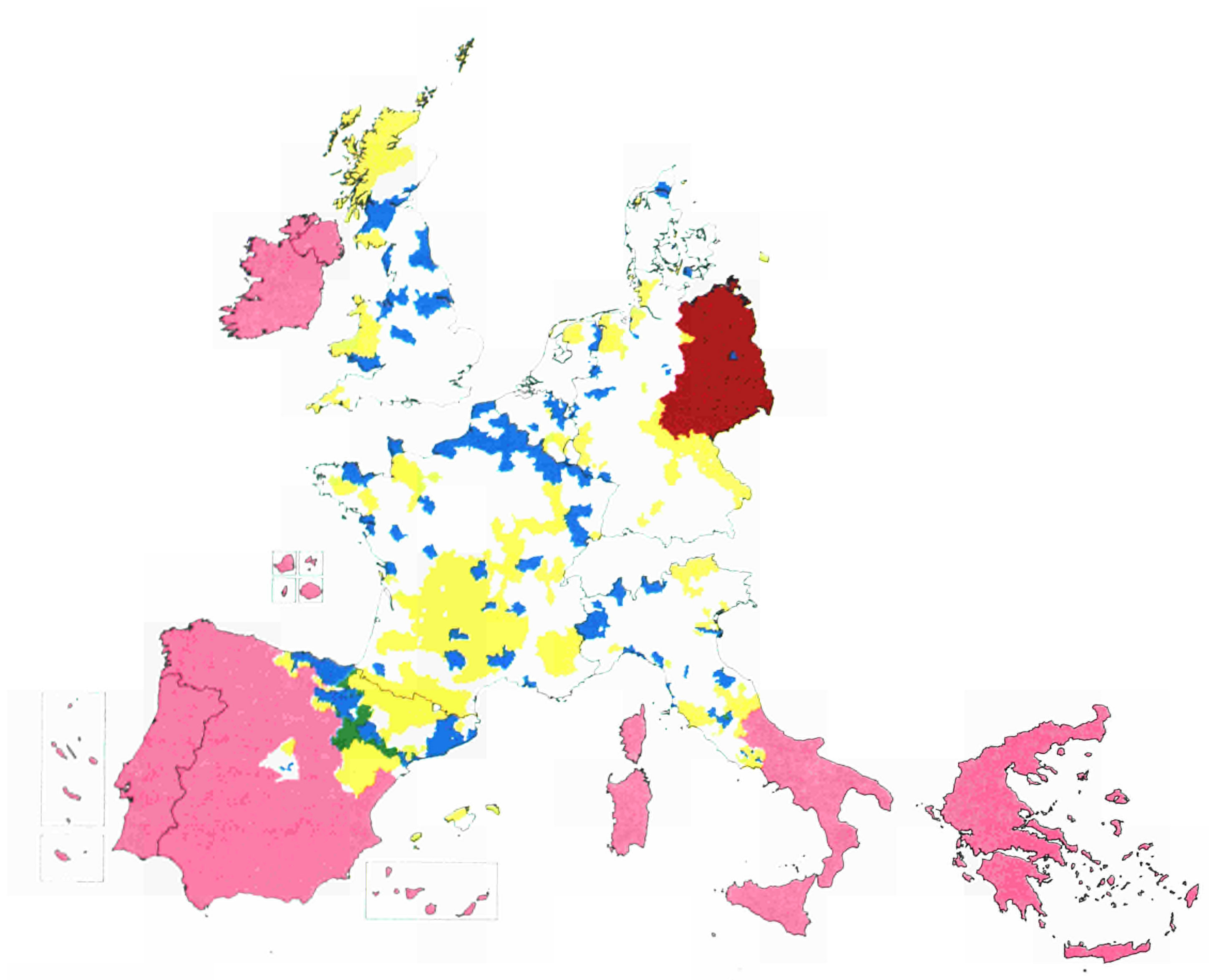
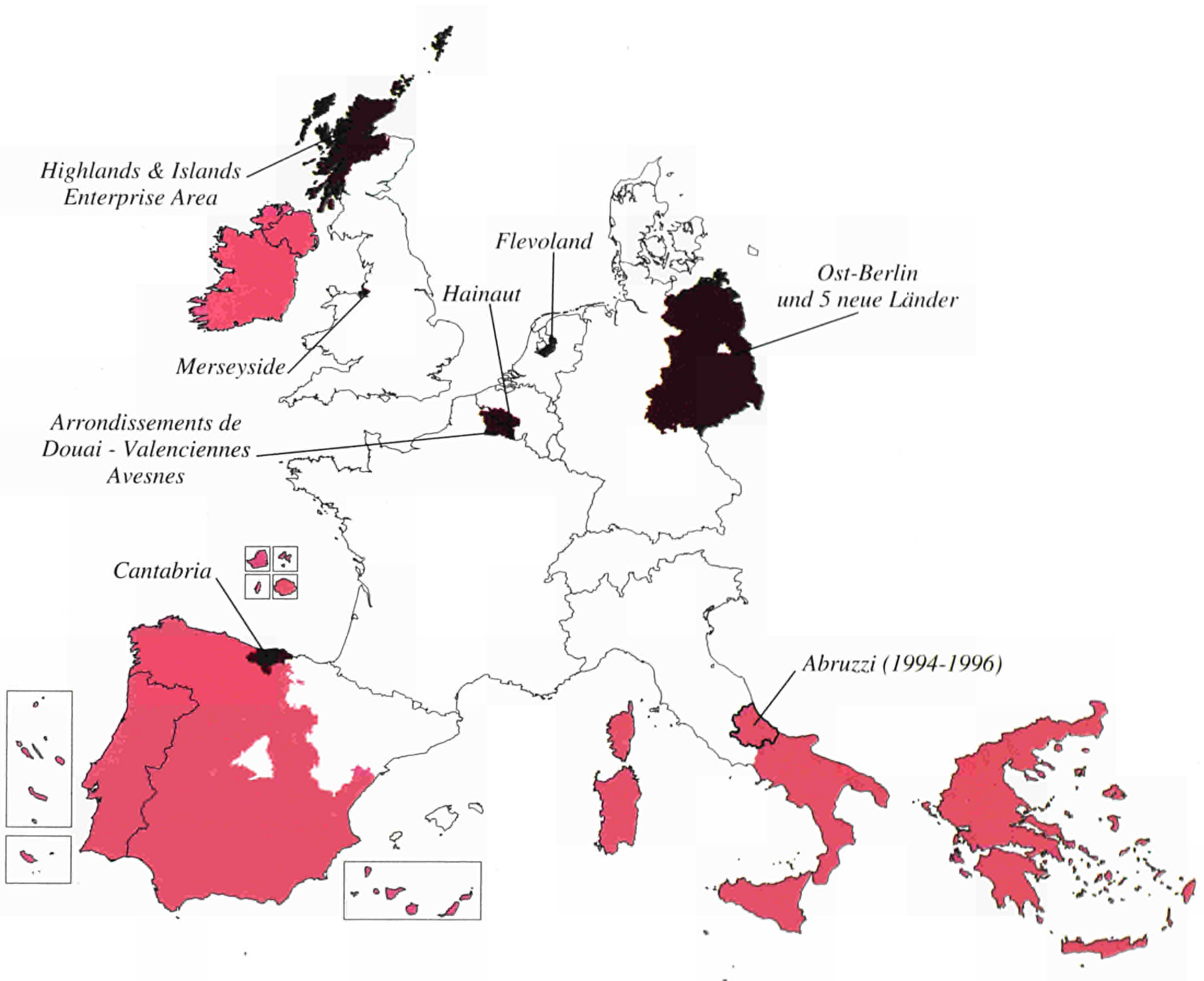
Regions eligible under the EC Structural Funds, 1989-93

(Objectives 1, 2 & 5b)



Regions eligible under Objective 1, 1994-99

(regions whose development is lagging behind)



■ Regions eligible under Objective 1, for the periods 1989-93 and 1994-99 (except for Abruzzi: until 31 December 1996)

■ Regions newly eligible under Objective 1 for the period 1994-99

Financial engineering techniques in regions covered by Objectives 1, 2 and 5b of the Community regional policy

Summary

Summary

In July 1991, Directorate-General XVI of the Commission of the European Communities commissioned a report on financial engineering techniques in the legal and tax context applying to regions eligible under Objectives 1, 2 and 5b. Following nine months of intensive legal and tax research by 24 national and two central teams of specialist legal and tax advisers, the results of the investigations have been collated and compiled and are reproduced below.

Objectives

DG XVI has previously commissioned two studies on the subject of financial engineering techniques. The first was concerned with the financing needs of small and medium-sized enterprises (SMEs) in assisted regions and the difficulties facing them. The second was intended as a guide for managers of Community-funded programmes and highlighted the importance of financial engineering techniques for the SMEs and for regional development. It also contains details of the various techniques involved.

The current study was required to cover the actual methods available for assisting SMEs financially in the assisted regions in each Member State and the various defects or limitations inherent in those methods. Positive features which promote the use of a technique were also required to be covered. Within this context, the objectives of the study could be summarized as follows:

- to identify the legal and regulatory framework relating to identified financial engineering techniques;
- to identify the legal and tax issues which specifically promote or hinder those financial engineering techniques;
- to comment on the legal deficiencies affecting financial engineering techniques by comparison with the situation in other Member States; and
- to make recommendations concerning the rectification of those deficiencies by reference to the legal framework.

Scope

The scope of the work covered four specified financial engineering techniques as they affect SMEs. The techniques concerned are:

- venture capital;
- guarantee funds and mutual guarantee schemes;
- leasing;
- factoring.

Key assumptions

According to the objectives of Directorate-General XVI, it was agreed that, in conducting the study, the following points would have to be borne in mind:

- The study was to be confined to techniques of relevance to SMEs. The Commission, in the context of financial engineering, includes within the category of small and medium-sized enterprises those businesses which satisfy the following criteria:
  - (i) less than 500 employees;
  - (ii) less than ECU 40 million assets;
  - (iii) less than ECU 75 million annual turnover; and
  - (iv) less than one-third ownership by a larger firm (as defined by the criteria above).

  These criteria were to be borne in mind when considering the range of techniques used in the Member States. Those which are inappropriate to the smaller-scale undertakings with which DG XVI is concerned were to be ignored. Likewise, obstacles or benefits which are inapplicable to the SMEs were to be excluded.

- The study was to be concerned with SMEs in the assisted regions designated as being eligible under Objectives 1, 2 and 5b. They include the territory of the former German Democratic Republic.
- The proposed study was intended to be an overview. DG XVI was not seeking to establish an in-depth catalogue of the detailed legal and tax provisions applicable in each Member State. General information and recommendations were, therefore, to be provided.
- Financial engineering techniques based on cross-border structures, car leasing and sale and lease-back operations were outside the scope of this study. The study was concerned with obstacles and positive features affecting local financial engineering techniques in each Member State.
- DG XVI was seeking to ascertain to what extent local and regional authorities can participate in financing small businesses by means of the techniques under consideration.

Structure

The key conclusions of this study, broken down country by country and technique by technique, are set out in the following pages.

Belgium

Venture capital

From a legal point of view, there are no significant legal obstacles which inhibit the use of this technique. There are, however, formalities which arise for consideration with regard to the intended recipients of venture capital. In practice, for instance, venture capital is often only provided to public limited companies (NV/SA) and the legal form of the recipient may have to be amended accordingly.

Certain limitations exist with regard to the manner of provision of venture capital. Banks and savings institutions, for instance, cannot generally invest directly in share capital.

From a tax point of view, a major drawback may be that the dividend exemption does not apply if the venture capital company (VCC) does not have enough taxable profits. This may lead to double taxation.

In some cases, interest paid by a limited liability company is treated as dividend. Furthermore, favourable tax regimes exist, for example an innovation company, an unemployment-zone company or an investment company (BEVEK/BEVAK).

Leasing

In Belgium, the concept of economic ownership is recognized for the purposes of direct taxation.

If the economic ownership is transferred to the lessee, the lessee is treated for tax purposes as if he had purchased the assets leased.

If there is no transfer of economic ownership, the leasing is treated as a rental agreement.

From a point of view of indirect taxation, the tax treatment of immovable property is based on legal ownership. As a consequence, the registration duty of 12.5% will be due on each transfer of legal ownership of immovable property.

The VAT legislation also may constitute an obstacle in the case of leasing of immovable property. The leasing of buildings becomes subject to VAT only if a considerable number of conditions are met. And even in this case, leasing of land is not considered to be a VAT activity.

As a result, the VAT paid on the construction of the building often cannot be recovered.

Factoring

There are legal restrictions on the factor itself. The factor is simply required to be incorporated as a Belgian company and to be recognized by the Minister for the Middle Classes.

From a tax point of view, factoring may be of interest to SMEs. In Belgium, it is difficult to build up a provision for bad debts. Factoring can be of assistance in this regard as it avoids these restrictions.

The recoverability of input VAT may, in certain circumstances, present an obstacle. This is because certain factoring transactions are not subject to VAT.

Guarantee funds

There are several examples of guarantee funds in Belgium. A number of limitations affect the beneficiaries of the guarantees provided. In the case of both the Public Guarantee Fund and the regional guarantees there are limitations on the eligible beneficiaries of guarantees, on the types of loan which are eligible to benefit from a guarantee, and on the maximum amount which can be guaranteed.

Belgian tax law treats guarantee funds favourably (by granting an exemption from corporate income tax, or reduced rates).

In general terms, no real obstacles have been identified either from a legal or a tax point of view.

Denmark

Venture capital

From a legal point of view, a number of detailed provisions affect each category of vehicle used for providing venture capital. Broadly speaking, the public or private limited company is the preferred form of vehicle. A number of alternative vehicles are sometimes used, however.

As far as the provision of debt finance is concerned, both subordinated debt and convertible bond arrangements are used and do not present any significant obstacles.

There are no major tax obstacles in Denmark. However, a number of issues do arise for consideration. Two particular problems present themselves. The dividend exemption enjoyed by the VCC only applies when the VCC holds at least 25% of the SME's share capital. Otherwise, a partial double taxation may result. Nevertheless, the above issues do not apply in the case of a VCC which is incorporated as an investment company. The dividends received by these companies are always exempt from tax.

The second disadvantage arises from the fact that capital gains made on the realization of shareholdings are fully taxable if the shares have been held for less than three years.

In Denmark, investment in VCCs is made particularly attractive for individuals. They may deduct the interest paid to finance the purchase of shares in the VCC for income tax purposes.

Leasing

In Denmark, the concept of economic ownership is recognized for direct tax purposes. However, transfer of the economic ownership to the lessee is rather exceptional.

In the case of the transfer of economic ownership, the lessee is treated as if he had purchased the assets leased.

Indirect taxation is based on legal ownership. As a consequence, problems may arise in the case of leasing of immovable property.

In Denmark, leasing is normally treated as operating leasing, i.e. the tax depreciation is with the lessor being the legal owner. From a tax point of view, there is thus normally no transfer of economic ownership. Only in certain exceptional situations may the economic ownership be considered for tax purposes to be transferred to the lessee. Financial leasing is thus rather exceptional in Denmark.

Factoring

There are no significant obstacles which affect the technique of factoring in Denmark. From a legal point of view, certain formalities must be respected. These include the necessity to give proper notice to the debtor of the transfer of the debt.

Factoring may be of interest from a tax point of view, especially as regards factoring without recourse as all probable losses are realized and, therefore, become deductible without limit.

From the point of view of VAT, the recoverability by the factor of input VAT may, in certain circumstances, present a problem. This is because certain factoring transactions are not subject to VAT. Furthermore, if the receivable is not recovered, the VAT paid by the SME to the State cannot be recovered by either the factor or the SME. This can create a major obstacle.

Guarantee funds

There is a general framework in Denmark with regard to guarantee funds. No real obstacles have been identified in the context of this framework.

A law concerning the establishment of the new Development Fund has recently been enacted and is expected to enter into force during the first half of 1992. This fund has been capitalized at ECU 250 000 000.

Local and regional authorities could participate in guarantee funds, but would need specific legislative authorization in order to do so.

From a tax point of view, there are no special provisions in existence. However, guarantors can set up reserves to cover bad debts only to a limited extent. This tax treatment does not reflect the risks inherent in the provision of the guarantees.

France

Venture capital

France has a highly organized system for providing venture capital support to SMEs, and ranks third as regards venture capital investments after the United States of America and the United Kingdom. The preferred instruments are ordinary shares, convertible bonds and preferred shares; debt finance is very seldom used.

From a tax point of view, an obstacle may be that, generally, capital gains are always taxable (possibly at reduced rates). Also, long-term capital losses can only be set off against long-term capital gains.

On the other hand, the forming of VCCs has been encouraged by providing tax exemptions in case the VCC takes the specific form of, for example, a 'société de capital risque'. Even if this is not the case, the risk of double taxation is generally excluded, not only in the case of debt but also in the case of equity finance because in the latter, the VCC can either benefit from the dividend exemption or claim the 'avoir fiscal'.

Finally, special tax benefits also exist for certain SMEs.

Leasing

In France, 'economic ownership' is not decisive in the tax treatment of leasing operations. From a tax point of view, all types of leasing are treated as mere rental agreements.

With respect to leasing of movable assets, the French tax legislator has, however, introduced some specific measures for a certain type of leasing in order to treat the lessee more as an economic owner for the purposes of capital gains taxation. This may constitute an obstacle for the lessor since he is not entitled to the special gains taxation.

Leasing of immovable property may constitute problems with respect to indirect taxation (registration tax is due on each sale of land and buildings and there is no VAT liability on such sales. Hence, a part of the VAT deduction must be paid back).

However, in the field of direct taxation of leasing of immovable property, a very advantageous regime exists for Sicomis.

Factoring

While there are a number of formalities which must be fulfilled, there are no significant legal obstacles to the establishment or operation of factoring companies. Factoring is not subject to a specific regulatory regime. However, factoring companies are subject to the law relating to banks and financial institutions and authorization must be obtained from the 'Comité des établissements de crédit'.

The ability of local and regional authorities to participate in the provision of factoring finance is limited owing to the constraints placed upon their activities.

Factoring may be of interest from a tax point of view, especially in the case of factoring without recourse since all probable losses are realized and, therefore, become deductible without limit.

The factor may opt to be subject to VAT. Therefore the recoverability of input VAT paid by the factor does not give rise to any problem. However, if the receivable is not recovered, the VAT paid by the SME to the State cannot be recovered by either the factor or the SME, which can create a major obstacle.

Guarantee funds

In France, guarantee funds have been set up at the national, regional, departmental and communal level. Although no real obstacles have been identified, there are a number of restrictions on the beneficiaries eligible to receive guarantees. There are also certain restrictions on the purposes for which a guarantee can be sought.

In general, there are no special tax provisions applicable to guarantee funds. Specific tax regimes exist, however, for regional development funds ('sociétés de développement régional') which enjoy a tax exemption applying to most of their income. 'Sociétés de cautionnement mutuel' can allocate part of their income to a taxable reserve. Both of the above can build up special provisions for risks.

Germany

Venture capital

The German venture capital market provides a wide range of investment vehicles and has been in expansion since the mid-1980s. Total invested capital has risen from DM 785 million in 1983 to DM 3 341 million in 1990. A major psychological barrier to the participation of venture capitalists in SMEs has been the traditional refusal of family owners to admit new shareholders. However, this tendency has dwindled over recent years.

As far as tax matters are concerned, no major obstacles appear. However, the fact that double taxation for 'Gewerbesteuer' and 'Vermögenssteuer', purposes may arise if no substantial holding exists (10%), is rather disadvantageous. On the other hand, in case the VCC

takes the form of an 'Unternehmersbeteiligungsgesellschaft' it is exempt from the abovementioned trade tax and net worth tax (i.e. regardless of the percentage of shareholding).

Other disadvantages are that capital gains on shares are always taxable and interest payments by the SME are partially included in the taxable base in computing trade tax on income.

Leasing

The concept of economic ownership is recognized in German tax law. In case there is a transfer of economic ownership, the lessee is treated in the same way as if he had purchased the leased assets.

As far as leasing with transfer of economic ownership is concerned, the limited deductibility (50%) of the lease payments for trade tax purposes constitutes a serious obstacle. In Germany, it might, therefore, be more interesting to enter into a lease agreement which does not imply transfer of economic ownership. Such a lease is treated as a mere rental agreement for tax purposes.

Indirect taxes may cause problems in the case of leasing of immovable property, since a registration tax is due on each transfer of title ('Verfgungsmacht').

Factoring

Factors do not face any significant obstacles to their operation from a legal point of view. They are only subject to regulation if they also conduct banking activities.

A number of practical issues arise for consideration. These do not, however, present any major legal obstacles.

The German State does not currently participate directly in factoring but it is clear that it could do so if it wished.

From a tax point of view, only factoring without recourse benefits from a tax advantage. Indeed the problem of the limited deductibility of the interest payments with regard to the 'Gewerbesteuer' (trade tax) is avoided.

The non-recoverability of the input VAT paid by the factor, to the extent that financing is involved, may present an obstacle.

It appears that, from both a legal and tax point of view, factoring without recourse offers certain advantages.

Guarantee funds

There are two types of entity involved in offering guarantees in Germany. These are the suretyship banks and the loan guarantee associations. Suretyship banks are subject to control under German banking legislation. Limits are imposed in particular on the scale of the transactions to be undertaken by reference to the level of proprietary capital at the suretyship bank's disposal.

Apart from the general prudential controls referred to, there are no significant restrictions on guarantee funds in Germany.

Greece

Venture capital

The legal and regulatory environment for venture capital in Greece is too restrictive. The activity is limited to specialized institutions which, in turn, are limited to equity financing of high-technology or innovative investments. The activity should be extended to other areas, given that Greece is not a country with a solid industrial base.

If the VCC does not satisfy the conditions of Law 1775/1988 (concerning activities, participating in SMEs, performing high technology, innovation businesses, amount

of capital, etc.) or is not an investment holding company, it cannot benefit from the specific tax benefits that exist for both these forms.

A negative aspect is that capital gains are only tax exempt when put in a special reserve account used to cover future capital losses, unless the VCC operates as an investment holding company.

Furthermore, several exclusions from the taxable base and reduced rates apply for SMEs meeting certain conditions.

Leasing

In Greek tax law, 'economic ownership' is not recognized. From a tax point of view, leasing is treated as a mere rental agreement.

As a consequence, a lot of incentives are lost. On the other hand, specific incentives promoting financial leasing of movable assets are provided.

Indirect taxes may give rise to problems as to financial leasing of immovable assets.

Factoring

It is difficult to assess the technique in Greece as there are at present no factoring companies and no banks engaging in factoring. Certain points have been highlighted, however, as regards potential problems.

Factoring can only be carried out by either banks or non-banks, provided that the latter engage exclusively in factoring. The type of non-bank which may qualify is also limited. This is regarded as an obstacle.

An assessment has been made of the potential tax treatment of any factors which might be set up in the future. Factoring without recourse may be beneficial because the factor, in contrast to the SMEs, can build up a provision for bad debts. Moreover, by transferring the receivable to a factor at an undervalue, the SME is able to deduct the losses it suffers as a result.

As far as indirect taxes are concerned, banks may be at a disadvantage to non-banks engaged in factoring as they may be subject to a special tax on banking transactions instead of VAT. This special tax may be denied on factoring services provided by banks and is not recoverable.

Guarantee funds

There are no guarantee funds or mutual guarantee funds in Greece. It is, therefore, not possible to evaluate them properly at the present time. If, however, an ordinary company were to offer guarantees, the Greek tax regime makes no allowance with regard to future losses which might be incurred. This could be an obstacle.

Ireland

Venture capital

The Irish venture capital market is relatively sophisticated, with an availability of a wide range of vehicles and methods. There are no significant obstacles to venture capital financing in Ireland, although compliance costs are significant.

As far as tax matters are concerned, no real obstacles present themselves. A disadvantage, however, is that capital gains on shares are in principle always taxable.

On the other hand, it can be considered advantageous that reduced rates apply to certain SMEs and that double taxation is avoided because dividend income is exempt with the receiving VCC.

Leasing

In Ireland, 'economic ownership' is decisive in the tax treatment of leasing. Since it is in practice very difficult

to meet the conditions to be considered as the (economic) owner of the leased assets, transfer of economic ownership is rather exceptional.

For tax purposes, leasing with transfer of economic ownership is translated as a straight purchase. However, in the case of a finance lease of movable assets, the lessee may be allowed to depreciate the asset and to deduct the total rental payments (except if it concerns a hire purchase agreement).

On the other hand, special incentives regarding rental payments are provided for operating a lease (where transfer of economic ownership is unusual) of immovable property.

Indirect taxation is based on legal ownership. Therefore, problems may arise with respect to indirect taxes on leasing of immovable property.

Factoring

Factors do not face any significant legal obstacles as regards their establishment or operation. They are not subject to licensing requirements. The recipients of factoring finance do not face any significant legal obstacles either.

From a tax point of view, in the context of factoring with recourse, where the debt is transferred to the factor, the SME can no longer build up a provision for bad debts. This may constitute an obstacle.

Without recourse may be beneficial owing to the difficult question of valuation of receivables being avoided by releasing capital losses which are tax deductible.

The recoverability of input VAT by the factor may not always be possible, depending on the transaction. This may present a problem. Furthermore, if the receivable is not recovered, the VAT paid by the SME to the State cannot be recovered by either the factor or the SME. This can create a major obstacle.

Guarantee funds

There are no specific entities established in Ireland as guarantee funds. Guarantees are, however, available through other entities such as banks and insurance companies. The Industrial Development Authority (IDA) also offers guarantees for certain purposes.

A number of restrictions apply to the offering of guarantees by the Industrial Development Authority in the form of selection criteria which must be satisfied by the applicants. These criteria partly describe the manufacturing entities which are eligible to receive assistance.

Some special tax regimes are available, more specifically in relation to the IDA (this being an entity which is not subject to tax). As to the tax regime of financial institutions offering guarantees, no special rules are applicable, which may, in view of the high risk inherent in the business, represent an obstacle.

Italy

Venture capital

The Italian institutional venture capital market is young in comparison with that of other industrialized countries, notably the United Kingdom. The main reasons for the delayed growth of merchant banking and venture capital activities are the lack of legal and fiscal rules to support venture capital providers, notably rules facilitating disinvestment.

As far as tax matters are concerned, the following negative aspects should be taken into consideration:

- Although exemption from corporate tax is granted to SMEs and VCCs situated in underdeveloped areas such as the Mezzogiorno area, an equalization tax is

levied in case such a company distributes dividends, which neutralizes the effect of the tax exemption. In some cases, partial double taxation may arise due to the non-refundability of the tax credit.

- Capital gains on shares are in principle fully taxable.
- The technique of redemption of shares is unknown in Italian law. On the other hand, several incentives have been created:
  - Specific forms for VCCs (SIF, SFI, etc.) with tax benefits;
  - Exemptions from local or corporate income tax for companies in certain regions (Mezzogiorno area, new offshore centre of Trieste).

As far as debt finance is concerned, interest payments are only deductible to a proportion equal to the ratio of gross taxable income to total gross income. This implies that the total amount remains undeductible if the SME is exempt from corporate income tax.

Leasing

The activity of leasing is not hindered in Italy by any significant legal obstacles. Leasing companies are not subject to regulatory control other than that applicable to them due to their particular form.

Before the Presidential Decree of 22 December 1986, the tax treatment of leasing was fairly advantageous, but this has now changed.

Factoring

Factors do not generally face any significant legal obstacles with regard to their establishment or operation.

From a tax point of view, factoring with recourse implies that the SME can no longer establish a provision for bad debts. This may represent an obstacle.

As far as factoring without recourse is concerned, this may be an interesting technique because the SME can deduct financial losses on receivables without limit.

The recoverability of input VAT by the factor may present a problem, depending on the transaction involved.

Guarantee funds

Most companies involved in guarantee funds are consortia. There are two types of consortia. No significant obstacles have been identified in relation to either of them.

Italy provides very favourable tax treatment (most of the income benefits from a tax exemption).

Luxembourg

Venture capital

No major legal obstacles exist to the provision of venture capital in Luxembourg except that the government scheme of issuing venture capital investment certificates and the consequent tax advantages are limited to Luxembourg residents. The holder of a certificate is free to sell the certificate to a third party provided he is a Luxembourg resident.

From a tax point of view, no major obstacles occur. It should, however, be noted that the dividend and capital gains exemption only applies under certain conditions, so that double taxation may result, not only for corporate income tax, but also for business tax and net-worth tax purposes. As far as debt finance is concerned, interest on loans in order to finance the acquisition of a participation in the SME is not deductible to the extent that it relates to exempt income.

Favourable regimes exist when the VCC takes the form of an investment fund (tax exempt dividend income) or a 1929 holding company (tax exempt interest and dividend income).

Furthermore, several laws (e.g. the laws of 13 December 1988 and 3 April 1989) have been enacted in order to promote the provision of risk capital through tax reductions.

Leasing

In Luxembourg, the concept of economic ownership is accepted for direct tax purposes. If the economic ownership is transferred to the lessee, he will be considered as purchaser for purposes of direct taxation.

In case there is no transfer of economic ownership, the leasing is treated as a rental agreement.

In Luxembourg, the immovable property transfer tax constitutes an important obstacle, since it is levied on each transfer of legal ownership of immovable property, even if VAT liability arises.

Factoring

On the whole, there are no significant legal obstacles to factoring. However, factoring companies must be licensed in order to establish in Luxembourg and are subject to minimum regulatory standards. They also face limits on the methods they can use to raise finance which are dependent on their status. Only licensed banks and non-banking financial institutions can, for instance, raise finance by means of deposits taken from clients.

The types of factoring which can be engaged in by the various categories of factor are limited.

Factoring could be a problem from a VAT point of view since the input VAT can only be partially recovered, depending on the activity.

Guarantee funds

There are two guarantee funds in existence: the National Association for Guarantees and Aid to Merchants and the Guarantee Office. Although there are some limits on the objects for which a guarantee can be granted, no significant obstacles have been identified.

Luxembourg tax law provides for a full tax exemption of the guarantee funds in existence.

The Netherlands

Venture capital

Like the United Kingdom, the Netherlands is a relatively unregulated successful market for venture capitalists. There are no significant legal or regulatory obstacles to the provision of equity or debt finance.

No major drawbacks occur as far as tax matters are concerned.

Double taxation is avoided in the case of interest as well as in the case of dividend income, since the latter is tax exempt if it is coming out of a qualifying participation (5%). Capital gains also remain tax free if they are realized on qualifying participations.

Finally, the fact that no special tax benefits have been granted to companies situated in less-developed areas may be considered a negative point.

Leasing

There is no specific legislation on leasing in the Netherlands. The parties enjoy contractual freedom. Contracts are judged by their contents and not by their form.

Depending on the legal qualification of the contents of a contract, certain legal rules limit the freedom of the parties, especially where these rules are obligatory.

Factoring

There are no significant legal or tax obstacles to factoring. However, the entry into force of the new Dutch Civil Code may give rise to problems with regard to the registration of deeds establishing silent pledges (which are necessary to establish good title to the debt transferred). It is expected that an enormous burden will be placed on the Department of Registration and that the latter is unlikely to be able to meet the demands placed upon it.

In the case of factoring with recourse, the factor from a VAT point of view may not be able to recover all or part of the input VAT.

Guarantee funds

Only guarantee funds have been found to exist. Three funds are in existence. Certain restrictions apply to the amount and duration of the guarantees which can be offered.

The 'Particuliere participatie maatschappij', dealt with under 'Venture capital', is eligible for investment guarantees.

The guarantors in the Netherlands appear to be the State and the Nederlandse Bank NV. Neither of these are subject to tax.

Portugal

Venture capital

The Portuguese venture capital market has not been a notable success and proposals are under consideration for reform of the financial system, including the institutions relevant to venture capital. Of all the Member States, Portugal perhaps provides the most stimulating challenge for the creative borrowing of concepts from other Member States.

From a tax point of view, no major obstacles occur. On the contrary, tax incentive schemes have been introduced for companies (SMEs or VCCs) situated in the Madeira/Azores free zones (temporary exemption from corporate tax).

Also, in case the VCC takes the specific form of a 'Sociedade de capital de risco' (SCR) or a 'Sociedade de fomento empresarial' (SFE), it benefits from a temporary exemption from corporation tax.

Leasing

In Portugal, 'economic ownership' is at present not recognized for tax purposes. From a tax point of view, leasing is treated as a mere rental agreement.

There are, however, some differences with respect to direct taxes (capital gains taxation, depreciation methods, deduction of immovable rents), which might constitute an obstacle.

The lessee is treated as an economic owner with regard to subsidies.

The Portuguese tax legislator has also introduced some specific measures in order to avoid the obstacles which arise in the indirect taxation of leasing of immovable property.

The Portuguese tax law also contains specific incentives promoting leasing companies.

Factoring

Factors will be treated as banks under currently proposed reforms. They are already supervised on the same

basis but would, under the reforms, be subject to even more stringent requirements. Both the existing and future requirements must be regarded as obstacles.

From a direct tax point of view, factoring with recourse leaves the SME in a less favourable position as the SME cannot build up a provision for bad debts if the debts are transferred to the factor. With regard to factoring without recourse, this may be of interest as the SME can deduct financial losses on receivables without limit.

In the case of indirect taxes, the input VAT paid by the factor cannot be recovered except as regards factoring with recourse and without financing. On the other hand, as regards financing by a factor, no stamp duty becomes due.

Spain

Venture capital

The Spanish venture capital market is characterized by intervention from the public sector, notably the autonomous communities. However, the end of the 1980s saw an increase in private sector venture capital organizations. No significant legal obstacles have been identified, although, as in Italy, small enterprises are reluctant to bring in outside shareholders.

From a tax point of view, major efforts have been performed to promote the technique of risk capital. For example, when the VCC operates under the special form of a 'Sociedad de capital riesgo', a 100% relief from corporate income tax on dividends received from qualifying shares is applicable. Such VCCs also benefit from an exemption from taxation on capital gains arising on the disposal of securities.

On the other hand, if the VCC has not taken this special form, partial double taxation may result on dividend income (if certain conditions are not met) and capital gains on shares are fully taxable.

Tax benefits exist for SMEs situated in certain areas (the 'promotional zones'). These benefits have taken the form of a reduction of rates of indirect and local taxation.

Leasing

In Spain, 'economic ownership' is not decisive in the tax treatment of leasing. For tax purposes, leasing is treated as a mere rental agreement.

Real obstacles therefore arise with respect to direct taxation: important incentives are lost in the case of leasing. However, the Spanish tax legislator has introduced some tax measures with regard to certain incentives for investment in order to treat the lessee more as an economic owner for the application of those incentives.

Specific measures are also provided for financial leasing of immovable property: there is an exemption from transfer tax for transfers to and from financial leasing companies. From this point of view, financial leasing of real estate is more favourable than a straight purchase. An obstacle, however, is that the rental payment that corresponds with the leasing of land is not deductible for a lessee under a financial lease, whereas the lessor cannot depreciate the land.

Factoring

While there are no significant tax obstacles, a number of legal issues arise for consideration. High share capitalization requirements, stringent cash ratios and the need to notify each assigned debt to the debtor by means of expensive notarial deeds all present obstacles.

From a tax point of view, factoring without recourse may be beneficial since all probable losses are realized and become deductible at that time, without limit.

As far as VAT is concerned, the factor cannot, or can only partially, recover VAT, depending on the nature of the activity.

Guarantee funds

Three schemes operate in Spain. These are the reciprocal guarantee companies, the second guarantee public corporations and the reinsurance companies. The primary vehicles used for the giving of guarantees are the reciprocal guarantee companies. These are subject to capital requirements.

In general terms, no significant obstacles have been identified.

United Kingdom

Venture capital

The United Kingdom venture capital industry is the largest in Europe and second only to the USA in importance. It can fairly be described as a finance industry which serves SMEs with considerable effect.

As far as tax matters are concerned, no major obstacles appear. However, it should be taken into account that capital gains are, in principle, taxable at full (or reduced) corporate income tax rates, and that, in case the SME is being financed by a debt, certain interest payments are treated as profit distribution.

Favourable factors, on the other hand, are that dividends received are never included in a company's taxable income and thus tax exempt, reduced tax rates apply to companies with taxable profits not exceeding a certain amount, and some companies (e.g. building societies) can claim a preferential tax regime, which might be of particular interest to SMEs.

Leasing

Leasing of both movable and immovable property is widely used in the United Kingdom by SMEs for the acquisition of factory/office space and necessary plant and equipment. It reduces capital requirements for start up or expansion, is generally considered to be a tax-advantageous financial technique, is widely available and is subject to little regulatory restriction.

Factoring

There are no real obstacles to the use of the technique in the United Kingdom.

Factoring with recourse may put the SME in a less favourable position since it cannot build up a tax-free provision for bad debts.

With regard to bad debts, the factor cannot, or can only partially, recover the input VAT.

Guarantee funds

Guarantee funds exist in the United Kingdom. There is a national loan guarantee scheme. The local authorities may also issue performance guarantees.

From a tax point of view, the guarantors in the national loan guarantee scheme are not subject to tax.

Some court decisions suggest that guarantors who are not financial institutions or banks may not be able to deduct the losses inherent in issuing guarantees. Financial institutions and banks can deduct payments made under a guarantee. This difference in tax treatment may represent an obstacle to the promotion of the guarantee funds.

Les techniques d'ingénierie financière dans les régions relevant des objectifs n°s 1, 2 et 5 b) de la politique régionale de la Communauté

Rapport de synthèse

Résumé

En juillet 1991, la direction générale XVI de la Commission des Communautés européennes a commandé un rapport sur les techniques d'ingénierie financière dans une perspective juridique et fiscale applicables aux régions éligibles au titre des objectifs n°s 1, 2 et 5 b). Après neuf mois de recherche intensive dans le domaine juridique et fiscal, menée par vingt-quatre équipes nationales et deux équipes centrales de conseillers spécialistes des questions juridiques et fiscales, voici la synthèse des résultats des recherches.

Objectifs

À l'origine, la DG XVI a commandé deux études portant sur les techniques d'ingénierie financière. La première était consacrée aux besoins en financement des petites et moyennes entreprises (PME) dans les régions bénéficiant d'une aide et aux difficultés qu'elles rencontrent. La seconde devait servir de guide pour les dirigeants de programmes financés par la Communauté et mettait en lumière l'importance des techniques d'ingénierie financière pour les PME et pour le développement régional. Elle comprend également un exposé détaillé des différentes techniques mises en œuvre.

La présente étude avait pour objet d'exposer les méthodes actuellement disponibles pour fournir un soutien financier aux PME des régions bénéficiant d'une aide dans chaque État membre et de présenter les diverses insuffisances ou limites inhérentes à ces méthodes. Il fallait également présenter les aspects positifs pouvant favoriser le recours à l'une de ces techniques. Dans cette perspective, on peut résumer comme suit les objectifs de l'étude:

- définir le cadre juridique et réglementaire relatif aux techniques d'ingénierie financière définies;
- définir les aspects juridiques et fiscaux qui favorisent ou entravent particulièrement ces techniques d'ingénierie financière;
- commenter les manques juridiques concernant les techniques d'ingénierie financière en comparant avec la situation dans d'autres États membres;
- émettre des recommandations pour corriger ces insuffisances en se référant au cadre juridique.

Champ d'application

Le champ d'application de notre travail englobait quatre techniques d'ingénierie financière déterminées concernant les PME. Les techniques en question sont les suivantes:

- le capital à risque;
- les fonds de garantie;
- les régimes de cautionnement mutuel;
- le leasing;
- l'affacturage.

Présupposés de base

Conformément aux objectifs fixés par la direction générale XVI, il était convenu au cours de cette étude de ne pas perdre de vue les éléments suivants:

- l'étude devait se limiter aux techniques applicables aux PME. La Commission, dans le cadre de l'ingénierie financière, inclut dans la catégorie des petites et moyennes entreprises les entreprises remplissant les critères suivants:
  - effectif de moins de 500 personnes;
  - actifs inférieurs à 40 millions d'écus;
  - chiffre d'affaires annuel inférieur à 75 millions d'écus;
  - moins de un tiers du capital détenu par une société de plus grande dimension (selon les critères ci-dessus).

Ces critères devaient être pris en compte lors de l'examen de l'éventail des techniques utilisées dans les États membres. Il a fallu laisser de côté celles qui

sont inadaptées aux entreprises de plus petite taille qui intéressent la DG XVI. De la même manière, il a fallu éliminer les obstacles ou les avantages inapplicables aux PME;

- l'étude devait porter sur les PME des régions bénéficiant d'une aide et désignées comme éligibles au titre des objectifs n°s 1, 2 et 5 b). Celles-ci comprennent le territoire de l'ancienne Allemagne de l'Est;
- l'étude proposée devait être une vue d'ensemble. La DG XVI n'a pas cherché à établir un catalogue en profondeur des dispositions juridiques et fiscales détaillées applicables dans chaque État membre. C'est pourquoi il fallait fournir des informations et des recommandations à caractère général;
- les techniques d'ingénierie financière basées sur les structures transfrontalières, le leasing de véhicules et les opérations de vente et de cession-bail étaient en dehors du champ de cette étude qui portait sur les obstacles et les aspects positifs concernant les techniques d'ingénierie financière locales dans chaque État membre;
- la DG XVI a cherché à savoir dans quelle mesure les autorités locales et régionales peuvent participer au financement de petites entreprises en utilisant les techniques en question.

Structure

Le présent rapport a été rédigé de part en part de manière uniforme afin de faciliter les comparaisons entre les situations des différents États membres en ce qui concerne chaque technique. Il est divisé en quatre chapitres, chacun étant consacré à l'une des techniques énumérées ci-dessus. Les fonds de garantie et les régimes de cautionnement mutuel sont traités conjointement. À l'intérieur de chaque chapitre, chacun des États membres de la Communauté européenne est traité dans l'ordre alphabétique anglais.

Tout ce qui concerne la fiscalité comparative est traité à part à la fin de chaque chapitre.

Les conclusions fondamentales énumérées pour chaque pays et pour chaque technique sont présentées dans les pages qui suivent.

Belgique

Capital à risque

D'un point de vue juridique, il n'existe pas d'obstacles majeurs empêchant l'utilisation de cette technique. Il faut toutefois tenir compte des formalités concernant les bénéficiaires éventuels du capital à risque. Dans la pratique, le capital à risque n'est souvent investi, par exemple, que dans des sociétés anonymes ouvertes au public (NV/SA), et le statut juridique du bénéficiaire peut devoir être modifié en conséquence.

Il existe bien certaines limitations en ce qui concerne le mode de prestation du capital à risque. Les banques et les établissements d'épargne, par exemple, ne peuvent en général pas investir directement en capital-actions.

D'un point de vue fiscal, le fait que l'exonération sur les dividendes ne s'applique pas si la société de capital à risque ne réalise pas suffisamment de bénéfices imposables peut constituer un obstacle majeur. Cela peut entraîner une double imposition.

Dans certains cas, les intérêts payés par une société à responsabilité limitée sont considérés comme dividendes. D'autre part, il existe des régimes fiscaux favorables qui concernent, par exemple, une société pour l'innovation, une société pour les régions touchées par le chômage ou une société pour l'investissement (BEVEK/BEVAK).

Leasing

En Belgique, la notion de «propriété économique» est prise en compte pour l'imposition directe.

Si la propriété économique est transférée au locataire, celui-ci est considéré du point de vue fiscal comme s'il avait acquis les actifs donnés à bail.

S'il n'y a pas de transfert de la propriété économique, le leasing est considéré comme un contrat locatif.

Du point de vue de l'imposition indirecte, le traitement fiscal des biens immobiliers se base sur la propriété juridique. En conséquence, le droit d'enregistrement de 12,5 % est exigible sur chaque transfert de propriété juridique de biens immobiliers.

La législation sur la TVA peut également constituer un obstacle pour le leasing de biens immobiliers. Un nombre considérable de conditions doivent être remplies pour que le leasing de bâtiments puisse être soumis à la TVA. Et même dans ce cas, le leasing foncier n'est pas considéré comme activité concernée par la TVA.

Il en résulte que, très souvent, la TVA payée sur la construction d'un bâtiment ne peut être récupérée.

Affacturage

Le factor lui-même est soumis à des restrictions juridiques. Il est simplement tenu d'être constitué comme société belge et d'être agréé par le ministre des Classes moyennes.

D'un point de vue fiscal, l'affacturage peut être intéressant pour les PME. En Belgique, il est difficile de constituer une provision pour les créances douteuses. L'affacturage peut être utile dans la mesure où il évite ces restrictions.

La récupérabilité de la TVA à l'achat peut dans certains cas représenter un obstacle, parce que certaines transactions d'affacturage ne sont pas soumises à la TVA.

Fonds de garantie

Il y a plusieurs exemples de fonds de garantie en Belgique. Un grand nombre de restrictions s'appliquent aux bénéficiaires des garanties fournies. Dans le cas du fonds de garantie public et des garanties régionales, il existe des restrictions concernant les bénéficiaires de garanties éligibles, les types d'emprunt éligibles pour bénéficier d'une garantie et le montant maximal pouvant être garanti.

En Belgique, le traitement des fonds de garantie est favorable au regard de la législation fiscale (grâce à l'octroi d'une exonération de l'impôt sur le revenu des sociétés ou à des taux réduits).

D'une manière générale, aucun obstacle réel n'a été constaté d'un point de vue juridique ou fiscal.

Danemark

Capital à risque

Dans le domaine juridique, un grand nombre de dispositions détaillées concernent chaque catégorie de moyen utilisé pour l'apport d'un capital à risque. D'une façon générale, la société à responsabilité limitée publique ou privée est le moyen de financement privilégié. Toutefois, on a parfois recours à un certain nombre d'autres moyens.

En ce qui concerne l'apport de financement par l'emprunt, on a recours aux systèmes des emprunts subordonnés et des obligations convertibles qui ne présentent aucun obstacle significatif.

Au Danemark, il n'existe pas d'obstacles majeurs d'ordre fiscal. Toutefois, un certain nombre d'aspects doivent être soulignés. Deux problèmes particuliers se posent. L'exonération sur les dividendes dont bénéficie la société de capital à risque ne s'applique que quand celle-ci détient au moins 25 % du capital-actions de la PME, faute de quoi il peut en découler une double imposition partielle. Néanmoins, les aspects ci-dessus ne valent pas dans le cas d'une société de capital à risque constituée en société d'investissement. Les dividendes perçus par ces sociétés sont toujours exonérés d'impôt.

Le second inconvénient vient du fait que les plus-values résultant de la réalisation de portefeuilles d'actions sont entièrement imposables si les actions sont détenues depuis moins de trois ans.

Au Danemark, les investissements dans les sociétés de capital à risque sont très intéressants pour les particuliers. Ceux-ci peuvent déduire les intérêts versés pour financer l'achat d'actions de la société de capital à risque du calcul de l'impôt sur le revenu.

Leasing

Au Danemark, la notion de «propriété économique» est reconnue en ce qui concerne l'imposition directe. Toutefois, le transfert de la propriété économique au locataire est assez exceptionnel.

En cas de transfert de la propriété économique, le locataire est considéré comme s'il avait acquis les actifs donnés à bail.

L'imposition indirecte est basée sur la propriété juridique. En conséquence, des problèmes peuvent se poser dans le cas du leasing de biens immobiliers.

Au Danemark, le leasing est normalement considéré comme leasing de fonctionnement, c'est-à-dire que la déduction d'impôt se fait au profit du bailleur qui est le propriétaire légal. Ainsi, d'un point de vue fiscal, il n'y a normalement aucun transfert de propriété économique. Ce n'est que dans certaines situations exceptionnelles que l'on peut considérer du point de vue fiscal que la propriété économique est transférée au locataire. C'est pourquoi le leasing financier reste assez exceptionnel au Danemark.

Affacturage

Il n'y a pas d'obstacles majeurs entravant le recours à la technique de l'affacturage au Danemark. D'un point de vue juridique, certaines formalités doivent être respectées, notamment la nécessité d'informer précisément le débiteur du transfert de la dette.

D'un point de vue fiscal, l'affacturage peut être intéressant, notamment l'affacturage sans recours, quand tou-

tes les pertes probables sont réalisées et deviennent ainsi déductibles sans aucune limitation.

En ce qui concerne la TVA, la récupérabilité par le factor de la TVA en amont peut, dans certains cas, poser problème, parce que certaines transactions d'affacturage ne sont pas soumises à la TVA. D'autre part, si la créance n'est pas récupérée, la TVA payée par la PME à l'État ne peut être récupérée ni par le factor ni par la PME. Cela peut constituer un obstacle important.

Fonds de garantie

Au Danemark, il existe un cadre juridique global concernant les fonds de garantie. Aucun obstacle réel n'a été constaté dans ce contexte.

Une loi concernant la création du nouveau fonds de développement a été arrêtée récemment et devrait entrer en vigueur au cours de la première moitié de 1992. Le capital de ce fonds s'élève à 250 millions d'écus.

Les autorités locales et régionales pourraient participer aux fonds de garantie, mais cela nécessiterait une autorisation légale particulière.

Dans le domaine fiscal, il n'existe pas de dispositions spéciales. Toutefois, les garants peuvent constituer des réserves pour couvrir seulement en partie les créances douteuses. Ce traitement fiscal ne reflète pas les risques inhérents à l'octroi des garanties.

France

Capital à risque

La France dispose d'un système très sophistiqué de soutien aux PME par le système du capital à risque, et elle se situe au troisième rang pour les investissements en capital à risque après les États-Unis et le Royaume-Uni. Les moyens les plus couramment utilisés sont les actions ordinaires, les obligations convertibles et les actions de préférence; on a très rarement recours au financement par l'emprunt.

D'un point de vue fiscal, le fait que les plus-values sont toujours imposables (éventuellement à des taux réduits) peut constituer un obstacle. De même, les pertes en capital à long terme peuvent seulement être compensées par des plus-values à long terme.

D'un autre côté, la constitution de sociétés de capital à risque est encouragée par l'octroi d'exonérations fiscales dans le cas où la société de capital à risque adopte la forme spécifique d'une société de capital à risque. Même si ce n'est pas le cas, le risque de double imposition est généralement exclu, non seulement lorsqu'il y a dette, mais aussi dans le cas de financement sur fonds propres, car dans ce dernier cas la société de capital à risque peut soit bénéficier de l'exonération sur les dividendes, soit faire valoir le système de l'avoir fiscal.

Enfin, il existe également des avantages fiscaux spéciaux pour certaines PME.

Leasing

En France, la «propriété économique» ne joue pas de rôle décisif dans le traitement fiscal des opérations de leasing. Du point de vue fiscal, toutes les catégories de leasing sont considérées comme de simples contrats locatifs.

En ce qui concerne le leasing des éléments d'actifs mobiliers, la loi fiscale française a toutefois introduit des mesures spécifiques pour un certain type de leasing

afin de traiter le locataire plus comme un propriétaire économique aux fins de l'imposition sur les plus-values. D'un autre côté, cela peut constituer un obstacle pour le bailleur puisqu'il n'a pas droit à l'imposition spéciale sur les plus-values.

Le leasing de biens immobiliers peut poser des problèmes en ce qui concerne l'imposition indirecte (une taxe d'enregistrement doit être versée pour chaque vente de biens immobiliers, et il n'existe pas d'obligation de TVA sur ces ventes. Il en résulte qu'une partie de la déduction de TVA doit être restituée).

Toutefois, dans le domaine de l'imposition directe et du leasing des biens immobiliers, il existe un régime très avantageux pour les Sicomi (sociétés immobilières pour le commerce et l'industrie).

Affacturage

Si les formalités à remplir sont nombreuses, il n'existe pas d'obstacles juridiques importants à la création ou au fonctionnement de sociétés d'affacturage. L'affacturage ne fait l'objet d'aucun régime réglementaire spécifique. Toutefois, les sociétés d'affacturage sont soumises à la loi sur les banques et les instituts financiers et elles doivent obtenir une autorisation du comité des établissements de crédit.

La possibilité pour les autorités locales et régionales de participer au financement par affacturage est limitée en raison des contraintes qui pèsent sur leur activité.

L'affacturage peut être intéressant du point de vue fiscal, notamment dans le cas de l'affacturage sans recours puisque toutes les pertes probables sont réalisées et deviennent, par conséquent, déductibles sans aucun plafond.

Le factor peut choisir d'être soumis à la TVA. La récupérabilité de la TVA en amont versée par le factor n'est donc pas source de difficultés. Toutefois, si la somme à recevoir n'est pas récupérée, la TVA payée par la PME à l'État ne peut être récupérée ni par le factor ni par la PME, ce qui peut constituer un obstacle majeur.

Fonds de garantie

En France, les fonds de garantie sont constitués aux niveaux national, régional, départemental et communal. Bien que l'on n'ait identifié aucun obstacle réel, il existe un certain nombre de restrictions applicables aux bénéficiaires susceptibles de recevoir des garanties. Il existe aussi certaines restrictions relatives à la destination d'une garantie.

D'une manière générale, il n'existe pas de dispositions fiscales particulières s'appliquant aux fonds de garantie. Il existe cependant des régimes fiscaux spécifiques pour les fonds de développement régional (sociétés de développement régional), qui bénéficient d'une exonération d'impôt sur la plus grande partie de leur revenu. Les sociétés de cautionnement mutuel peuvent affecter une partie de leur revenu à une réserve imposable. Ces deux catégories de sociétés peuvent constituer des réserves spéciales pour risques.

Allemagne

Capital à risque

Le marché allemand du capital à risque fournit un large éventail de moyens d'investissement et est en expansion depuis le milieu des années 80. Le montant total du capital investi est passé de 785 millions de DM en 1983 à 3,341 milliards en 1990. Un obstacle psychologique majeur à la participation d'investisseurs en capital à risque dans les PME est constitué par le refus traditionnel des détenteurs de capitaux familiaux d'admettre de nouveaux actionnaires. Toutefois, cette tendance s'est atténuée au cours des dernières années.

On ne constate aucun obstacle majeur dans le domaine fiscal. Cependant, le fait qu'il peut y avoir double imposition au titre de la «Gewerbesteuer» et de la «Vermö-

gensssteuer» lorsqu'il n'existe pas d'exonération substantielle (10 %) représente un certain inconvénient. Par contre, si la société de capital à risque se constitue en «Unternehmerbeteiligungsgesellschaft», elle est exonérée de la taxe professionnelle susmentionnée et de l'impôt sur la valeur nette (c'est-à-dire sans tenir compte du pourcentage d'actionnariat).

Le fait que les plus-values réalisées sur les actions sont toujours imposables et le fait que les paiements d'intérêts par la PME sont partiellement inclus dans l'assiette imposable lors du calcul de la taxe professionnelle sur le revenu constituent d'autres inconvénients.

Leasing

La notion de «propriété économique» est reconnue par le droit fiscal allemand. S'il y a transfert de la propriété économique, le locataire est traité comme s'il avait acquis les actifs donnés à bail.

En ce qui concerne le leasing avec transfert de propriété économique, la déductibilité limitée (50 %) du leasing applicable à la taxe professionnelle constitue un sérieux obstacle. C'est pourquoi il serait plus intéressant en Allemagne de souscrire un contrat de location n'impliquant aucun transfert de propriété économique. Du point de vue fiscal, ce type de bail est considéré comme un simple contrat de location.

Les impôts indirects peuvent être source de problèmes dans le cas du leasing de biens immobiliers, étant donné qu'un impôt d'enregistrement est exigible sur chaque transfert de titre («Verfügungsmacht»).

Affacturage

Du point de vue juridique, l'action des factors n'est entravée par aucun obstacle majeur. Ils sont simplement soumis à une réglementation quand ils sont également impliqués dans des activités bancaires.

Un certain nombre d'aspects pratiques doivent être pris en compte. Ils ne présentent cependant aucun obstacle juridique majeur.

En général, l'État allemand ne participe pas directement à l'affacturage. Il est pourtant clair qu'il pourrait le faire s'il le souhaitait.

D'un point de vue fiscal, seul l'affacturage sans recours bénéficie d'avantages fiscaux. En effet, celui-ci évite le problème de la déductibilité limitée des intérêts versés en ce qui concerne la «Gewerbesteuer» (taxe professionnelle).

La non-récupérabilité de la TVA en amont payée par le factor en proportion du financement peut représenter un obstacle.

Il apparaît que, du point de vue juridique aussi bien que fiscal, l'affacturage sans recours offre certains avantages.

Fonds de garantie

En Allemagne, il existe deux types d'organismes impliqués dans l'octroi de garanties. Il s'agit des banques de cautionnement et des associations de garantie d'emprunt. Les banques de cautionnement sont soumises au contrôle au titre de la législation bancaire allemande. Des limites sont imposées, en particulier sur le volume des transactions pouvant être engagées en fonction du capital propre dont dispose la banque de cautionnement.

En dehors des contrôles généraux de surveillance visés, il n'existe pas de restrictions importantes sur les fonds de garantie en Allemagne.

Grèce

Capital à risque

Le contexte juridique et réglementaire qui entoure le capital à risque en Grèce est trop restrictif. L'activité est limitée à des instituts spécialisés qui sont à leur tour

limités au financement sur fonds propres d'investissements dans la haute technologie ou d'investissements innovateurs. L'activité gagnerait à être étendue à d'autres secteurs, étant donné que la Grèce est un pays ne disposant pas d'une solide base industrielle.

Si la société de capital à risque ne remplit pas les conditions fixées par la loi 1775/1988 (relative aux activités, à la participation dans les PME, à l'utilisation de la haute technologie, aux activités d'innovation, au montant du capital...) ou si elle n'est pas une société holding d'investissement, elle ne peut bénéficier des avantages fiscaux spécifiques s'appliquant à ces deux catégories.

Un point négatif est que les plus-values ne sont exonérées d'impôt que si elles sont mises sur un compte de réserve spécial utilisé pour couvrir les futures pertes en capital, à moins que la société de capital à risque n'opère comme société holding d'investissement.

Par ailleurs, les PME qui remplissent certaines conditions bénéficient de plusieurs exclusions de l'assiette de l'impôt et de taux réduits.

Leasing

La législation fiscale grecque ne reconnaît pas la notion de «propriété économique». D'un point de vue fiscal, le leasing est considéré comme un simple contrat de location.

Cela entraîne la perte de nombreux moyens d'incitation. D'un autre côté, des incitations spécifiques au leasing financier d'éléments d'actifs mobiliers sont prévues.

Les impôts indirects peuvent poser des problèmes en ce qui concerne le leasing financier de biens immobiliers.

Affacturage

Il est difficile de porter un jugement sur cette technique en Grèce, étant donné qu'il n'existe actuellement aucune société d'affacturage ni aucune banque pratiquant l'affacturage. On a cependant mis en lumière certains aspects concernant des problèmes potentiels.

L'affacturage ne peut être appliqué par des banques ou par d'autres organismes non bancaires qu'à condition que ceux-ci pratiquent exclusivement l'affacturage. La catégorie d'organismes non bancaires pouvant remplir ces conditions est également limitée, ce que l'on peut considérer comme un obstacle.

On a réalisé une évaluation du traitement fiscal potentiel de tous les factors pouvant être constitués à l'avenir. L'affacturage sans recours peut être avantageux, car le factor, contrairement aux PME, peut constituer une provision pour les créances douteuses. De plus, en transférant la créance à un factor en la sous-évaluant, la PME peut déduire les pertes qu'elle subit en conséquence.

En ce qui concerne les impôts indirects, les banques peuvent être désavantagées par rapport aux organismes non bancaires pratiquant l'affacturage, dans la mesure où elles peuvent être soumises à un impôt spécial sur les transactions bancaires et non pas à la TVA.

Cet impôt spécial peut être refusé sur les services d'affacturage fournis par les banques et il n'est pas récupérable.

Fonds de garantie

Il n'existe pas en Grèce de fonds de garantie ni de fonds de garantie mutuelle. Il est donc, au stade actuel, impossible d'en faire une évaluation correcte. Toutefois, si une société ordinaire devait offrir des garanties, le régime fiscal grec ne tiendrait aucun compte des pertes futures qui pourraient être subies, ce qui pourrait être un obstacle.

Irlande

Capital à risque

Le marché irlandais du capital à risque est relativement complexe et dispose d'un large éventail de moyens et

de méthodes. Il n'y a pas, en Irlande, d'obstacles majeurs au financement par le capital à risque, bien que les frais de procédure soient élevés.

Dans le domaine fiscal, on ne rencontre aucune difficulté réelle. Cependant, le fait que les plus-values sur les actions sont en principe toujours imposables constitue un inconvénient.

D'un autre côté, on peut considérer comme un avantage que des taux réduits soient appliqués à certaines PME et qu'on évite la double imposition puisque le revenu des dividendes de la société de capital à risque bénéficiaire est exonéré.

Leasing

En Irlande, la notion de «propriété économique» a une importance décisive pour le traitement fiscal du leasing. Étant donné qu'il est en pratique très difficile de remplir les conditions nécessaires pour être considéré comme propriétaire (économique) des actifs donnés à bail, le transfert de propriété économique est assez exceptionnel.

Du point de vue fiscal, le leasing avec transfert de propriété économique est considéré comme un achat simple. Toutefois, dans le cas d'un leasing financier d'éléments d'actifs mobiliers, le locataire peut être autorisé à réduire le montant de l'actif et à déduire le total des versements locatifs (sauf si cela concerne une location-vente).

Par ailleurs, des moyens d'incitation particuliers concernant les paiements locatifs sont prévus pour le leasing opérationnel de biens immobiliers (quand le transfert de propriété économique est inhabituel).

L'imposition indirecte se base sur la propriété juridique. C'est pourquoi il peut y avoir des problèmes en ce qui concerne les impôts indirects sur le leasing des biens immobiliers.

Affacturage

La constitution ou le fonctionnement des factors n'est entravé par aucun obstacle juridique majeur. Ils ne sont astreints à aucune demande d'autorisation. Les bénéficiaires du financement par affacturage ne rencontrent également aucun obstacle important.

Du point de vue fiscal et dans le cadre de l'affacturage avec recours, lorsque la dette est transférée au factor, la PME ne peut plus constituer de provision pour les créances douteuses. Cela peut constituer un obstacle.

L'affacturage sans recours peut être avantageux car la difficile question de l'évaluation des sommes à recevoir est évitée par la libération des pertes en capital qui sont déductibles de l'impôt.

Il se peut que la récupérabilité de la TVA en amont par le factor ne soit pas toujours possible, cela dépend de la transaction, ce qui peut constituer un problème. De plus, si la somme à recevoir n'est pas récupérée, la TVA payée par la PME à l'État ne peut être récupérée ni par le factor ni par la PME. Cela peut constituer un obstacle majeur.

Fonds de garantie

En Irlande, il n'existe pas d'organismes spécifiques constitués en fonds de garantie. On peut toutefois obtenir des garanties par l'intermédiaire d'autres organismes tels que les banques et les compagnies d'assurances. L'Office du développement industriel offre également des garanties pour remplir certains objectifs.

Un certain nombre de restrictions s'appliquent à l'octroi de garanties par l'Office de développement industriel sous forme de critères de sélection devant être remplis par les demandeurs. Ces critères définissent en partie les entreprises de fabrication susceptibles de recevoir une aide.

Il existe certains régimes fiscaux particuliers, notamment liés à l'IDA (Association internationale de développement), organisme qui n'est pas soumis à l'impôt. En ce qui concerne le régime fiscal des institutions financières offrant des garanties, il n'existe aucune réglementation particulière, ce qui peut représenter un obstacle eu égard au risque important inhérent à l'activité.

Italie

Capital à risque

Le marché institutionnel italien du capital à risque est jeune comparé à celui des autres pays industrialisés, notamment du Royaume-Uni. La raison principale qui explique le retard dans le développement des banques de financement et des opérations de capital à risque est l'absence de réglementation juridique et fiscale destinée à soutenir les bailleurs de capital à risque, notamment de réglementation facilitant le désinvestissement.

Dans le domaine fiscal, on doit noter les aspects négatifs suivants:

— bien que les PME et les sociétés de capital à risque situées dans les régions sous-développées telles que le Mezzogiorno soient exonérées de l'impôt sur les sociétés, un impôt de péréquation est prélevé quand ces sociétés répartissent des dividendes, ce qui neutralise l'effet de l'exonération fiscale. Il peut y avoir, dans certains cas, double imposition partielle du fait de la non-remboursabilité du crédit d'impôt;

— les plus-values sur les actions sont en principe entièrement imposables;

— la législation italienne ne connaît pas la technique du rachat d'actions.

D'un autre côté, on a créé plusieurs moyens d'incitation:

— des formes spécifiques de sociétés de capital à risque (SIF, SFI, etc.) s'accompagnant d'avantages fiscaux;

— l'exonération de l'impôt local ou de l'impôt sur le revenu des sociétés pour les sociétés situées dans certaines régions (Mezzogiorno, nouveau centre offshore de Trieste).

En ce qui concerne le financement par l'emprunt, les paiements d'intérêts ne sont déductibles que dans une proportion égale au revenu imposable brut par rapport au revenu total brut, ce qui implique que le montant total reste non déductible si la PME est exonérée de l'impôt sur le revenu des sociétés.

Leasing

En Italie, les opérations de leasing ne sont entravées par aucun obstacle juridique majeur. Les sociétés de leasing ne sont soumises à aucun contrôle réglementaire autre que ceux liés à leur statut particulier.

Avant le décret présidentiel du 22 décembre 1986, le traitement fiscal du leasing était plutôt avantageux, mais ce n'est plus le cas aujourd'hui.

Affacturage

La constitution ou l'activité des factors ne rencontre en général aucun obstacle juridique majeur.

D'un point de vue fiscal, l'affacturage avec recours implique que la PME ne peut plus constituer de provision pour les créances douteuses, ce qui peut représenter un obstacle.

Pour ce qui est de l'affacturage sans recours, ce peut être une technique intéressante car la PME peut déduire les pertes financières subies sur les créances sans aucune limitation.

Selon la transaction effectuée, la récupérabilité de la TVA en amont par le factor peut être une difficulté.

Fonds de garantie

La plupart des sociétés impliquées dans les fonds de garantie sont des consortiums. Il existe deux types de

consortiums décrits ci-après, et on n'a constaté aucun obstacle important les concernant.

L'Italie offre un traitement fiscal très favorable (la plus grande partie du revenu est exonérée d'impôt).

Luxembourg

Capital à risque

Au Luxembourg, aucun obstacle juridique majeur ne s'oppose à la fourniture de capital à risque, si ce n'est la procédure gouvernementale de délivrance de certificats d'investissement en capital à risque et le fait que les avantages fiscaux qui résultent de ce système sont limités aux résidents au Luxembourg. Le détenteur d'un certificat est libre de vendre ce certificat à un tiers pourvu que celui-ci soit résident au Luxembourg.

D'un point de vue fiscal, on ne constate aucun obstacle majeur. Il faut cependant noter que l'exonération sur les dividendes et sur les plus-values ne s'applique que dans certaines conditions, ce qui peut entraîner une double imposition non seulement dans le cadre de l'impôt sur le revenu des sociétés, mais aussi dans celui de l'impôt commercial et industriel et de l'impôt sur la valeur nette. Dans le cas du financement par l'emprunt, les intérêts sur les emprunts pour financer l'acquisition d'une participation dans une PME ne sont pas déductibles dans la proportion du revenu exonéré.

Il existe des régimes favorables quand la société de capital à risque se constitue en fonds d'investissement (revenu sur les dividendes exonéré d'impôt) ou en société holding, «loi de 1929» (intérêts et revenus sur les dividendes exonérés d'impôt).

En outre, plusieurs dispositions légales (par exemple les lois du 13 décembre 1988 et du 3 avril 1989) ont été adoptées afin d'encourager la fourniture de capital à risque grâce à des abattements fiscaux.

Leasing

Au Luxembourg, la notion de «propriété économique» est reconnue en ce qui concerne la fiscalité directe. Si la propriété économique est transférée au locataire, celui-ci est considéré comme acquéreur aux fins de l'imposition directe.

Dans le cas où il n'y a pas de transfert de propriété économique, le leasing est considéré comme un contrat de location.

Au Luxembourg, l'impôt sur le transfert de biens immobiliers constitue un obstacle important, car il est prélevé sur chaque transfert de propriété juridique de biens immobiliers, même en cas d'assujettissement à la TVA.

Affacturage

Globalement, il n'y a pas d'obstacles juridiques importants à l'affacturage. Toutefois, les sociétés d'affacturage doivent être patentées pour pouvoir s'établir au Luxembourg et elles sont soumises à un minimum de normes réglementaires. Elles sont également limitées en fonction de leur statut en ce qui concerne les méthodes qu'elles peuvent utiliser pour rassembler des capitaux. Seules les banques agréées et les instituts financiers non bancaires peuvent, par exemple, rassembler des capitaux en utilisant les dépôts effectués par les clients.

Les types d'affacturage pouvant être pratiqués par les différentes catégories de factors sont limités.

L'affacturage pourrait être un problème du point de vue de la TVA, étant donné que la TVA en amont ne peut être que partiellement récupérée en fonction de l'activité pratiquée.

Fonds de garantie

Il existe deux fonds de garantie: l'Association nationale pour les garanties et l'aide aux commerçants et l'Office de garantie. Bien qu'il y ait certaines restrictions sur les objets pouvant bénéficier d'une garantie, on n'a constaté aucun obstacle majeur.

La législation fiscale luxembourgeoise prévoit une exonération d'impôt complète des fonds de garantie existants.

Pays-Bas

Capital à risque

Comme le Royaume-Uni, les Pays-Bas constituent un marché relativement avantageux et peu réglementé pour les investisseurs en capital à risque. Il n'existe pas d'obstacle juridique ou réglementaire majeur à l'apport d'un financement sur fonds propres ou par l'emprunt.

On ne rencontre pas d'inconvénients majeurs dans le domaine fiscal.

La double imposition est évitée pour le revenu des intérêts et le revenu des dividendes, car celui-ci est exonéré d'impôt s'il provient d'une participation qualifiée (5 %). Les plus-values sont également exonérées d'impôt si elles sont réalisées sur des participations qualifiées.

Enfin, le fait qu'aucun avantage fiscal particulier n'est accordé aux sociétés situées dans des régions moins développées peut être considéré comme un point négatif.

Leasing

Les Pays-Bas n'ont aucune législation spécifique-concernant le leasing. Les partenaires jouissent d'une liberté contractuelle. Les contrats sont jugés en fonction de leur contenu et non pas de leur forme. Selon le statut juridique du contenu d'un contrat, certaines règles limitent la liberté des partenaires, notamment lorsque ces règles sont obligatoires.

Affacturage

Il n'existe pas d'obstacle juridique ou fiscal majeur à l'affacturage. Toutefois, l'entrée en vigueur du nouveau code civil néerlandais peut entraîner des problèmes en ce qui concerne l'enregistrement des actes constituant des promesses d'aide (nécessaires pour l'établissement du titre de la dette transférée). On s'attend à ce que le département d'enregistrement soit surchargé et il est peu probable qu'il puisse satisfaire les demandes qui lui seront présentées.

Dans le cas de l'affacturage avec recours et du point de vue de la TVA, le factor peut ne pas pouvoir récupérer tout ou partie de la TVA en amont.

Fonds de garantie

Il n'existe pas d'autres fonds que les fonds de garantie, et ils sont au nombre de trois. Certaines restrictions s'appliquent au montant et à la durée des garanties pouvant être offertes.

Les Particuliere Participatie Maatschappij traitées dans le chapitre consacré au capital à risque sont éligibles pour les garanties d'investissement.

Aux Pays-Bas, les garants sont l'État et la Nederlandse Bank NV, qui ne sont ni l'un ni l'autre soumis à l'impôt.

Portugal

Capital à risque

Jusqu'à présent, le système portugais de capital à risque n'a pas été un grand succès, et on examine actuellement des propositions en vue de réformer le système financier, notamment les institutions relatives au capital à risque. De tous les États membres, c'est peut-être le Portugal qui offre la situation la plus stimulante pour emprunter avec créativité les conceptions en vigueur dans d'autres États membres.

D'un point de vue fiscal, on ne rencontre aucun obstacle majeur. Bien au contraire, des régimes fiscaux incitatifs ont été mis en place pour les sociétés (PME ou

sociétés de capital à risque) situées dans les zones franches de Madère et des Açores (exonération temporaire de l'impôt sur les sociétés).

De même, si la société de capital à risque prend la forme spécifique d'une «sociedade de capital de risco» (SCR) ou d'une «sociedade de fomento empresarial» (SFE), elle bénéficie d'une exonération temporaire de l'impôt sur les sociétés.

Leasing

Dans le domaine fiscal, le Portugal ne connaît pas actuellement la notion de «propriété économique». Du point de vue fiscal, le leasing est considéré comme un simple contrat locatif.

Il existe cependant un certain nombre de différences en ce qui concerne les impôts directs (impôts sur les plus-values, méthodes d'amortissement, déduction des loyers immobiliers), qui pourraient constituer un obstacle.

En ce qui concerne les aides financières, le locataire est considéré comme détenteur de capital économique.

Au Portugal, le législateur fiscal a également introduit certaines mesures spécifiques afin d'éviter les obstacles inhérents à l'imposition indirecte du leasing de biens immobiliers.

La législation fiscale portugaise comprend également certaines mesures d'incitation spécifiques destinées à encourager les sociétés de leasing.

Affacturage

Les réformes actuellement proposées prévoient que les factors soient traités comme des banques. Ils sont déjà contrôlés sur la même base que les banques, mais les réformes prévoient de les soumettre à des exigences encore plus strictes. Les exigences actuelles et à venir doivent être considérées comme un obstacle.

Du point de vue de la fiscalité directe, l'affacturage avec recours place la PME dans une situation moins favorable, étant donné qu'elle ne peut constituer de provision pour les créances douteuses si les dettes sont transférées au factor. Pour ce qui est de l'affacturage sans recours, il peut être avantageux, étant donné que la PME peut déduire les pertes financières sur les sommes à recevoir sans aucun plafonnement.

En ce qui concerne les impôts indirects, la TVA en amont payée par le factor ne peut être récupérée, excepté en ce qui concerne l'affacturage avec recours et sans financement. D'un autre côté, dans le cas du financement par un factor, aucun droit de timbre n'est dû.

Espagne

Capital à risque

Le marché espagnol du capital à risque est caractérisé par l'intervention du secteur public, notamment des communautés autonomes. Toutefois, la fin des années 80 a vu une augmentation du nombre d'organisations de capital à risque du secteur privé. On n'a constaté aucun obstacle juridique important, bien que, comme en Italie, les petites entreprises soient peu disposées à s'ouvrir aux actionnaires extérieurs.

D'un point de vue fiscal, des efforts importants ont été accomplis afin d'encourager la technique du capital à risque. Par exemple, quand la société de capital à risque opère avec le statut spécial de «sociedad de capital riesgo», un dégrèvement à 100 % de l'impôt sur le revenu des sociétés appliqué aux dividendes perçus sur les actions de garantie est possible. Ces sociétés de capital à risque bénéficient également d'une exonération de l'impôt sur les plus-values effectuées sur la vente de titres.

D'un autre côté, si la société de capital à risque n'a pas pris ce statut spécial, il peut en résulter une double imposition partielle sur le revenu des dividendes (si certaines conditions ne sont pas remplies), et les plus-values sur les actions sont entièrement imposables.

Il existe des avantages fiscaux pour les PME situées dans certaines régions (les «zones prioritaires»). Ces avantages prennent la forme d'une réduction des taux d'imposition indirecte et locale.

Leasing

En Espagne, la «propriété économique» n'est pas très importante pour le traitement fiscal du leasing. En matière d'impôt, le leasing est considéré comme un simple contrat locatif.

C'est donc dans le domaine de la fiscalité directe que l'on est confronté à de véritables obstacles: le leasing ne bénéficie pas de mesures d'incitation importantes. Toutefois, le législateur espagnol a introduit plusieurs mesures fiscales concernant certains moyens d'incitation à l'investissement afin de traiter davantage le locataire comme un détenteur de capital économique en vue de l'application de ces moyens d'incitation.

Des mesures spécifiques sont également prévues pour le leasing financier de biens immobiliers: il existe une exonération de l'impôt sur le transfert de biens pour les transferts vers les sociétés de leasing financier et à partir de ces sociétés. De ce point de vue, le leasing financier de biens immobiliers est plus avantageux qu'un achat direct. Un obstacle vient cependant du fait que le paiement locatif correspondant au leasing de terrain n'est pas déductible pour un locataire sous le régime du leasing financier, étant donné que le bailleur ne peut pas amortir le terrain.

Affacturage

Bien qu'il n'y ait pas d'obstacles fiscaux importants, un certain nombre d'aspects juridiques doivent être pris en compte. Un haut niveau d'exigences de capitalisation en actions, des coefficients stricts de réserves obligatoires et l'obligation de notifier au débiteur toutes les dettes engagées par le biais d'actes notariés coûteux: tout cela constitue des obstacles.

D'un point de vue fiscal, l'affacturage sans recours peut être avantageux puisque toutes les pertes probables sont réalisées et deviennent déductibles à ce moment sans aucune limitation.

Pour ce qui est de la TVA, le factor ne peut la récupérer, ou seulement partiellement, en fonction de la nature de l'activité.

Fonds de garantie

Il existe en Espagne trois systèmes: les sociétés de cautionnement mutuel, les sociétés publiques de garantie seconde et les sociétés de réassurance. Les sociétés de cautionnement mutuel sont le moyen privilégié utilisé pour l'octroi de garanties. Elles sont soumises aux impératifs sur le capital.

D'une manière générale, on n'a constaté aucun obstacle majeur.

Royaume-Uni

Capital à risque

L'industrie du Royaume-Uni financée par le capital à risque est la plus développée d'Europe et n'est précédée en importance que par celle des États-Unis. On peut véritablement la définir comme une industrie de la finance qui a sur les PME une influence considérable.

Dans le domaine fiscal, on ne constate aucun obstacle majeur. Il faut, toutefois, noter que les plus-values sont en principe imposables aux taux pleins (ou réduits) d'imposition sur le revenu des sociétés et que, dans le cas où la PME est financée par un emprunt, certains paiements d'intérêts sont considérés comme distribution de bénéfices.

Par contre, le fait que les dividendes perçus ne sont jamais inclus dans le revenu imposable d'une société et sont ainsi exonérés d'impôt, que des taux d'imposition réduits s'appliquent aux sociétés dont les bénéfices imposables n'excèdent pas un certain montant et qu'un certain nombre de sociétés (par exemple les sociétés de crédit immobilier) ont droit à un régime fiscal préférentiel pouvant intéresser particulièrement les PME constitu un avantage.

Leasing

Au Royaume-Uni, le leasing d'éléments d'actifs mobiliers et de biens immobiliers est largement pratiqué par les PME pour l'acquisition d'espaces d'usines ou de bureaux ainsi que du matériel et des équipements nécessaires; il réduit les exigences en capital pour le démarrage ou l'expansion, est généralement considéré comme une technique financière avantageuse du point de vue fiscal, et est largement accessible et soumis à peu de restrictions réglementaires.

Affacturage

Au Royaume-Uni, l'utilisation de cette technique ne rencontre pas de réels obstacles.

L'affacturage avec recours peut placer la PME dans une situation moins favorable, car elle ne peut constituer de provision exonérée d'impôt pour les créances douteuses.

En ce qui concerne ces créances, le factor ne peut récupérer la TVA en amont ou seulement partiellement.

Fonds de garantie

Il existe des fonds de garantie au Royaume-Uni. Il y a un système national de garantie d'emprunt. Les autorités locales peuvent également émettre des garanties de bonne fin.

D'un point de vue fiscal, dans le système national de garantie d'emprunt, les garants ne sont pas imposables.

Certaines décisions de justice suggèrent que les garants qui ne sont ni des instituts financiers ni des banques ne puissent pas déduire les pertes inhérentes à l'émission de garanties. Les instituts financiers et les banques peuvent déduire les paiements effectués au titre d'une garantie. Cette différence de traitement fiscal peut constituer un obstacle au développement des fonds de garantie.

Venture capital

Belgium

Introduction

From a legal point of view, there are no significant legal obstacles which inhibit the use of this technique. There are, however, formalities which arise for consideration with regard to the intended recipients of venture capital. In practice, for instance, venture capital is often only provided to public limited companies (NV/SA) and the legal form of the recipient may have to be amended accordingly.

Certain limitations exist with regard to the manner of provision of venture capital. Banks and savings institutions, for instance, cannot generally invest directly in share capital.

From a tax point of view, a major drawback may be that the dividend exemption does not apply if the venture capital company (VCC) does not have enough taxable profits. This may lead to double taxation.

In some cases, interest paid by a limited liability company is treated as dividend. Furthermore, favourable tax regimes exist, for example an innovation company, an unemployment-zone company or an investment company (BEVEK/BEVAK).

I. Legal and regulatory issues

1. *Typical investment vehicle used*

Although venture capital may, in principle, be provided by individuals to individuals, it appears that in practice nearly all parties involved in venture capital business are corporations. Hence, this section will focus on corporations.

Consideration will only be given to the three main types of (Belgian) company:

the Naamloze Vennootschap/Société anonyme (NV/SA);

the Besloten Vennootschap met Beperkte Aansprakelijkheid/Société privée à responsabilité limitée (BVBA/SPRL); and

the Coöperatieve Vennootschap met Beperkte Aansprakelijkheid/Société coopérative à responsabilité limitée (CV/SC).

The main features of each of these types of company is provided separately.

One further entity requires a mention. This is the 'investment trust'. Investment trusts (Beleggingsinstellingen/organisme de placement) are institutions which make a public call on investors' savings and which operate in accordance with the principles of risk spreading.

They can be organized either by contract, in which case the trust is called a 'beleggingsfonds/fonds de placement' (investment fund) and the 'fund' is managed by a 'beheersvennootschap/société de gestion' (administration company), or by means of a company, in which case the trust is called a 'beleggingsvennootschap/société d'investissement' (investment company). Both types of investment trust must be administered and managed in the exclusive interest of the investing public.

2. *Applicable legal measures*

There is no specific legislation governing venture capital as such.

Certain pieces of legislation will, however, have an effect on venture capitalists themselves or on the provision by them of investment finance:

Article 14 of Royal Decree No 185;

Royal Decrees of 8 May 1990 and 14 June 1990;

These would prevent the provision of share capital in a direct manner by banks and savings institutions;

Articles 108 to 119 of the Act of 4 December 1990;

These define investment trusts;

Act of 2 April 1962, as amended;

Royal Decree of 16 November 1979;

Act of 17 July 1959, as amended;

Act of 30 December 1970, as amended;

Act of 4 August 1978, as amended;

Decree of the Walloon Regional Executive of 7 December 1989.

3. *The recipient of venture capital*

In practice, venture capital is only provided to undertakings which are incorporated.

The need to incorporate does not constitute a significant obstacle as the capital requirements are relatively low and the formation costs are fairly insignificant (see below).

As the shares of a BVBA/SPRL and CV/SC are subject to serious transfer restrictions, a venture capitalist will normally prefer to invest, or even exclusively invest, in corporations in the form of NV/SA. In order to attract equity capital from VCCs, SPRLs and SCs can be asked to re-register as SAs; re-registration is fairly simple and cheap, and does not involve a dissolution of the company or a transfer of assets.

The formation of a company necessarily entails ongoing administrative obligations and accounting duties (application for VAT and trade registration numbers, publication of annual accounts and excerpts of specific board resolutions, requirement of regular bookkeeping, etc.) but these requirements do not constitute a significant restriction with regard to attracting venture capital.

Conclusions:

No regulations generally restrict the obtaining of venture capital.

In practice, the undertaking will have to be incorporated and preferably in the form of an NV/SA.

4. *The provision of venture capital*

4.1. Equity finance

The term 'equity finance', as used in this report, can be defined as 'any capital supplied in the form of a direct investment in small and medium-sized enterprises by means of the acquisition of shares, either new ones, within the framework of the incorporation or the increase in capital of an SME, or existing shares.

Where a venture capitalist invests in shares of an SME, it often wishes to dispose of these shares in the medium or long term. It is, therefore, important for the venture capitalist to know at the moment of investing that the stock will be saleable or transferable. Moreover, the venture capitalist may wish to have legal assurance that it can oblige a third person to purchase the stock.

Separate details have, therefore, been provided with regard to pre-emption rights, shareholder agreements and approval clauses.

If the venture capitalist itself is a listed company or its activity would pertain to Belgian listed companies, shareholding disclosure requirements will apply. Separate details have also been provided with regard to these.

Every Belgian natural person or corporation may provide venture capital without restrictions in so far as the general corporate, accounting and fiscal regulations which would apply to any natural person or corporation are abided by.

However, by law, banks and savings institutions are in principle precluded from providing share capital in a direct manner (Article 14 of Royal Decree No 185; Royal Decrees of 8 May 1990 and 14 June 1990).

Banks and savings institutions, acting alone or together with their subsidiaries and the subsidiaries of their subsidiaries (hereinafter the 'banks'), cannot directly invest in share capital, subject to exceptions:

banks can invest in other credit institutions;

banks can acquire a shareholding in companies in order to hedge against questionable debtors. Such a stake must be sold within a period of two years;

banks can acquire shares with a view to offering them to the public. Such shares must be sold within a period of one year;

banks can make investments which are small in relation to their own equity capital and which do not result in a shareholding representing more than 5% of the voting rights of the company in which the shares are purchased.

The Commissie voor het Bank- en Financiewezen/ Commission bancaire et financière (CBF) may grant exemptions on a case-by-case basis.

As such, no regulation generally restricts lending by banks for the purposes of investment in the share capital of a company.

It should be noted, however, that an NV/SA must not provide securities with a view to the acquisition of its shares by third parties (Article 52 ter of the Companies Act). Hence, in principle, the bank which lends money to a third party, in order to enable this party to buy shares of a company, must not be given security by this company with a view to securing the repayment of the loan. Such security would be null and void according to legal doctrine.

Investment trusts

Investment trusts, as defined by Articles 108 to 119 of the Act of 4 December 1990, are virtually precluded from providing venture capital. Investment trusts must indeed spread their risks and must not acquire such stock of a company that would enable them to influence the management of this company. Moreover, an investment trust must abstain from any agreement which would impede its administrative autonomy (Articles 126 and 127 of the Act).

The Act of 4 December 1990 and the Royal Decree of 4 March 1991 (as amended by the Royal Decree of 23 October 1991) lay down the conditions for Belgian and foreign investment trusts to operate in Belgium.

No consideration will be given to foreign investment trusts as they fall outside the scope of this report.

With respect to Belgian investment trusts, the Act obliges the investment trusts to act within only one single 'category'; categories cannot be combined. The categories are:

investment trusts which comply with the requirements of the EC Directive of 20 December 1985;

securities and liquidities;

commodities, options and futures on commodities;

financial options and futures;

real estate;

high risk capital (this includes venture capital);

other.

By Royal Decree of 4 March 1991, the operating conditions of the first two categories have been regulated.

The investment trusts operating within these categories must invest mainly in listed securities or other financial investments which can be traded on an organized exchange.

Venture capitalists which carry out their activity in the form of a company and, more particularly, in the form of an NV/SA, as in practice will be the case, will have to comply with the Companies Act. For the purpose of supplying venture capital, the by-laws of the venture capital company must provide an express object clause to do so.

In principle, the venture capitalist which has been incorporated is not transparent. However, in the event of the venture capitalist being a listed company, shareholding disclosure requirements will apply.

Conclusion: No regulation generally restricts the provision of venture share capital.

Equity stake in unlisted companies

- General

As in practice venture capitalists will usually invest in an NV/SA, consideration will only be given to the hypothesis of an equity stake in an NV/SA.

The contribution in capital by a venture capitalist may occur at various stages in the corporate existence of an SME.

In particular, the following situations may be distinguished:

Start-up capital: the venture capitalist contributes to the formation of the company;

Expansion capital: the venture capitalist brings in new capital in order to finance the company's expansion;

Replacement capital: the venture capitalist takes over the equity stake of another shareholder;

Mezzanine finance: the venture capitalist takes an equity stake as a step towards stock-exchange listing.

None of these forms of contribution of capital is specifically regulated by law. Instead, these operations are governed by the legal provisions, depending on the type of operation, with respect to:

the formation of a company;

the subscription to a share capital increase;

the transfer of shares.

An NV/SA must not provide loans and security with a view to the acquisition of its shares by third parties (Article 52 ter of the Companies Act).

This rule may constitute a difficulty in obtaining venture capital.

However, it does not apply to loans or securities granted to:

personnel of the company to allow that personnel to acquire shares of the company;

related companies in respect of which at least half of the voting rights are held by the members of the personnel of the company to allow those related companies to acquire the shares of the company to which at least one half of the votes is attached.

This exception obviously facilitates MBO (management buy-out) financing.

- Participation in the formation of a company

(a) The costs related to the formation of a company are fairly low.
The expenses related to the formation of an NV/SA with the legally required minimum capital of BFR 1.25 million amount to BFR 35 000. These expenses include the notary's fee, registration duties on contributed capital, costs of the deed and publication.
The notary's fee is laid down by law and is calculated in proportion to the contributed capital according to a digressive tariff: from 0.57% on the first amount up to BFR 1.5 million, up to 0.0144% on the amount in excess of BFR 134 million.
Conclusion: The expenses related to the formation of a company do not constitute a significant impediment to incorporation.

(b) The formalities associated with the formation of a company are not a problem as most of them are accomplished by the notary public.

(c) Participation in the formation of a company may result in liability.

In the event of bankruptcy of the company within a time period of three years after incorporation, the contributors are personally liable for all or a part of the debts of the company, if, at the moment of incorporation, they knew or should have known

that the capital was manifestly insufficient to carry out the planned activity during the first two years of its incorporation.

However, one may assume that a venture capitalist will submit a sound business plan (as is required by law) before taking part in the formation of the company. Save serious professional error, this form of liability may be ruled out.

Conclusion: The contingent liability associated with the formation of a company does not appear to constitute an obstacle to the venture capitalist wishing to make a capital investment.

(d) At the moment of incorporation, the venture capitalist may be granted particular advantages, such as preference shares, or he may be given non-voting shares.

Shareholder agreements, whether ancillary to a specific form of shares or not, may stipulate options or obligations to repurchase shares by the other shareholders.

Shareholder agreements, however, must not provide that the venture capitalist shall be exempted from any loss, or that he shall be entitled to all the profits. Such clauses are void.

Conclusion: At the moment of incorporation, the venture capitalist may be attributed a specific class of shares. It may equally be stipulated in which circumstances he can dispose of his shareholding. However, the venture capitalist cannot be exonerated from every entrepreneurial risk.

- Subscription to a share capital increase

(a) In principle, shares which are subscribed in cash must be offered in priority to existing shareholders in proportion to their shareholdings. This is referred to as a 'priority right'.

In practice, the entry of the venture capitalist as a member of the company is negotiated with the existing shareholders prior to such entry.

Therefore, it has to be assumed that there is a qualified majority among the shareholders to suppress the priority right.

Conclusion: The priority rights do not constitute a practical restriction to the provision of venture capital.

(b) A share capital increase implies a modification of the by-laws.

Expenses related thereto are the costs of a notarial deed (limited) and registration duties on the contributed capital (limited, see above).

Conclusion: Expenses related to a share capital increase do not constitute a significant restriction.

- Transfer of shares

(a) In theory, approval and pre-emption clauses should form an obstacle to the entry of a venture capitalist in the share capital of a corporation.

In practice, however, the entry of a venture capitalist into the company is made on demand of the shareholders.

It is assumed that the existing shareholders will approve the transfer of shares and will not use their pre-emption right.

Conclusion: Approval and pre-emption clauses do not constitute a practical restriction to the provision of venture capital.

(b) The acquisition of shares may be accompanied by a shareholder's agreement.

Such agreements must not prescribe that the venture capitalist shall be exempted from any loss, or that he shall be entitled to all profits. Such clauses are void.

Conclusion: As entrepreneurial risk is inherent in venture capital, this risk cannot refrain the venture capitalist from making his investment.

Contribution of equity capital to a listed company

As such, the contribution of equity capital to a listed company falls outside the scope of this report.

The listing of a company takes place at the moment that a company itself is convinced that it has a trade record which inspires confidence in institutional investors and/or the public at large. At that stage, the company no longer needs the contribution of a venture capitalist. Even so, its intervention would be fairly modest, since the venture capitalists currently active in Belgium have a fairly small capital to invest, due to their policy of spreading risks.

On the other hand, it is not the aim of a venture capitalist to invest in a listed company: not only would the venture capitalist be excluded from any participation in or supervision of the management, but he could also not expect a substantial surplus value on his investment.

However, the Commission's definition of an SME may include Belgian listed companies. The conditions for offering shares to the public and for listing shares on the stock exchange have been provided separately.

4.2. Debt finance

Debt finance is (non-equity) funding by a venture capitalist to an SME in the form of loans which have a fixed repayment programme and which in certain circumstances can be converted into equity capital.

Separate details have been provided with respect to all forms of debt finance.

Debt finance by means of bonds

Bonds may be issued in various manners: they may be offered to a restricted number of investors or by a call on public savings. Bonds (and rights attached thereto) may be listed on the Stock Exchange or not.

Only companies which are of a sufficient size and benefit from the confidence of the public at large and also institutional investors are able to offer bonds publicly and to have them listed on the Stock Exchange. This report does not focus on this type of debt finance.

The private placing of bonds is highlighted below. Information on the types of bonds is provided separately.

Preliminary conditions in order to provide non-equity funding

No specific legislation governs the provision of non-equity finance.

Every Belgian natural person or corporation may provide non-equity finance without restriction as long as the general corporate, accounting and fiscal regulations which would apply to any natural person or corporation are abided by.

Banks and private savings institutions are entitled to subscribe to bond issues and to purchase bonds on the secondary market in their own name and on their own behalf.

Investment trusts may also subscribe to bond issues, although the issuing companies must have made public annual accounts for at least two financial years. Unlisted bonds may be purchased up to a maximum of 10% of the trust's assets.

In principle, an investment backed up by listed bonds is unlimited. However, the investment fund can invest only a percentage of its assets in the securities of one single issuer; moreover, an investment trust can acquire only a small part of the securities of one issuer. It should be remembered, however, that not all categories of investment trust are regulated. Certain categories are not yet covered by such rules. Venture capital falls within the 'high risk capital' category; it is, therefore, unregulated (see above under 'Equity finance', and 'Investment trusts').

Conclusion: No regulation generally restricts the provision of non-equity finance.

Preliminary conditions to attract non-equity funding by means of bonds

Only undertakings in the form of a corporation are entitled to issue bonds.

The selected legal status may contain limitations as far as the type of bonds which the company is entitled to issue is concerned.

A BVBA/SPRL may only issue registered bonds. Moreover, it must not issue convertible bonds or bonds with warrants attached.

This restriction may, however, cease to exist by conversion of the BVBA/SPRL to another corporate form.

The NV/SA and the CV/SC may issue both registered and bearer bonds. These companies are entitled to issue convertible bonds or bonds with warrants.

Conclusion: In order to issue bonds, companies must be organized in the appropriate legal form.

Issuing bonds

(a) The decision to issue bonds without rights of conversion or subscription may be made by the management body unless the by-laws expressly prohibit it from doing so.

Impediments in a company's by-laws may be overcome by amendments thereof.

As the issue of convertible bonds and bonds with warrants implies a future or potential share capital increase, only the general shareholders' meeting may take the decision to issue such securities.

The Board of Directors may equally take such a decision, provided it was authorized by the general shareholders' meeting to increase the company's share capital to a specified amount.

Rights of conversion or subscription attached to convertibles or warrants are valid during a 10-year period after their issue. In cases where the issue coincides with a non-application of the priority right, the period of exercising the warrants is restricted to five years.

(b) The minimum nominal value of bonds must not be lower than BFR 1 000, unless the obligation is denominated in a foreign currency.

(c) Bondholders are entitled to attend the general shareholders' meeting, but they only have an advisory role. In specific circumstances, this may be a reason for a corporation not to issue bonds. As such, however, this provision does not constitute an obstacle for a venture capital company. In many cases the venture capital company may want to abstain from any intervention in the management of the company.

(d) Bearer bonds must comply with specific, though limited, formalities. Registered bonds have to be registered in a special register kept at the company's registered office and a certificate must be delivered to the bondholder in order to demonstrate registration.

Both types of bond are freely transferable: bearer bonds by delivery, registered bonds by entry in the appropriate register upon presentation of a declaration of transfer, or, alternatively, after a notice issued by a bailiff certifying an assignment of the bond.

(e) By the issue of bonds, a loan agreement is entered into.

Upon application of the borrower, the courts have the power to substitute the legal interest rate (currently 8% per annum) for those interest rates and benefits which have been stipulated in the loan agreement as a result of the exploitation of the borrower's ignorance, passions, feebleness or needs and which manifestly exceed normal interest rates or the degree of risk pertaining to the loan.

The intended situation is that of usury and the sanction may only be applied in the exceptional circumstances that the interest rate and the benefits are clearly disproportionate to the risk incurred.

The issue of the bonds may therefore be caught by the prohibition on usury laid down in Article 1907 ter of the Civil Code. This is not a serious obstacle in practice to the operation of venture capital companies.

Published case-law has shown reluctance to apply Article 1907 ter whenever the borrower is a commercial undertaking.

For the Article to apply, two conditions have to be satisfied.

First, the borrower must demonstrate exploitation of its needs. Some published case-law has ruled that exploitation of needs does not occur when an undertaking is in need of funds to improve or expand its business. Other cases have ruled out exploitation on the grounds that the borrower paid the loan punctually and never objected to the interest rate.

Second, the borrower must demonstrate that the stipulated interest rate exceeds normal interest rates in a manifest manner. To this end, the courts examine the conditions on the capital market at the time the contested loan agreement was entered into. If interest rates similar to the stipulated interest rate were used by other credit institutions, the excessive nature will not be established.

A higher interest rate than the normal interest rate may lawfully be stipulated for the purpose of covering the risk of insolvency of the borrower, provided such risk cannot be minimized by taking security.

(f) A company is entitled to give a mortgage to secure repayment of its bonds. In practice, however, such security is extremely rare.

(g) Companies must notify the Commissie voor het Bank- en Financiewezen/Commission bancaire et financière in advance in the event they want to place convertible bonds and warrants in private and if they have made a call on public savings in the past.

(h) Reference should be made to the description above concerning the giving of loans or security by an NV/SA with regard to the acquisition of its own shares by third parties.

Conclusions:

There are no substantial impediments to issuing bonds without conversion or subscription rights.

Convertible bonds and warrants have a limited conversion period.

The minimal nominal value of bonds does not constitute an impediment.

The creation and transferability does not constitute an obstacle.

In practice, usury laws do not matter.

Bonds cannot in principle be secured if they are issued for the acquisition of shares of the company which gives the security.

Bondholders have access to the general shareholders' meeting, albeit without voting rights. This does not obstruct bond issues.

4.3. Ordinary loans

Debt finance can be provided by VCCs in the form of an ordinary subordinated loan.

It cannot be excluded that, occasionally, security is given by the SME to the VCC in order to attract debt financing. (There would be no difference between this and an ordinary bank loan.) It has to be noted, however, that VCCs cannot be granted a 'pand op de handelszaak/gage sur fonds de commerce' (i.e. a floating charge over the business), since such security can only be given to credit institutions which are recognized by the government.

II. Issues of taxation

1. *Introduction*

The SME is often confronted with the difficulty of attracting financial means from third parties.

Indeed, on the one hand, to contract a loan with a bank, the SME usually has too low an equity so that the financial institutions feel rather reticent to grant loan.

On the other hand, because of the high risk of the investment, only very few persons will be willing to increase the capital (and therewith the loan capacity) of the SME.

The VCC can therefore play an important role in the expansion of the SME.

The VCC and the target company (SME) will have to determine how the capital is to be injected. It may very well be that there is a conflict of interest between both parties in determining how the injection will be executed.

In general, the (tax) differences between debt financing and equity financing can be established as follows:

In the case of debt financing by the VCC, the interest payments are for the SME in principle tax-deductible expenses, which have a negative impact on the results (possibly into a loss position) and on the cash flow of the SME. The VCC will be fully taxable on the interest income.

It may very well be that this situation is not at all desirable. Indeed, the SME will probably be in need of extra means at the time when heavy investments are planned. These will already have a negative impact on the results (depreciation of the investment). From a tax point of view such a situation may also prove to be unwise. The interest deduction cannot be properly used because of insufficient profits (creation of losses) whereas the interest income with the VCC is immediately taxed.

To meet both economic and tax demands, two main options are available:

- either the loan agreement is concluded under circumstances where the interest rate is in the beginning rather low (e.g. profit-sharing loan or convertible loan); or
- the VCC decides to participate in the capital of the SME.

In the case of equity financing, the following problems arise:

Dividend income: if the VCC is in need of a more or less regular income to finance its own investment, this will have to be done by way of a dividend distribution. This may present a lot of problems.

Dividends are normally not tax deductible so that the dividend capacity will normally be lower than the interest payment capacity. However, some incentives exist that introduce a system of tax-deductible dividends.

In the case of a dividend distribution, both the VCC and the individual shareholder will receive a dividend. The dividend taxation of individuals is often very disadvantageous.

To avoid this problem, the VCC might opt for preference shares so that dividends can be distributed to the VCC and not to the individual shareholder.

The VCC receiving the dividends can claim the dividend exemption (a ratio of 95%), but may only properly use it if it has enough taxable profits. This will normally not be the case, since the main income of the VCC consists of dividend income. Therefore, two options could be considered:

- a combination of interests and dividends;
- instead of distributing dividends, the VCC might aim for the realization of a capital gain on shares.

Capital gains income: this way could be interesting since, by doing so, the SME retains all profits.

Problems are:

- if the value of the SME decreases, the capital loss realized on the sale of the shares is in principle not tax deductible;
- if the value of the SME increases, the capital gain will in principle be tax exempt. The problem is that the individual shareholders will normally not have enough means to purchase the shares. Moreover, as far as tax is concerned, their position is rather uninteresting because they cannot claim an interest deduction (unless in very specific circumstances) which has, of course, a very negative impact on the financing of this purchase.

Therefore, one could consider a redemption of shares. This means that the SME purchases its own shares. Only to the extent a hidden capital gain is expressed, taxation takes place with the SME. For the VCC, the capital gain is treated as dividend income which can benefit from the dividend exemption (95%).

A summary is given of all the important items that could influence the decision-making of the VCC and the SME under 'Equity finance' and 'Debt finance'.

Practical guidance, resulting from the information under 'Equity finance' and 'Debt finance', is given under 'Practical taxation guidance'.

2. *Equity finance*

2.1. Introduction

Does a registration tax apply or do any other duties exist?

Contributions in cash or in kind against shares are subject to a registration duty of 0.5%. The taxable base is the amount of cash or the value of the contribution after deduction of obligations (net contribution).

Additional costs of creating a company are:

- costs for publication in the Offical Gazette;
- an annual stamp duty on company securities which are quoted on the Belgian Stock Exchange;
- notarial fees;
- commercial registration fees.

All these costs are in principle tax deductible.

Are there conditions to be met in respect of the legal form of the VCC?

Belgian company law provides no special legislation concerning VCCs.

A VCC will most likely operate in Belgium under the form of a public limited liability company (NV/SA).

Other legal forms which are often used are the private limited liability company, (the so-called BVBA/SPRL) and the cooperative company (CV/SC) (see Section I.1).

As is seen later, the choice of the legal form may have a major impact on the tax treatment of debt financing.

Are there limits as to the degree of participation of the VCC in the SME?

If the VCC takes an interest in the SME of 50% or more, the SME can no longer benefit from the reduced corporate tax rates (see below).

2.2. Tax situation of the SME

Creation of the company and increase of capital

Are there registration or other duties?

Contributions in cash or in kind against shares are subject to a registration duty of 0.5%. The taxable base is the amount of cash or the value of the contribution after deduction of obligations (net contribution).

Additional costs of creating a company are:

- costs for publication in the Offical Gazette;
- an annual stamp duty on company securities which are quoted on the Belgian Stock Exchange;
- notarial fees;
- commercial registration fees.

All these costs are in principle tax deductible.

Are there exemptions for certain zones, projects, activities?

Companies established in an employment zone before the end of 1991 are exempted from registration duties ('droit d'apport').

Innovation companies established before the end of 1990 are exempted from registration duties ('droit d'apport').

No registration duty ('droit d'apport') is due for:

- the creation of reconversion companies before 12 December 1990;
- the capital increase in these companies within 10 years after the year of the constitution of these companies;
- the constitution before 23 July 1990 of companies located in a reconversion zone;
- the capital increase in these companies until 31 December 1992.

In Annex, we attach an enumeration of the reconversion zones.

Is the indirect tax treatment different for the following types of share: ordinary, preference or redeemable shares?

There is no difference in the tax treatment of these shares where the registration duties are concerned.

Corporate tax

How is the taxable base determined?

Are the costs related to the creation/increase of the capital deductible?

These costs are deductible. Two options are possible:

- all costs are deductible in the year of creation/ increase of the capital.
- the costs can be depreciated over a maximum of five years.

Are there specific regimes for certain SMEs?

- SMEs established in employment zones

The creation of new companies within the employment zones is no longer possible. However, the regime remains applicable to the existing companies established in those zones.

In Annex 1, an enumeration of the conditions to be met and the tax benefits is given. The principal tax advantage is the exemption of corporate income tax.

- Reconversion companies

The creation of new companies is no longer possible. However, the regime remains applicable to the existing companies. The main advantage is that the private shareholder of these companies may deduct the full amount spent each year to repurchase the shares he is required to buy back from the public investment company. For more information, see Annex 2.

- Other companies located in the reconversion zones

New companies can no longer be created, but capital increases in existing companies remain possible. No corporate income tax is due on dividends up to a maximum amount of 8% of the cash paid-in capital. This exemption depends mainly on investments and employment. For more information, see Annex 3.

- Innovation companies

New innovation companies can no longer be created. Existing companies can, under certain circumstances, pay out a tax-free dividend of 13% of the paid-in capital. For more information, see Annex 4.

Rates:

Normal tax rate: 39%

Reduced tax rate:

BFR 0 to 1 000 000: 28%

BFR 1 000 000 to 3 600 000: 36%

BFR 3 600 000 to 13 000 000: 41%

These reduced rates do not apply to:

(i) companies held 50% or more by other companies;

(ii) companies of which the distributed profits are higher than 13% of the paid-in capital;

(iii) companies being also holding companies (under certain circumstances).

Are there specific regimes for certain SMEs (certain zones, activities or projects)?

As mentioned above, under certain circumstances an exemption of corporate income tax exists for T-zone companies, reconversion companies and innovation companies.

How does a redemption of shares affect the tax position of the SME?

The price paid by the SME to its shareholder in the case of redemption of shares constitutes taxable income (at the normal corporate income tax rate), to the extent the price exceeds the amount of the paid-in capital and the previously taxed but undistributed reserves.

Dividend distribution

Does a different tax regime apply to dividend distribution to the individual shareholder of the SME, on the one hand, and to the VCC, on the other hand?

No (with exception of withholding tax).

Does a different tax regime apply according to the different types of share: ordinary, preference, redeemable or other shares?

No.

Is the tax base affected by the distribution of dividends (deductible dividends)?

Dividend distributions are normally not deductible. However, the following exceptions exist:

- as mentioned above, certain incentives (e.g. companies located in a reconversion zone) are linked to dividend distributions;
- pursuant to Royal Decree No 15, dividends paid on shares issued in 1982 and 1983, may, under certain circumstances, be exempt from corporate income tax up to an amount of 8% of this cash paid-in capital. The deduction of 8% applies for 12 years (for capital increases in 1982) or 11 years (for capital increases during 1983). The deduction may be extended at 5% for one or two further years.

Is the tax rate affected by the distribution of dividends?

The corporation tax rate is not affected. However, the reduced rates (see above) do not apply to companies that distribute profits which are higher than 13% of the paid-in capital.

Is a withholding tax withheld? Rate? Exemption for dividends?

If the SME distributes dividends to the individual shareholder of the SME, normally a withholding tax of 25% applies. This withholding tax is normally the final taxation.

Example:

SME:	Profit before taxes	100
	Ordinary tax rate	39%
	Dividend	61
	Withholding tax of 25%	15.25
	Net dividend	45.75

If the recipient of the dividends is a company, the following distinction must be made:

- in the case of a 25% (or more) participation during at least one year, an exemption of withholding tax applies;
- in the other cases, a withholding tax of 25% is levied but can normally be recovered by the parent company.

Exemptions with regard to withholding tax exist:

- Royal Decree No 15-dividends: 20% withholding tax;
- Employment-zone dividends: 0% withholding tax.

2.3. Taxation of the VCC

Corporate taxation

Are the costs related to the creation of the VCC deductible?

Yes.

Are management costs and interest deductible?

Yes.

Dividend taxation

Dividends constitute taxable income for the VCC. However, the VCC will normally benefit from an exemption of 95%. A problem may be that this dividend exemption of 95% applies as a deduction. This means that if the VCC does not have enough profits, the dividend deduction cannot be used. This may lead to a double taxation.

How is the capital gain taxed if the shares of the SME are sold?

The capital gain is normally fully tax exempt.

What about capital losses?

Capital losses on shares are in principle not tax deductible.

What is the tax position of the VCC in the case of redemption of the shares by the SME?

The redemption capital gain is in principle treated as dividend income, which means a tax exemption of 95%.

Are specific tax regimes available?

Yes, for open-ended and closed-ended investment companies.

Rates

Normal/reduced rates: normally the ordinary tax rates apply.

Is there recoverability of the tax withheld by the SME?

Yes, the withholding tax, if withheld, can be computed and is repayable.

Distribution of dividends by the VCC

Does a different tax regime apply according to the different types of share?

No.

Is the tax base affected by the distribution of dividends (deductible dividend)?

No.

Is the tax rate affected by the distribution of dividends?

No.

Is a withholding tax withheld?

Yes, a withholding tax of 25% is withheld. However, it seems that dividends distributed to the European Commission are exempted from withholding tax (still to be checked).

Transfer of shares

In the case of transfer of shares of the SME, do special taxes apply on these transfers?

No.

2.4. Tax situation of individual shareholder

Is the interest paid on the loan granted in view of the purchase of the shares of the SME deductible?

No, except under certain rather restrictive conditions (regular monthly remuneration, loan from a third party, etc.)

How are the dividends taxed?

At a 25% rate (which is normally not recoverable).

Example:

SME	100
Corporate tax	39%
	61
Withholding tax of 25%	15.25
Net dividend	45.75

2.5. In case the SME is not a company but an unincorporated enterprise

In principle the VCC will receive taxable profits taxed at the normal corporate tax rate. However, some authors defend another solution.

3. *Debt finance*

Preliminary question: Is there a debt/equity ratio to be respected ?

There are no requirements governing the debt/equity ratio of companies in Belgium.

3.1. Tax situation of the SME

Does the choice between the following types of loan granted to the SME have implications for the tax situation of the SME?

- *ordinary loans;*
- *convertible loans;*
- *profit-sharing loans;*
- *other types (if regularly used).*

No.

What is the deduction regime in the different types of loans? Are there specific regimes available?

In Belgium, specific regimes are not available.

The interest payments are normally deductible.

That part of the interest exceeding the interest rate provided by a Royal Decree by three percentage points is considered an excessive interest charge and therefore not deductible. This limitation may be an obstacle for profit-sharing loans. However, this limitation does not apply to interest paid by and to Belgian financial institutions and on publicly issued bonds.

What is the situation if the VCC, participating in the SME, grants a loan?

If the SME has the legal form of an NV or a CVA, the treatment of the interest payment does not change.

If, however, the SME adopts the legal form of a BVBA, CV or VOF ('société de personnes'), etc., the interest payment is considered as a dividend distribution and therefore subject to corporate tax (plus possibly withholding tax).

What is the withholding tax for each of the different types of loans?

The withholding tax rate is in principle 10% (25%). However, an exemption from withholding tax normally applies.

3.2. Tax situation of the VCC that grants a loan to the SME

What is the situation concerning the different types of loan?

- *ordinary loans;*
- *convertible loans;*
- *profit-sharing loans;*
- *other types.*

The interest income will constitute taxable profit for the VCC.

If, however, the SME is a 'société de personnes', the interest income will be treated as dividend income (95% exemption).

In respect of the taxability of the interest, are there exemptions or reductions for certain zones or activities?

No.

How are the capital gains taxable?

Taxable at the full rate.

What if the loan is converted into capital with capital gains or capital losses?

The capital gain is taxable at the normal rate, the capital loss is tax deductible.

Are capital losses on receivables realized by the VCC deductible?

Yes.

Are interest payments deductible?

Yes.

Is there a withholding tax on interest paid by the VCC?

Yes (10%), but large exemptions are available.

3.3. Tax situation of the fund

If the fund is a juridical entity with its main seat in Belgium and if its business consists of an exploitation or lucrative transaction, the tax treatment is no different from that of the VCC.

If the fund does not consist of an exploitation or lucrative transaction, the withholding tax of 10% on the interest income is the final taxation.

ANNEX 1

SMEs established in employment zones

The creation of new companies within the employment zones is no longer possible. However, the regime still applies to the existing companies established in those zones.

Conditions

In order to obtain the benefits, a number of conditions must be fulfilled:

The enterprise must employ at least 10 individuals within two years.

Joint ventures, temporary associations and branches of Belgian and foreign enterprises are not allowed.

All activities must be located in the zone. However, from 1989 onwards, companies in T-zones can establish sales or service offices abroad.

Benefits

The benefits (until 31 December of the 10th year following the year in which the activities are started) are:

- exemption from corporate income tax on all profits; however:

  benefits resulting from abnormal advantages given to the T-zone company are taxable;

  the tax-loss carry-forward must be used as if there were no exemption from corporate tax;

  the investment deduction usually cannot (or to a very limited extent) be transferred.

- exemption from immovable prepayment ('précompte immobilier').
- exemption from withholding tax on dividends (interest and royalties). Moreover, the Belgian shareholder (or lender) can, in specific circumstances (investment before 24 July 1991) claim a fictitious withholding tax.

ANNEX 2

Reconversion companies

Conditions

In order to take advantage of the incentives, the following conditions must be complied with:

A reconversion contract which establishes how the company will implement the investments which contribute to the modernization of the industrial activity in the reconversion zone in which the company is located must be concluded between the company, its private shareholders (or the majority of the private shareholders with respect to a capital increase) and a public investment company that owns a participation in the company.

The reconversion contract must at least specify the following:

(a) the obligations of the public investment company and the private shareholders as to their respective capital contributions;

(b) the obligation of the reconversion company as to the nature and extent of the investments, when the investments are to be made and the minimum number of jobs to be created;

(c) the obligation of the private shareholders to purchase from the public investment company each year at least 10% of its shares at a price equal to the issue price; the repurchase must take place as from the fourth year and up to and including the 13th year after the year in which the shares were issued;

(d) the powers of the public investment company to enforce the obligations of all the parties to the reconversion contract.

The reconversion company must establish its registered office and main operation in a reconversion zone.

The reconversion company must be incorporated between 1984 and 1988 which is extended to 31 December 1990.

Contributions to the capital of the reconversion company must be within the framework of the reconversion contract and must be in cash, and the contribution of the public investment company may not exceed 49% of the total contribution.

However, when a public investment company acts as a private shareholder, the 49% limit may be exceeded. The contribution of a real private shareholder not being a public investment company should amount to at least one third of the capital of the reconversion company.

Within the period fixed in the reconversion contract, the reconversion company must invest at least 80% of the total contributions in tangible assets which promote the research, development, manufacture or sale of:

(a) new products;

(b) new technologies and their applications;

(c) industrial processes intended to save energy and raw materials or protect the environment;

(d) products and technologies and their applications intended to modernize the industrial activity in the reconversion zone or the employment there.

Benefits

Reconversion companies established in reconversion zones are not granted benefits. The benefits are granted to the private shareholders of the reconversion companies. Resident and non-resident companies qualifying as private shareholders within the framework of the reconversion contract may, for corporate tax purposes, exclude from their taxable profits the full amount spent each year to repurchase the shares they are required to buy back from the public investment company because of the 10% repurchase commitment (not the shares held by the public investment company as a private shareholder). For the purpose of repurchasing, the public

investment company never qualifies as a private shareholder.

The companies are permitted to carry forward any amount they were unable to deduct because of insufficient profits. However, the exemption each year may not exceed 10% of the repurchase commitment. Conclusively, a carry-forward in practice will be possible only if the exemption period is prolonged.

The exclusion from taxable profits is only granted if the following conditions are met:

The exempt profits are recorded in a separate reserve account and are not taken into account for the purposes of computing any distribution by the company (e.g. dividends, salaries, remuneration).

The repurchased shares must be kept within the Belgian operation of the company.

If, in a given year, these conditions are not satisfied, all earlier exempted profits must be added to taxable income in that financial year.

ANNEX 3

Other companies located in the reconversion zones

Conditions

Companies which do not enter into a reconversion contract, but are located in a reconversion zone, may also qualify for certain tax incentives. To qualify, companies must:

- have been incorporated between 1984 and 22 July 1990; all contributions to the capital must be in cash;
- establish and maintain their registered office and main operation in a reconversion zone;
- invest, before the end of the first year of the exemption period, 60% of the contribution received in tangible assets of the type in which reconversion companies must invest and of which the use may not be given up.

Benefits

No corporate tax is due on dividends up to an amount of 8% of the cash paid-in capital (capital is defined as 'the subscribed capital on 22 July 1990 that becomes cash paid-in capital and the capital that is subscribed and paid in between 23 July 1990 and 31 December 1992') to the extent that the 'capital' is used, before the end of the financial year, to acquire qualifying new fixed assets of which the use is not transferred to a third party;

'Qualifying assets' are tangible assets in the zone which promote the research, development, manufacture or sale of:

- new products;
- new technologies and their applications;
- industrial processes intended to save energy or raw materials or protect the environment;
- products and technologies and their application intended to modernize the industrial activity or the employment in the zone;
- for each BFR 5 million that is invested one person has to be employed;
- for each BFR 5 million investment linked to the rise of capital between 23 July 1990 and 31 December 1992 an unemployed worker must be engaged;
- during 10 consecutive financial years or 15 consecutive financial years with respect to companies incorporated before income year 1990.

ANNEX 4

Innovation companies

Tax incentives to encourage venture capital in innovation companies are provided for in the Law of 31 July 1984.

Conditions

In order to take advantage of these incentives, the following conditions must be complied with:

innovation companies must have been incorporated between 1984 and 1990 (recognition procedure commenced before 23 July 1990) and all contributions to their capital (until 31 December 1990), either at the time of incorporation or at the time of a capital increase, must be in cash;

the companies' business activities must consist exclusively of supplying services or manufacturing products using innovative high-technology processes and selling such processes;

an innovation company must file a statement with the Minister for Finance committing the company to providing further useful information and to not establishing operations abroad other than sales and/or service offices;

the company must be recognized by the Minister for Finance on approval by the Ministers for Economic Affairs, Small Businesses and Science Policy;

recognition will be withdrawn if the company employs more than 99 people at the end of any financial year.

Benefits

For 10 consecutive financial years, a recognized company may exempt its distributed profits from corporate tax to the extent of 13% of the paid-in capital outstanding at the beginning of the financial year.

The exemption period starts from the first, second or third year after that of its incorporation, at the election of the company. The election must be made irrevocably in the deed of incorporation or capital increase. The exemption period ends on 31 December of the 10th, 11th or 12th calendar year after the year of incorporation. The exemption for the first three financial years of the exemption period is either applicable to the retained benefits or to the distributed benefits, at the company's election. For the remaining seven financial years of the exemption period, the exemption is only applicable to the distributed benefits. The retained benefits that have been exempted must be recorded in a separate reserve account and may neither be distributed nor used for the purposes of computing any distributions or salaries.

The basic rate of the investment deduction may be increased by 5 percentage points for innovation companies, if they acquire appropriate assets no later than 31 December of the 10th year after the year of incorporation.

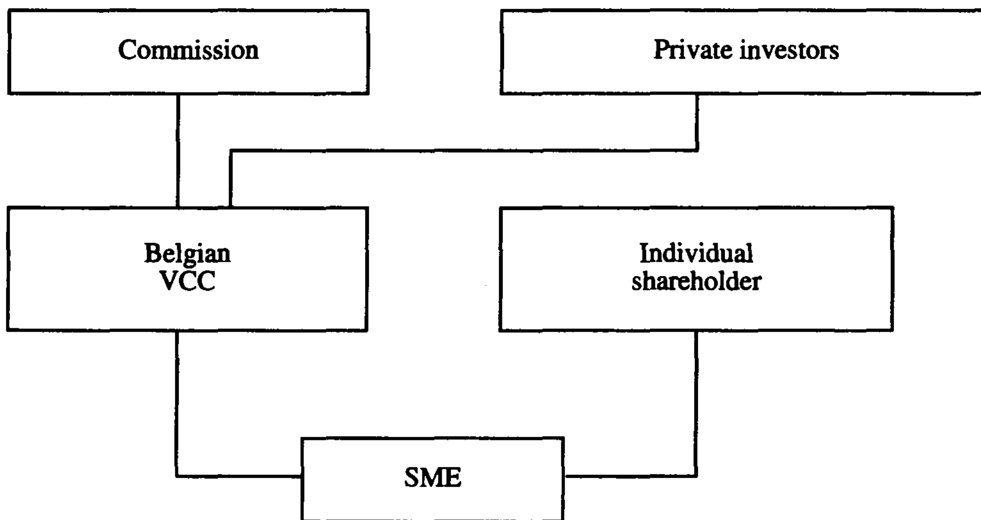
Capital gains which are realized on shares in innovation companies and invested in a business operation are exempted from corporation tax, provided that the shares were subscribed to by the disposer and that they were fully paid up more than three years before they were disposed of.

A 10-year exemption from the immovable prepayment on land, buildings and equipment invested in the Brussels Region during 1984 to 1993 is available.

Practical guidance

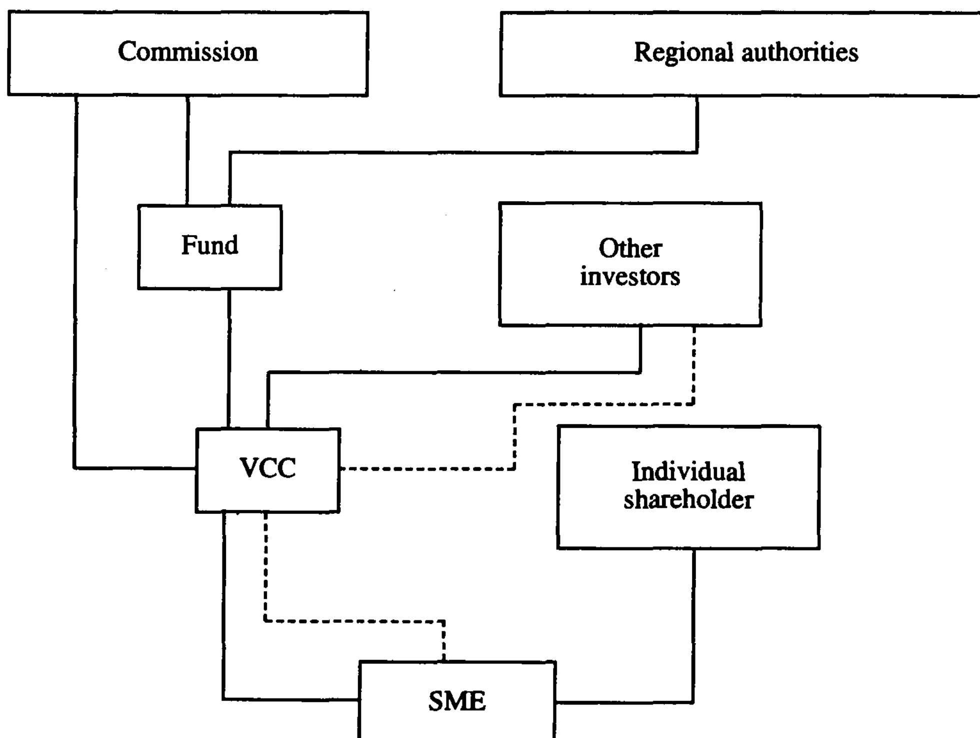
I. Equity finance

1. Scheme



II. Debt finance

1. Scheme



2. *Comments on structure*	2. *Comments on structure*
2.1. *Position of the SME*	2.1. *Position of the SME*
Costs of increasing capital:	Costs of granting loan:
Capital duty of 0.5%; notarial fees, etc.	No costs.
These costs can in absolute figures be an obstacle, although they are relatively seen, rather limited and tax deductible. These costs, being tax deductible for the SME, have a negative impact on the results.	
In certain cases, an exemption of capital duty exists (e.g. reconversion companies and companies located in reconversion zones).	
Taxable base:	Taxable base:
The profits of the SME are positively influenced by the capital increase. This means that if normally losses would have occurred, because of the capital increase a better result can be shown.	The interest payments are normally deductible expenses that have a negative impact on the results and the cash flow.
If the capital increase leads to a profit situation, this profit is normally taxed at 39%.	This situation may prove unwise because a loss position may be created (no immediate use of interest deduction) and other advantages related to profit are lost (e.g. reconversion status, etc.).
Because special tax regimes exist (e.g. employment zone, etc.), the taxable base is heavily reduced, so that this disadvantage decreases.	This disadvantage may partially disappear if it is a profit-sharing loan.
	In case the VCC participates in the SME to which the VCC also grants a loan, the interest payments are not deductible if the SME is a 'société de personnes' (this could be an advantage).
Tax rate:	Tax rate:

The profits are taxed at 39%. However, reduced rates are applicable if the individual shareholder owns more than 50% of the shares. The capital increase by the VCC may cause a problem since most of the SMEs in Belgium are thinly capitalized.

Certain regimes introduce an exemption system.

The deductible interest payments save a taxation of 39% or of the reduced rate.

Redemption of shares:

Only to the extent hidden gains are expressed, the redemption leads to taxation.

Reimbursement of the loan:

Has normally no impact on the taxable result.

Dividend distribution:

The dividends are part of the taxable base.
However, under certain regimes, a deductible dividend is introduced.

If the amount of dividends exceeds 13% of the capital, the reduced rates are no longer applicable.

On the dividends distributed to the individual shareholder, a withholding tax of 25% applies; on the dividends distributed to the VCC, the same withholding tax applies, but an exemption exists for VCCs that have a participation of at least 25% during at least one year.

Interest payment:

The deductible interest paid to the VCC is normally exempt from withholding tax.

The as dividend qualified interest payments are subject to corporate tax (as ordinary dividends) and then to a withholding tax of 25%. An exemption of withholding tax applies if the VCC holds a participation of at least 25% during a period of at least one year.

2.2. *Position of the VCC*

Taxable base:

(a) Dividend income:

This income is in principle tax exempt to an amount of 95% (plus recoverability of withholding tax) under the condition the VCC has enough taxable profit, which might be a problem since the VCC will normally only have an interest burden and tax-exempt income.
This can lead to double taxation (39% with the SME and 39% with the VCC).

2.2. *Position of the VCC*

Taxable base:

(a) Interest income:

This income is fully taxable at 39% (whereas the interest deduction with the SME only benefits from the saving of reduced rates).

In case the interest income is treated as dividend, see left side.

(b) Capital gains taxation:

In principle tax exempt; in the case of redemption of shares, taxation as dividend income.

(c) Capital loss on shares:

In principle not deductible.

Dividend distribution:

The normal rules apply. However, an exemption applies to dividend distribution to the Commission.

Transfer of shares:

No special tax applies.

2.3. *Position of the individual shareholder*

Dividend income:

The corporate tax plus the 25% withholding tax form the final taxation.

Purchase of the shares:

The financing of this operation may be difficult since the individual shareholder cannot normally deduct the interest burden (exceptions exist).

2.4. *Position of the fund*

No dividend income (see Scheme).

3. *Unincorporated SME*

(b) Capital gains taxation:

The capital gains realized at the moment of converting the loan into capital is fully taxable.

(c) Capital loss on loans:

In principle deductible.

Interest payment to the fund:

If this fund is a normal taxable company, the ordinary rules apply.

If this fund is not subject to corporate tax, a withholding tax of 10% may apply.

Transfer of loans:

No special tax applies.

2.3. *Position of the individual shareholder*

Dividend income:

The corporate tax plus the 25% withholding tax form the final taxation.

There is no transfer of shares to the extent a loan is granted.
The interest burden thus remains with the SME.

2.4. *Position of the fund*

The interest income is fully taxable. Only when the fund would not be subject to corporate tax the withholding of 10% on interest would be the final taxation.

3. *Unincorporated SME*

If the VCC participates in the SME (sharing of profits and losses), an equivalent part of the profits/losses is as such attributed to the VCC which is normally taxed on this income.

If the VCC grants a loan, the interest is deductible with the SME and fully taxable with the VCC.

Conclusion

Equity finance

Major disadvantages:

Costs related to increase of capital.

The capital increase will normally lead to a higher taxable base und thus a higher tax burden with the SME.

The reduced rates may be lost.

The dividend exemption does not apply if the VCC does not have enough taxable profits, which may lead to double taxation.

The capital losses on the transfer of shares are not tax deductible.

The tax situation of the individual shareholder may be very disadvantageous as to the purchase of shares.

Major advantages:

To the extent special regimes apply, no corporate tax may be due on (part of) the profits of the SME, whereas the dividend income for the VCC is tax exempt.

Debt finance

Major disadvantages:

The deductible interest payments may lead to a loss position of the SME, whereas the interest income with the VCC is immediately taxable. By being in a loss position, some special regimes may not be used.

Some interest payments are treated as dividend payments.

Capital gains are taxable.

Major advantages:

No costs are related to the granting of the loan.

The taxable base of the SME will normally be reduced.

Capital gains on shares are tax exempt.	The reduced rates remain untouched. The risk of double taxation (with SME/VCC) does not normally exist. The capital losses are deductible. The private shareholder is not confronted with a purchase of shares.

Belgium	Equity			Debt		
	VCC with qualifying participation[1]	VCC without qualifying participation	SME under specific regimes[1, 2]		Ordinary interest payments	Interest payments qualified as dividends[1, 3]
SME profit before tax	100	100	100	Interest payment	100	100
				Taxable base with SME	(–100)	0
Corporation tax of 39%	–39	–39	– 0	Withholding tax[4]	0	0
Gross dividend	61	61	100	Interest income before tax	100	100
Withholding tax of 25%	– 0	– 15.25	– 0	Taxable base VCC	100	5
				CIT	–39	1.95
Net dividend before tax at recipient's level	61	45.75	100			
Taxable base of 5% (95% exemption)	3.05	61	5			
CIT at VCC's level	1.19	– 1.19	1.95			
Net dividend after tax	59.81	59.81	98.05	Net income after tax	61	98.05

[1] In case of a minimum participation of 25% during at least one year: no withholding tax is due; in other cases, a refundable withholding tax of 25% applies.

[2] For T-zone and innovation companies and companies established in reconversion zones.

[3] If the SME is a 'société de personnes' in which the VCC participates, the interest payment is not deductible.

[4] Generally 10% is due but large exemptions are available.

III. Other issues

Local and regional authority issues

As far as the Belgian regions eligible under Objectives 1, 2 and 5b are concerned, the same legal provisions relevant to venture capital are applicable as in the rest of the country. These areas are geographically located in Flanders as well as in Wallonia.

However, State aid is a matter which, as a result of federal devolution, falls within the legislative competence of the regions; therefore the Flemish and Walloon Regions may, each for the areas within their respective territory, elaborate aid schemes.

Due to a process of federal devolution there are, apart from the national State, three regions, namely the Flemish Region, the Walloon Region and the Brussels Region. Each region has a regional parliament empowered with legislative powers and a regional executive vested with executive powers.

The three regions have substantial power with respect to economic policy and, in particular, powers to enhance economic expansion.

State intervention is twofold.

On the one hand, national and regional investment agencies were created (see below); on the other hand, the regional executives, in well-defined circumstances, can grant interest and capital subsidies. These subsidies fall outside the scope of this report.

National Investment Agency

The Nationale Investeringsmaatschappij/Société nationale d'investissement (hereinafer 'NIM/SNI') was incorporated by the national government as a Naamloze Vennootschap/Société anonyme (NV/SA) of public interest.

The NIM/SNI carries out three basic investment functions:

(a) Venture capital (in its widest meaning)

The NIM/SNI encourages the creation of new companies and the expansion or the reorganization of existing companies by means of taking an equity stake or by subscribing to convertible debentures. In this capacity, the NIM/SNI is entitled to give a State guarantee for high risk ventures which are clearly in the public interest.

(b) Public investment initiative

The NIM/SNI stimulates national and regional development and the creation of employment by setting up companies and developing growth projects in order to enhance economic expansion.

(c) Interventions by national government order

The third function is to carry out economic projects in the name and on behalf of the State. Unlike the two other functions, financing is directly provided by the State.
Due to the process of federal devolution, the national government no longer orders the NIM/SNI to make new investments.

The Flemish Investment Agency

The Royal Decree of 16 November 1979 created the Gewestelijke Investerings-maatschappij voor Vlaanderen, i.e. the Regional Investment Agency for Flanders (hereinafer 'GIMV'). GIMV has a twofold function.

On the one hand, it is an investment company providing risk capital on a temporary basis to private companies established in Flanders. It may also subscribe to convertible bonds. Several subsidiaries provide specialized services at different stages in the growth of a company (Take-off-Fonds, Venture Capital, Kamofin) or focus on the venture capital needs of particular industrial sectors (Fishlink, Vlaamse Milieuholding).

On the other hand, the GIMV stimulates economic initiatives of the regional executive by taking part in the creation of companies and managing such participations.

The Walloon Investment Agency (SIRW)

The purpose of this agency is twofold. On the one hand, it serves to stimulate the regional economy by creation, reorganization or expansion of private companies (NV/SA, CV/SC). To this end, the agency is entitled to take an equity stake or to subscribe to debt instruments, whether or not convertible.

On the other hand, the SIRW stimulates economic initiatives of the Walloon regional executive along the lines of the GIMV.

The SIRW also has subsidiary companies, including Financière Wallone des PME. This company provides financial aid to the growth of small and medium-sized enterprises whose expansion is impeded by a lack of capital. Therefore, the company grants subordinated loans as a compliment to medium-term credit facilities.

IV. Comparative legal and regulatory issues

1. *Absent positive features*

Below, the positive measures in place in other Member States but which are absent in Belgium are dealt with.

The positive measures and features examined in this section with respect to the 12 Member States can be classified under three main headings:

- The regulation of venture capital, i.e. the creation of an adequate legal framework to set up investment vehicles and to provide or to receive venture capital.
- Incentives for venture capital, i.e. measures stimulating investment vehicles to provide venture capital or stimulating undertakings to call upon venture capital (e.g. tax deductions, capital grants and interest rebates).
- Publicly owned vehicles. The setting-up of publicly owned investment vehicles by national, regional or local authorities.

2. *Measures pertaining to the regulation of venture capital*

Participating bonds

In some EC Member States, bonds may be issued whereby the repayment of interest or the reimbursement of the capital is linked to the borrower attaining a certain turnover or profit level (see France, Section I.4 and Germany, section I.3).

Absence of positive feature

It is not clear whether participating bonds may be issued in Belgium. In the event such bonds are issued publicly, the Commission bancaire et financière/ Commissie voor het Bank- en Financiewezen (CBF) must give its prior approval which will be refused if the issue may be disruptive for the orderly operation of the Belgian capital market. In the past, a bond linked to the index of consumer retail prices has been prohibited.

Relevance of absent feature

Though participating bonds could provide an incentive for venture capital companies to invest in the early stages of the development of the recipient company, they do not seem to have been successful in France. As the borrowing company has some discretion whether or not to make a profit, the repayment of participating bonds is uncertain. This fact will weigh on the introduction of such legislation in Belgium. Moreover, under Belgian law, a fairly similar result to a participating bond may be achieved by issuing non-voting or profit shares. These shares qualify for a dividend, but disentitle the holder, except in very specific circumstances, to take part in the decision-making process of the issuing company.

Introduction into national law

An amendment could be made to the Companies Act allowing companies to issue participating bonds.

Investment fund — investment limits

The regulation of collective investment schemes specializing in venture capital (see Germany, Section I.3 and Ireland, Section I.5).

Absence of positive feature

The legislation on Belgian investment trusts restricts the activity of the said trusts to one single category of investments. Subordinate legislation covering the category 'high risk capital' (including venture capital) has not yet been implemented.

Relevance of absent feature

It can be expected that the operation of Belgian venture capital investment trusts will promote the financing of SMEs.

Introduction into national law

The implementing legislation should be issued enabling the operation of high risk capital investment trusts.

Grants

In Greece, a grant is given whenever a venture capital company takes an equity stake in an SME which invests in high technology or innovation (see Greece).

Absence of positive feature

In Belgium, no direct cash grants are available for venture capital companies investing in high-technology undertakings. However, the SME itself may benefit directly from aid given by the region pursuant to the legislation on economic expansion.

Relevance of absent feature

Giving a direct cash grant would stimulate the venture capital companies to invest in certain high risk industries, particularly if these high risk industries themselves do not qualify for any investment aid. For a venture capital company, a cash grant constitutes an immediate return, whereas an investment in a high risk company may only become profitable after a long period of time.

Introduction into national law

To create a similar scheme in Belgium, the competent authorities, the regions, would have to amend their respective legislation on economic expansion.

Compensation scheme

The loan compensation scheme reduces the losses sustained by venture capital companies (see the Netherlands, Section I.3).

Absence of positive feature

An equivalent to the Dutch 'Garantieregeling' does not exist in Belgium.

Relevance of absent feature

A similar scheme could be beneficial for the development of risk capital as it reduces the risk exposure of the VCC.

Introduction into national law

To create a similar scheme, the competent authorities, i.e. the respective regions, would have to amend the legislation on economic expansion.

Publicly owned venture capital companies

Local authority participation

Local authorities are empowered to provide venture capital (see Greece, Section II.1; Ireland, Section I.3, and the United Kingdom, Section I.5). In some of the EC Member States, express approval to this end is necessary (see France, Section I, and the Netherlands Section II.1).

Absence of positive feature

In Belgium, the possibility for communities ('communes/-gemeenten') to provide venture capital is restricted.

Communities have no other powers than those delegated by law. Article 31 of the constitution provides that a community may regulate any matter of exclusively municipal interest. The concept of municipal interest has not been defined by law.

It is submitted that the provision of venture capital by communities is not likely to be a matter of exclusively municipal interest for the reasons specified below.

First, pursuant to Article 31 of the Constitution, a community has no power to regulate matters which exceed

the municipal interest. Providing venture capital is not a matter which may be qualified as an exclusively municipal interest. In fact, when a community provides venture capital, it makes an investment in a private venture, without any direct benefit for itself nor for its inhabitants. The investment does not ameliorate the municipal infrastructure, nor does it improve services for the benefit of the community's residents. The community is, therefore, not enhancing its own interests, but either private interests or interests which go beyond the municipal interest, such as employment, regional development or industrial innovation.

Therefore, providing venture capital is a matter which appears to exceed an exclusively municipal interest.

The same argument applies in respect of intermunicipal associations and intermunicipal undertakings.

- Many communities cooperate by means of intermunicipal associations. However, like a community, an intermunicipal association has to carry out a well-defined task of municipal interest.
- Pursuant to Article 261 of the Communities Act, a community may, subject to approval, set up a municipal undertaking to provide municipal services of a commercial or industrial nature. In addition to the problem of municipal interest it has to be noted that such an undertaking does not have a legal personality distinct from the community itself. Therefore, losses incurred by the undertaking are those of the community. For this reason, supervisory authorities are very likely to disapprove a municipal venture capital fund.

Furthermore, a matter ceases to be of municipal interest when a higher authority has already regulated the same subject-matter. Since the regional legislator has worked out a body of law pertaining to public venture capital companies, without delegating any specific powers and without providing any executive role to the communities, municipal powers seem to be exhausted.

Finally, bodies of public law, such as a community and an intermunicipal association, have to act in the public interest. Supervisory authorities are empowered to annul or to suspend any decision by a community or an intermunicipal association which militates against the public interest. Decisions carrying a high degree of financial risk qualify for suspension or annulment.

In practice, there are no municipal venture capital undertakings nor intermunicipal venture capital associations.

Relevance of absent feature

It is submitted that as a result of the operation of public venture capital companies (NIM, SIRW and GIMV), the creation of (inter)municipal venture capital funds would only constitute a marginal contribution to the development of this industry.

Introduction into national law

The Communities Act could empower communities to set up municipal venture capital funds. In that case, the Communities Act should be amended to the effect that, like certain utilities, municipal undertakings become limited companies of public law. Alternatively, the regions could amend the acts on economic expansion in order to provide a role for communities in providing venture capital.

Non-profit-making capital holding companies

The existence of non-profit-making capital holding companies (see Germany, Section III.1).

Absence of positive feature

These holding companies do not exist as such in Belgium. However, it is worth noting that there are venture capital companies owned by the State (e.g. NIM/SNI and its related companies) and by the regions (GIMV and SRIW). Depending on the circumstances of the case, the directors of these companies decide either along the lines of sound commercial management and

profit-making principles, or by giving priority to certain public, regional or long-term interests.

Relevance of absent feature

As the public sector is already established in the venture capital sector, the creation of non-profit-making capital holding companies is likely to make only a marginal contribution to the financing of SMEs.

Introduction to national law

To set up these companies, no legislative modifications are required.

Whether any (or indeed more) governmental bodies should be active as venture capital providers is a question of policy which is answered differently according to the political attitudes of each government.

The operation of publicly owned venture capital companies is based on a mixture of market principles and policy considerations, such as stimulating employment, enhancing high technology, regional development, environmental concerns, etc.

These policy issues fall outside the scope of this report.

3. *Absent techniques*

All of the techniques covered by this report exist in Belgium.

4. *General recommendations*

Set out below are a number of general recommendations. These do not refer to specific provisions in place in other Member States which are absent in Belgium. They deal with general issues of importance to the success of venture capital in Belgium.

Recommendations concerning the regulation of venture capital

It may be stated that in Belgium the existing legal framework is adequate to allow individuals or corporations to provide or to receive venture capital. When a number of the abovementioned beneficial techniques (e.g. investment trusts, participating bonds) are enacted, it is very likely that they will be used in practice too.

However, the question is whether the implementation of these measures will actually contribute to an increase in the number of venture capital transactions or whether they will merely cause a shift in the techniques currently used for these operations.

The regulation of the 'second stock-exchange market' may well illustrate the point.

Despite the fact that there is a separate stock market where listing requirements are less stringent than on the official exchange ('second stock-exchange market'), very few companies are currently listed on this exchange.

Business attitudes have an impact on the use of venture capital too.

In Belgium, many SMEs are owned by families. In the past, many families have been reluctant to admit venture capital companies as new shareholders, for they feared, rightly or wrongly, a loss of control over their business.

Recommendations concerning the incentives

The question whether in Belgium additional incentives have to be enacted is basically a political question. The government enjoys a very wide discretion in selecting the undertakings and projects which qualify for aid. It also decides in which form aid will be given and how each aid scheme will be administered. Aid policy is therefore a matter to be decided by the government in accordance with its political vision and taking account of Belgium's international competitive position.

Denmark

Introduction

From a legal point of view, a number of detailed provisions affect each category of vehicle used for providing venture capital. Broadly speaking, the public or private limited company is the preferred form of vehicle. A number of alternative vehicles are sometimes used, however.

As far as the provision of debt finance is concerned, both subordinated debt and convertible bond arrangements are used and do not present any significant obstacles.

There are no major tax obstacles in Denmark. However, a number of issues do arise for consideration. Two particular problems present themselves. The dividend exemption enjoyed by the VCC only applies when the VCC holds at least 25% of the SME's share capital. Otherwise, a partial double taxation may result. Nevertheless, the above issues do not apply in the case of a VCC which is incorporated as an investment company. The dividends received by these companies are always exempt from tax.

The second disadvantage arises from the fact that capital gains made on the realization of shareholdings are fully taxable if the shares have been held for less than three years.

In Denmark, investment in VCCs is made particularly attractive for individuals. They may deduct the interest paid to finance the purchase of shares in the VCC for income tax purposes.

I. Legal and regulatory issues

1. *Typical investment vehicle used*

Public limited liability company ('Aktieselskab');

Private limited liability company ('Anpartsselskab');

Partnership with personal liability of partners ('interessentskab');

Limited partnership ('Kommanditselskab');

Cooperative associations ('Andelsforeninger');

Jointly owned shipping firm ('Partrederi');

Funds ('Fonde').

2. *Applicable legal measures*

Act No 370 of 13 June 1973 as amended by Act No 308 of 16 May 1990 (on public limited liability companies);

Act No 371 of 13 June 1973 as amended by Act No 308 of 16 May 1990 (on private limited liability companies);

Danish Naval Act No 653 of 13 October 1989, Chapter 3 (on jointly owned shipping firms);

Act No 300 of 6 June 1984 (on funds);

Act No 862 of 14 December 1990 (on commercial funds).

There are no other specific legal measures regulating the remaining vehicles mentioned in Section 1 above. The most that can be said is that these remaining vehicles may have to comply with certain provisions of various general laws when carrying out certain activities. Thus, for example, partnerships with personal liability of partners are subject to Company Act No 435 of 24 June 1986 (Articles 8, 16, 18 and 35) in respect of the participants' rights to sign on behalf of the company.

3. *The investment vehicle*

Public and private limited companies

These two vehicles are regulated in a similar manner and will therefore be analysed together.

None of the participants in these two vehicles are fully personally responsible for the obligations of the company as the liability of each participant only corresponds jointly and severally with his share of the capital.

All such companies are commercial. The minimum capital requirement for a public company (A/S) is DKR 500 000 divided into a minimum of three shares which can all be owned by one legal entity. The minimum capital requirement for a private company (ApS) is DKR 200 000 which can also be held by one legal entity.

All aspects concerning these two types of company are heavily regulated by law. Rules exist on the incorporation of the companies, the paying-in of the capital, the issue of shares, registration of the shares of the participants, increase of capital, decrease of capital, the management of the company (i.e. divided into a management, a board of Directors, and a general assembly), the possibility to pay dividends, dissolution of the company, mergers, transformation of an A/S into an ApS, and external audits as well as the presentation of accounts.

However, only one version of each kind of company exists, i.e. an A/S is an A/S within its legal framework which is also the case for an ApS. No division or subdivision of an A/S or an ApS in terms of, for instance,

investment trusts, variable capital companies, venture capital companies etc. exists in Denmark under the limited liability company structure.

These two types of company are by far the most commonly used commercial legal structure for venture capital investment. The coherent legislation seems to be the reason for this.

Incorporation

Within the framework of the law there is no restriction as to who may incorporate an A/S or an ApS. However, three founders, who are not simultaneously required to be shareholders, are needed in order to incorporate an A/S. Only one founder is required to incorporate an ApS. The companies must be registered in Erhvervs- & Selskabsstyrelsen (the Danish Commerce and Companies Agency) which checks compliance with the legal requirements before admission to the register.

The similarities between the two types of company prevail. They are therefore subject to the same rules. Only a few differences exist, the most important of which are the following:

- Minimum capital requirements of DKR 500 000 for the A/S and DKR 200 000 for the ApS.
- The number of founders are respectively three and one.
- An A/S is required to have a board of directors of a minimum of three members whilst an ApS is not necessarily required to have a board of directors. Both types of company are required to have a manager registered as such.
- An A/S can own up to 10% of its own shares whilst an ApS cannot own its own shares.
- The legal requirements for the management to act in case of the loss of more than 50% of a company's registered share capital are more rigorous for an ApS than for an A/S.

An A/S or an ApS which is not registered cannot enter into contractual obligations, (i.e. acquire rights or duties). Persons who enter into or are responsible for the entry into an obligation on behalf of a company not yet registered are personally, jointly and severally liable for the fulfilment of this obligation. Upon registration, the company takes over the obligations entered into between the point of incorporation and registration of the company. Due to the frequent long delays encountered in registration at the Danish Commerce and Companies Agency, 'shelf companies' are often used in practice. Shelf companies are A/S and ApS incorporated and registered with the minimum capital required, and on condition that the company has since registration not engaged in any kind of activity.

Upon acquisition of a shelf company the general assembly (i.e. the purchasers) will decide on change of name of the company, registered address, purpose and other changes of the Articles of Association, as well as the management of the company and possibly a change of accounting year, although this requires the consensus of the tax authorities which is normally given as a matter of routine. The change of the accounting year must not exceed 12 months.

The above changes are registered in the Danish Commerce and Companies Agency provided the legal and formal requirements have been fulfilled. The registration number in the Danish Commerce and Companies Agency remains unchanged which is, in most cases, the only prevailing identity. with the company as it was before the changes. Those who acquire a company and the management can, immediately after the decision of the changes and before registration, initiate activities through the company without triggering the abovementioned personal, joint and several liability.

The law requires that at least two founders, half of the members of the board and all directors shall be domiciled in Denmark unless the Minister for Industry grants an exception. EC citizens have been granted general dispensation to the extent that not even domicile within the European Community is requested as long as EC citizenship is maintained. Consequently, dispensation is only needed where a higher number than stated above, of non-EC citizens, domiciled outside Denmark, should enter the company as directors or members of the board.

By law the annual accounts of an A/S or an ApS are subject to external audits and the audited accounts should be submitted to the Danish Commerce and Companies Agency.

The cost of registering a company stands at about DKR 1700 plus 0.4% of the capital subscribed. In addition, a capital gains fee is paid amounting to 1% of the issued share capital less debts and obligations to be held by the company in connection with the investment. However, the fee shall amount to at least 1% of the nominal value of the shares granted by the participants. In addition, fees to advisers assisting with the incorporation of the company should be taken into account. A breakdown of costs to be borne by the company must appear from the official documents in connection with incorporation and in connection with a decision on a capital increase.

Shareholder agreements are widely used in connection with venture capital primarily because a simple majority vote gives full influence. This is not seen as an obstacle to the provision of venture capital finance. The same applies to shareholder rights which cannot be waived in shareholder agreements.

Shares of A/Ss can be officially quoted at Københavns Fondsbors (the Copenhagen Stock Exchange) if a company's total share capital is at least DKR 15 000 000 and provided that a minimum of 25% of the share class quoted is offered to the public.

Another exchange (Exchange III under the Copenhagen Stock Exchange) for minor companies has not been a great success. The demands of this exchange are a minimum share capital of DKR 2 000 000 and a maximum of DKR 15 000 000, provided that at least 15% of the share capital (minimum DKR 1 000 000) is offered for public sale.

In general, it is not advisable to seek a quotation on the Stock Exchange if the company does not employ at least 100 employees and if it does not have an annual turnover of at least DKR 100 000 000. A very comprehensive set of rules applies to the information required in a prospectus in order to obtain a quotation on the Copenhagen Stock Exchange. The typical cost of introducing a company to quotation is approximately 5% of the revenue attributable to the listing.

There are no stock markets on which the venture capital company can dispose of its unlisted holdings. However, this issue is usually resolved in shareholder agreements where it is common to regulate in detail the means by which to dispose of shareholdings.

The following vehicles may also be used for venture capital finance. The fact that they are hardly ever used for this purpose is not so much due to the legal obstacles they face, which in any case are not numerous, but rather that A/Ss and ApSs are the much preferred vehicles. The severe regulatory control, including an obligation for external audits to be carried out, make A/Ss and ApSs the safest vehicles for venture capital investors concerned about security. These other vehicles will, however, be examined below in so far as they may be relevant to venture capital finance.

Partnerships with personal liability of partners

This vehicle is hardly ever used for venture capital finance. It may become relevant in relation to certain activities which limit the corporate structure which a company may take and where, typically, it is not possible to form an A/S or an ApS. In these cases a partnership with limited liability of the partners may be one of the few means available if several persons want to run joint commercial activities. Such activities include real-estate brokers, chartered surveyors, translators, doctors and, until recently, practising advocates. Also, an A/S's acquisition of an agricultural holding requires the prior approval of the Minister for Agriculture, an approval which is very rarely given. This explains why agricultural holdings run by several persons are practically organized as such partnerships.

If recourse is to be had to this vehicle, the following factors have to be borne in mind.

Typically these partnerships have between 2 and 15 participants. If the written agreement between the parties

does not state otherwise, each participant can veto all decisions, and each participant can incur personal liabilities on behalf of the company. Companies engaged in trade, craftsmanship and industry are obliged to register in a local company register (different from the abovementioned nationwide Danish Commerce and Companies Agency) stating the names and addresses of the responsible participants as well as stating the possible limitations of the individual participants' rights to sign on behalf of the company (Company Act No 435 of 24 June 1986, Article 8, 16, 19 and 35). Further registration does not take place. Accounts are not made available to the public.

Limited partnerships

If a venture capital vehicle were to adopt such a structure, it should do so as a limited and not a general partner. As a general partner, the venture capital vehicle would assume the risks for the overall activities of the limited partnership to an extent which would normally be totally unacceptable to a venture capital vehicle.

Otherwise, the limited partnership structure is attractive for tax reasons (see 'Issues of taxation' below).

Cooperative associations

A cooperative association will typically have a management and it is also normal for there to be an agreement between the parties that the cooperative association is only liable to the extent of the common assets whilst the individual members are only liable to the extent of their shares. Sometimes cooperative associations are termed an AmbA which indicates a cooperative association with limited liability.

Jointly owned shipping firms

This type of vehicle, common but not limited to the shipping and fishing sectors, adopts a similar structure to that of a partnership with personal liability of the partners. The only important difference is that the part-owner of a shipping firm only responds in proportion to his share of the ship or to the liabilities of the jointly owned shipping firm, i.e. not jointly and severally, whereas the part-owner responds with his entire private assets.

Funds

The importance of funds as owners of companies is decreasing as the fiscal advantages once connected with them have been reduced. Companies owned by funds are not typically of a kind in need of financial support. Investment in funds does not seem to be a relevant issue.

4. The recipient of venture capital

Public and private limited liability companies

These two legal structures are relevant for both large companies and SMEs. However, in practice, large companies seeking investments from the general public and whose shares are quoted on the Stock Exchange are always A/Ss. Quite small companies with only one owner and very few employees (one to five persons) are normally only ApSs.

Partnership with personal liability of partners

This structure is prevalent in sectors where public and private limited companies cannot operate, namely real estate brokers, chartered surveyors, translators, doctors and lawyers.

Cooperative associations

This vehicle is particularly relevant in the agricultural sector.

Jointly owned shipping firms

The classic recipients are naturally companies engaged in the shipping and fishing sectors.

5. *The provision of venture capital*

5.1. Debt finance

Financial support to commercial enterprises is sometimes provided for by subordinated debt arrangements.

The essence of such arrangements is that a creditor agrees, for the benefit of ail other creditors of the company, to subordinate his debt in the case, of, for example, bankruptcy, to the effect that the creditor will not receive any dividends as long as the other creditors have not been fully repaid and that the creditor in question agrees to refrain from demanding or receiving instalments on the debt unless coverage is available on similar conditions.

Subordinated debt arrangements can also be made for the benefit of one or more other specifically defined creditors and in this case the subordinated creditor agrees to transfer to the beneficiaries his right to receive dividends in the case of bankruptcy in the form of both his own dividends as well as the beneficiaries' dividends.

The method is rather simple in that no registration as such is demanded and no specific costs in connection with the arrangement are incurred. A stamp duty of 0.3% of the amount borrowed is levied on all non-secured debt agreements. Subordinated debt arrangements are not considered as capital invested in companies in situations where solvency of the company prevails. Subordinated debt arrangements can be an important element in the evaluation of whether a company in financial difficulties, despite these difficulties, can continue activities on a sound basis, in which case the subordinated debt arrangement will be considered, to a certain extent, as capital invested.

Where a public limited company has lost the share capital but the management still considers the re-establishment of the share capital possible by means of expected profits, it may be possible for the company to continue activities, if major creditors accept a subordinated debt arrangement until the share capital has been re-established.

Subordinated debt arrangements are regularly used as an instrument for recently formed public limited companies in which a group of creditors connected to the management hold debts.

A loan in connection with a subordinated debt arrangement can still acquire interest during the period of subordination.

Subordinated debt arrangements can be applied for under all the abovementioned company structures.

5.2. Convertible bonds

The general assemblies of public and private limited companies can decide to obtain loans against bonds giving the lender a right to convert his claim into shares of the company.

Such a decision can be made by the majority which, according to the Articles of Association, is required to amend them. Usually the lender obtains the status of a normal creditor with a right to be paid interest irrespective of whether the annual accounts of the company make it possible to pay dividends to the shareholders, in case of dissolution of the company. It is possible to apply to the loan agreement a subordinated debt arrangement as described above and to make the interest payable fluctuate according to the profits of the company or to the dividend payable to the shareholders.

The lender is not obliged to convert his bonds into shares. In case of a devaluation of the company at the time of maturity of the loan, the creditor can choose instead to demand repayment of his bonds. This possibility makes this instrument particularly interesting in connection with the supply of venture capital.

The general assembly can stipulate detailed rules as to the position of a lender in case of future increases or decreases of capital and similar conditions likely to

influence the position of the lender upon maturity of his conversion right.

Convertible bonds cannot be issued for an amount exceeding half of the share capital at the time of making the decision to issue convertible bonds.

The rate of conversion between the amount lent and the normal share amount is subject to agreement, but the amount paid in under a bond cannot be less than the nominal value of the shares, into which the bond shall be converted, unless the lender pays in further capital to this effect.

By issuing convertible bonds the company's intentions will usually be to attempt to obtain cheaper interest rates by giving the lender a share of profits possibly obtained at a later stage. However, the agreement can state that conversion will take place at a rate agreed, at the time of granting the loan, as well as at a conversion rate corresponding to the market value of the shares at the time of maturity. The rate of conversion cannot be lower than par. The Articles of Association can stipulate for the lender a right of membership of the board of directors and a similar agreement can be stipulated in the loan agreement itself.

Depending on the contents of a loan agreement, it is usually sensible to state a maximum dividend payable until the point of maturity, as well as stipulating the position of the lender in case of a breach of contract.

II. Issues of taxation

1. *Introduction*

The SME is often confronted with the difficulty of attracting financial means from third parties.

Indeed, on the one hand, to contract a loan with a bank, the SME has most of the time too low an equity so that the financial institutions feel rather reticent to grant any loan.

On the other hand, because of the high risk of the investment, only very few persons will be willing to increase the capital (and therewith the loan capacity) of the SME.

The venture capital company can therefore play an important role in the expansion of the SME.

The VCC and the target company (SME) will have to determine how the capital is to be injected. It may very well be that there is a conflict of interest between both parties in determining how the injection will be executed.

In general, the (tax) differences between debt financing and equity financing can be established as follows:

In the case of debt financing by the VCC, the interest payments are for the SME in principle tax-deductible expenses, which have a negative impact on the results (possibly into a loss position) and on the cash flow of the SME. The VCC will be fully taxable on the interest income.

It may very well be that this situation is not at all desirable. Indeed, the SME will probably be in need of extra means at a time when heavy investments are planned which will already have a negative impact on the results (depreciation of the investment). From a tax point of view, such a situation may also prove to be unwise. The interest deduction cannot be properly used because of insufficient profits (creation of losses) whereas the interest income with the VCC is immediately taxed.

To meet both economic and tax demands, two main options are available:

- either the loan agreement is concluded under circumstances where the interest rate is in the beginning rather low (e.g. profit-sharing loan or convertible loan); or
- the VCC decides to participate in the capital of the SME.

In the case of equity financing, the following problems arise:

Dividend income: if the VCC is in need of a more or less regular income to finance its own investment, this will have to be done by way of dividend distribution. This may present a lot of problems.

Dividends are normally not tax deductible so that the dividend capacity of the SME will normally be lower than the interest payment capacity.

In the case of dividend distribution, both the VCC and the individual shareholder will receive a dividend. The dividend taxation of individuals is often very disadvantageous.

To avoid this problem, the VCC might opt for preference shares so that dividends can be distributed to the VCC and not to the individual shareholder.

Companies holding more than 25% of the shares in another Danish company can receive dividends free of tax, if the shares have been held for the whole accounting year in which the dividend is received.

Other resident companies shall include 66% of the dividend received in the taxable income which is being taxed at the company tax rate of 38%. The 30% tax withheld can be set off against the company tax pay-

able. If there are no taxes to be paid, the 30% tax withheld will be paid back.

Capital gains income: the advantage of an SME retaining all profits is normally reflected in an increase in the value of the shares in the hands of the shareholder who may eventually realize a capital gain.

Problems are:

- if the value of the SME decreases, the capital loss realized on the sale of the shares is not tax deductible if the shares are held for more than three years;
- if the value of the SME increases, the capital gain will be tax exempt if the shares are held for longer than three years. Otherwise, the gain is taxable;
- if the shareholding in the SME is decreased or terminated by way of a redemption of shares, the redeemed amount will be considered a dividend distribution and taxed as such. This means that the VCC will not be taxed on the distribution provided the VCC holds a substantial shareholding – more than 25% – of the share capital;
- if all shares in the SME are redeemed, the tax authorities can, upon application, allow the redeemed amount to be taxed according to the normal capital gains tax rules.

In the next part (Equity finance/Debt finance), a summary is given of all the important items that could influence the decision-making of the VCC and the SME.

In the last part, practical taxation guidance is given.

2. *Equity finance*

2.1. Creation of the VCC

Is there a registration tax or do other duties exist?

Any contribution in cash or in kind, whether at incorporation or on an increase of capital in exchange for shares, is in principle subject to a capital duty of 1%.

Additional costs are:

- the Registrar of Companies charges a basic fee of DKR 1 700 plus 0.4% of the subscribed capital;
- charges for listing on the Stock Exchange; the annual fees at present are as follows:

Paid-in capital (million DKR)	Fee (DKR)
0–5	5 000
5–20	12 445
20–100	22 530
100–200	39 210
more	54 820

These costs are not deductible.

Are there conditions to be met in respect of the legal form of the VCC?

The company law does not provide any special legislation concerning VCCs (see Section I.2 above).

A VCC will most likely operate under the form of a public limited company (A/S) or a private limited company (ApS).

Are there limits as to the degree of participation of the VCC in the SME?

There are no limits to the degree of participation. No prior approval is necessary.

2.2. Tax situation of the SME

Creation of the company and increase of capital

Are there registration or other duties?

Any contribution in cash or in kind, whether at incorporation or on an increase of capital in exchange for shares, is in principle subject to a capital duty of 1%.

Additional costs are:

- the Registrar of Companies charges a basic fee of DKR 1 700 plus 0.4% of the subscribed capital;
- charges for listing on the Stock Exchange; the annual fees at present are as follows:

Paid-in capital (million DKR)	Fee (DKR)
0–5	5 000
5–20	12 445
20–100	22 530
100–200	39 210
more	54 820

The capital duty of 1% is not deductible. All other costs including lawyers' and accountants' fees are tax deductible.

Are there exemptions for certain zones, projects or activities?

No exemptions exist.

Is the indirect tax treatment different for the following types of share: ordinary, preference or redeemable shares?

No.

Corporate tax

How is the taxable base determined?

Are the costs related to the creation/increase of the capital deductible?

The costs related to the creation/increase are tax deductible except for the capital duty of 1%.

Are there specific regimes for certain SMEs?

No special tax regimes exist, although SMEs located in certain zones can benefit from loans at a low rate, grants, accelerated depreciation, etc.

None of these aspects refer directly to equity finance.

Rates

The normal tax rate is 38% (1991).

No specific regimes exist.

How does a redemption of shares affect the tax position of the SME ?

No taxation with the SME applies.

Dividend distribution

Does a different tax regime apply to dividend distribution to X (individual shareholder of the SME) and to the VCC?

No.

Does a different tax regime apply according to the different types of share: ordinary, preference, redeemable or other shares?

There is no different tax regime applicable according to the type of share.

Is the tax base affected by the distribution of dividend (deductible dividend)?

The tax base is not affected by the distribution of dividends.

Is the tax rate affected by the distribution of dividends?

The tax rate is not affected by the distribution of dividends: no reduction applies for the declaring company.

Is a withholding tax withheld? Rate? Exemption for dividends?

A withholding tax of 30% is withheld on the distribution of dividends. There are no exemptions.

2.3. Taxation of the VCC

Corporate taxation

Are the costs related to the creation of the VCC deductible?

The capital duty of 1% is not deductible. All other costs, including lawyers' and accountants' fees, are tax deductible.

Are management costs and interest deductible?

Management costs and interest are deductible if they are incurred in the acquisition or maintenance of business income. Dividend income is considered to be business income for the VCC.

Dividend taxation

- No substantial holding:

Companies holding less than 25% of the paid-in capital of a company shall include 66% of the dividend received in the taxable income which is being taxed at the company tax rate of 38% (1991). The 30% tax withheld can be set off against the company tax payable. If there are no taxes to be paid, the 30% tax withheld will be paid back.

- Substantial holding:

Dividends paid by one Danish company to another Danish company holding more than 25% of the paid-in capital of the declaring company during the entire year are exempt from tax. Upon request, the paying company must issue a certificate showing that the dividends are covered by the imputation system.

- Investment companies:

Certain investment companies are exempt from tax on dividends if the following conditions are met:

(a) the dividend-paying corporation is a resident of Denmark;

(b) the shares of the company itself are quoted on the Stock Exchange;

(c) the company's purpose and actual business is solely to own and administrate shares of other companies;

(d) the company must pay out to its shareholders the dividends received prior to the time for filing its tax return for the income year in question.

How is the capital gain taxed if the shares of the SME are sold?

If the shares of the SME are sold and if they have been held for less than three years or have been purchased by a trader in securities, the gain, if any, is considered as ordinary income.

Gains on shares held for three years or more are not taxable, irrespective of the holding.

What about capital losses?

A loss recognized by a company from the sale of shares owned for less than three years can only be carried forward for five years to be deducted from taxable gains on the sale of shares owned for less than three years.

Upon application the tax authorities can allow the sales price to be taxed as a capital gain. Such permission will normally be obtained in situations where the shareholder – the VCC – disposes of its entire shareholding in the SME either by redemption of the VCC's total shareholding in the SME or partly by way of redemption/ sale to a third party.

A loss is also only deductible to the extent that it exceeds the amount of exempt dividends received by the parent company.

If the shares were owned for more than three years, then the loss is not deductible for tax purposes.

If the VCC sells the shares of the SME to the SME, the whole sales price is subject to income tax, except in the year when the winding-up of the company is completed. Exemption is obtained on application.

Rates:

Normal/reduced rates: the normal corporate tax rate is 38%. Some dividend income is tax exempt.

There are no specific tax rates for VCCs, with exception of the investment company.

Is there recoverability of the tax withheld by the SME?

The withholding tax is recoverable.

Distribution of dividends by the VCC

Does a different tax regime apply according to the different types of share?

There is no difference in taxation between the different types of share.

Is the tax base affected by the distribution of dividends (deductible dividend)?

Dividends distributed by the VCC cannot be deducted from the taxable base.

Is the tax rate affected by the distribution of dividends?

The tax rate is not affected by the distribution of dividends.

Is a withholding tax withheld?

A withholding tax at the rate of 30% is withheld by the VCC. There are no exemptions.

Example:

		Participation < 25%	Participation > 25%
SME:			
Profit before tax		100	100
Corporate tax		–38	–38
Gross dividend		62	62
Withholding tax of 30%		–18.6	–18.6
Net dividend		43.4	43.4
VCC			
Taxable dividend		43.4	43.4
Withholding tax		+18.6	+18.6
Gross dividend		62.0	62.0
Taxable 66%		40.9	0
Corporate tax		15.5	
Tax withheld		–18.6	
Restitution		3.1	___
Net dividend		41.5	62

Transfer of shares

In the case of transfer of shares of the SME, do special taxes apply on this transfer?

Upon the issue of shares the share capital or the increase of share capital is subject to a capital tax of 1% to be paid by the company, (see Section 2.2).

When shares are sold or in any other way transferred a duty is levied at the rate of 1% of the market value of the transferred shares. This duty does not apply to shares issued by a private limited company. The transfer capital tax is payable by the parties (seller or buyer) and is normally borne by the buyer.

2.4. Tax situation of the individual shareholder

Is the interest paid on the loan granted in view of the purchase of the shares of the SME deductible?

All types of interest expenses are tax deductible in ordinary taxable income.

How are the dividends taxed?

From 1 January 1991 the Danish imputation system was abolished and a new category of income for individual taxpayers was introduced, i.e. 'dividend income'. This dividend income consisting of dividends and other distributions by resident companies, distributions by qualifying resident investment organizations and proceeds of sales of shares to the company which issues those shares will no longer be included in the (ordinary) taxable income. Instead, the dividend income will only be subject to the existing dividend withholding tax rate of 30%, to the extent that the dividend does not exceed a basic amount of DKR 30 100 for the year 1992. Married couples are entitled to twice this amount with a possible transfer from one spouse to the other.

To the extent that the dividends received exceed the stated amount, the tax will be 45%, levied by way of assessment with a credit for the dividend withholding tax.

Example:

		< DKR 30 000	> DKR 30 000
SME			
Profit before tax		100	
Corporate tax		−38	
Dividend		62	
Withholding tax of 30%		18.6	
Net dividend		43.4	43.4
Individual shareholder		The net dividend received is tax-free	43.4 +18.6
Taxable income		The tax withheld is a non-recoverable final tax	62.0
Dividend income tax of 45%			27.9
Tax withheld			−18.6
Taxes due			9.3
Net dividend		43.4	34.1

New rules on taxation of dividends from Danish companies were introduced on 1 January 1991.

2.5. In case the SME is not a company but an unincorporated enterprise

In principle, due to the transparency of the enterprise, the VCC cannot take a participation in such an SME.

3. *Debt finance*

Preliminary remarks

Danish law does not contain general rules on debt/equity ratios, but banking and other financial institutions are subject to regulations.

A stamp duty is due, which varies, depending on the precise nature of the document concerned, from 0.1 to 1.5% (see Annex).

3.1. Tax situation of the SME

Does the choice between the following types of loan granted to the SME have implications for the tax situation of the SME:

- *ordinary loans;*
- *convertible loans;*
- *profit-sharing loans;*
- *other types (if regularly used)?*

No, even in the case where the creditor participates in profits and losses. However, as will be mentioned hereinafter, in the case of profit-sharing loans granted by the shareholder, the interest is automatically treated as dividend income.

What is the deduction regime in the different types of loan?

Are there specific regimes available?

In principle, interest is tax deductible.

If conditions are imposed on a domestic company that would not normally be imposed on independent companies, the authorities may correct the transaction to reflect the true circumstances.

What is the situation if the VCC, participating in the SME, grants a loan?

The main rule is that the interest payment is tax deductible for the SME and the interest is taxable income for the VCC.

When a loan is granted without interest (0%), considered the VCC has a majority in the SME, the VCC is taxed on a fixed interest income, which is based on an amount of the national bank base rate plus 4%.

There are now specific limits on how high interest rates can be before the interest payment is considered dividend.

The assumption is, however, that interest exceeding a fair market interest rate could be reclassified as dividend payment. The part of the interest which is reclassified as dividend is not tax deductible in the SME.

What is the withholding tax for each of the different types of loan?

There is no withholding tax rate on interest.

3.2. Tax situation of the VCC that grants the loan to the SME

What is the situation concerning the different types of loan:

- *ordinary loans;*
- *convertible loans;*
- *profit-sharing loans;*
- *other types?*

Interest received is subject to corporate tax as ordinary income, unless the interest is reclassified as dividend income.

In respect of the taxability of the interest, are there exemptions or reductions for certain zones or activities?

Certain regions are designated as development regions. Support may be given in the form of loans on favourable terms of up to 90% of the investment at low interest with the loan being amortized over 20 years for land and buildings and 10 years for machinery, equipment, etc.

However, interest income remains fully taxable.

How are the capital gains taxable?

A resident VCC is liable to tax on all gains and losses on financial assets and liabilities, irrespective of the interest rate on the asset.

In principle, all companies may deduct losses on all financial assets, but losses on amounts due from group companies are only tax deductible if the asset is acquired in payment of business transactions and the owner of the asset is not jointly taxed with the debtor or the asset was acquired after joint taxation had ceased.

Group companies are defined as companies in which the same group of shareholders, at the time when the claim was acquired or later, directly or indirectly control more than 50% of the votes in each company.

What if the loan is converted into capital with capital gains or capital losses?

If loans are converted into capital, the capital gain is fully taxable.

Losses on loans realized in connection with a conversion into capital are not tax deductible if it is a group loan.

Are capital losses on receivables realized by the VCC deductible?

Losses from the sale of debt claims are normally deductible. Interest payments are deductible, with the exception of the costs of the issue of the debt.

Is there a withholding tax on interest paid by the VCC?

There is no withholding tax on interest.

3.3. Tax situation of the fund

Under Danish law no specific regimes exist for funds receiving dividend and interest income.

Annex

Stamp duty

Transfers of documents are stamped at the same rate as applies to the establishment of a new legal relation.

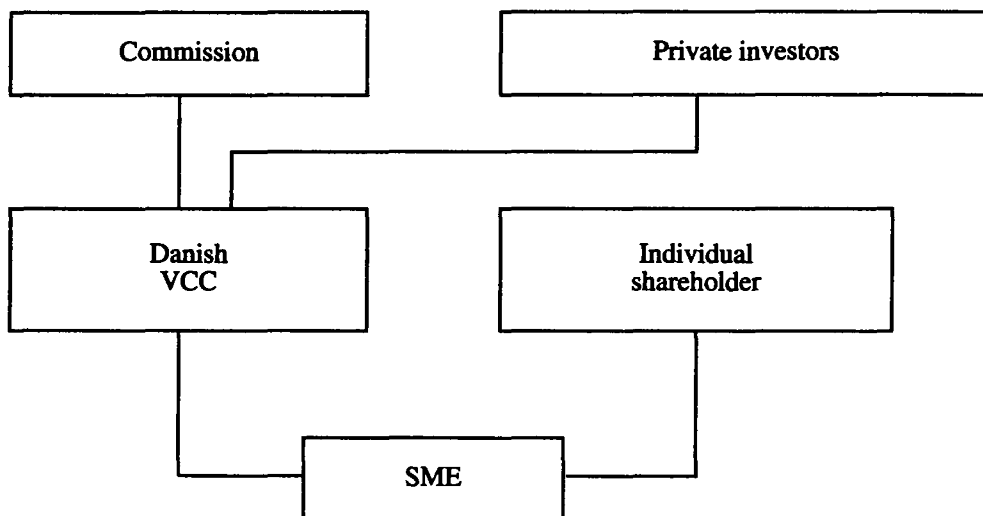
	(%)
Conveyance of real property	1.2
Overdraft contracts and other loan contracts	0.3
Debt instruments secured by a mortgage on real property or on movable property	1.5
Pledges of movable property, shares, securities, etc.	0.3
Guarantees	0.3
Other debt instruments	0.3
Goodwill, patents, trade marks and copyright	0.1
Licence contracts	free of stamp duty

No stamp duty is payable on non-capital contributions of assets for the establishment of a company, i.e. against payment in shares. This applies to all assets with the exception of real property.

Practical taxation guidelines

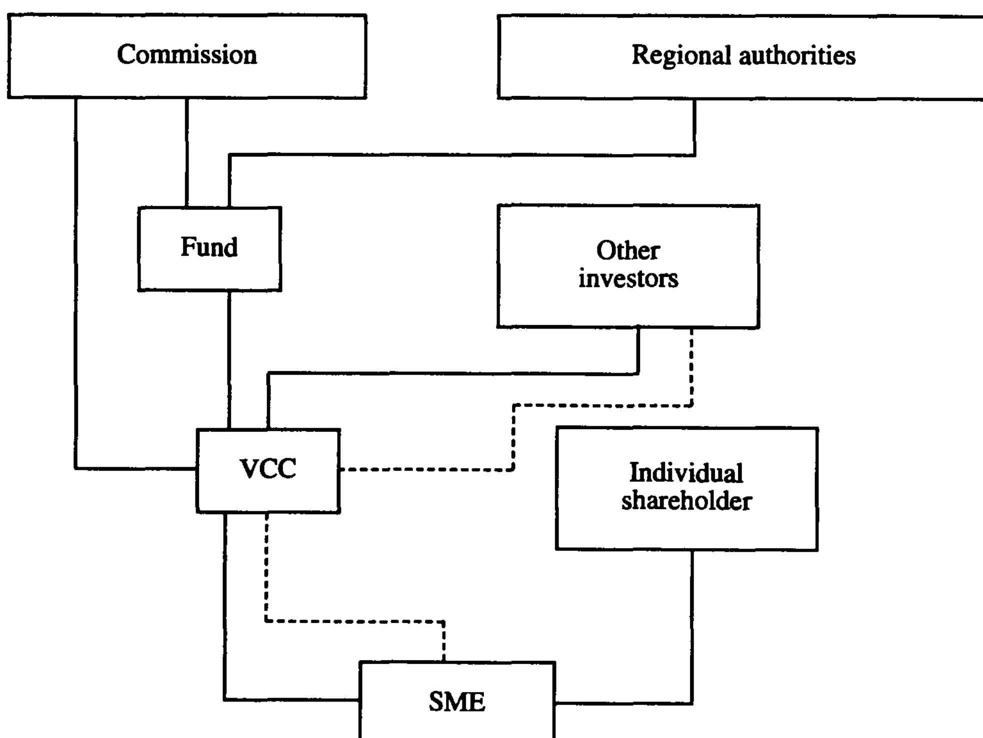
I. Equity finance

1. Scheme



II. Debt finance

1. Scheme



2. *Comments on structure*

2.1. *Position of the SME*

Costs of increasing capital:

Capital duty of 1%; registration cost of DKR 1 700 plus 0.4% of the subscribed capital.

These costs can be an obstacle, also because the capital duty of 1% is not tax deductible.

These costs have a negative impact on the book results.

Taxable base:

The profits of the SME are positively influenced by the capital increase.
This means that if normally losses would have occurred, because of the capital increase a better result can be shown.

If the capital increase leads to a profit situation, this profit is normally taxed at 38%.

Tax rate:

The profits are taxed at 38%. No reduced rates are applicable.

Redemption of shares:

The redemption does not lead to taxation for the SME.

Dividend distribution:

The dividends are part of the taxable base.

2. *Comments on structure*

2.1. *Position of the SME*

Costs of granting a loan:

0.1 to 1.5% depending on the precise nature of the document concerned. These costs are not deductible.

Taxable base:

The interest payments are normally deductible expenses that have a negative impact on the results and the cash flow. However, the interest exceeding a fair market interest could be reclassified as a dividend payment. These reclassified interest payments are not tax deductible.
This situation may prove unwise because a loss position may be created (no immediate use of interest deduction).
This disadvantage may partially disappear if it is a profit-sharing loan.

Tax rate:

The deductible interest payments save a taxation of 38%.

Reimbursement of the loan:

Has normally no impact on the taxable result.

Interest payment:

The deductible interest paid to the VCC is normally exempt from withholding tax.

On the dividends distributed both to the individual shareholder and the VCC, a withholding tax of 30% applies.

2.2. *Position of the VCC*

Taxable base:

(a) Dividend income:

If the VCC does not have a substantial shareholding (25% or more) during the entire year, 66% of dividend received from a Danish SME is included in the tax base and subject to normal corporation tax at 38%. This is a partial compensation for economic double taxation. No refund (tax credit) is available with respect to the corporate tax paid by a Danish SME.

(b) Capital gains taxation:

Tax exempt if the shares are held for more than three years; otherwise the capital gain is taxable.
In the case of redemption of shares, the sales price becomes taxable, unless qualified as dividend.

(c) Capital loss on shares:

A loss recognized by a company from a sale of shares owned for less than three years can only be carried forward for five years to be deducted from taxable gains on the sale of shares owned for less than three years.

Dividend distribution:

The normal rules apply. However, an exemption applies to dividend distribution to the Commission.

Transfer of shares:

2.2. *Position* of the VCC

Taxable base:

(a) Interest income:

This income is fully taxable at 38%.

(b) Capital gains taxation:

(b) Capital gains taxation:
The capital gain realized at the moment of converting the loan into capital is fully taxable.

(c) Capital loss on loans:

Losses on loans realized in connection with a conversion into capital are not tax deductible in any case. No special rules apply to group loans.

Interest payment to the fund:

No withholding tax applies.

Transfer of loans:

A special tax of 1% on the market value of the transferred shares applies. This tax does not apply to shares issued by a private limited company.

No special tax applies.

2.3. *Position of the individual shareholder*

Dividend income:

To the extent the dividend does not exceed a certain amount, the withholding tax of 30% is the final taxation.

Purchase of the shares:

The interest paid to finance this operation is tax deductible.

2.3. *Position of the individual shareholder*

Dividend income:

See left side.

There is no transfer of shares to the extent a loan is granted. The interest burden thus remains with the SME.

2.4. *Position of the fund*

No dividend income (see Scheme).

2.4. *Position of the fund*

The interest income is fully taxable. Apparently no special vehicles exist for interest income.

3. *The SME is unincorporated*

If the VCC participates in the SME (sharing of profits and losses), an equivalent part of the profits/losses is as such attributed to the VCC which is normally taxed on this income.

3. *The SME is unincorporated*

If the VCC grants a loan, the interest is deductible for the SME and fully taxable for the VCC.

Conclusion

Equity finance

1. *Major disadvantages:*

costs related to increase of capital;

the capital increase will normally lead to a higher taxable base and thus to a higher tax burden with the SME;

Debt finance

1. *Major disadvantages:*

the deductible interest payments may lead to a loss position of the SME, whereas the interest income by the VCC is immediately taxable;

the costs of granting a loan vary between 0.1 and 1.5%;

the dividend exemption does not apply if the VCC has no substantial holding, which may lead to partial double taxation (i.e. on 66% of the dividend);

the capital gains are fully taxable if the shares are held for less than three years;

the capital losses on the transfer of shares are not tax deductible if the shares are held for more than three years;

a transfer tax of 1% applies on the sale of shares.

capital gains are taxable.

2. *Major advantages:*

the dividend income for the VCC is tax exempt if the VCC has a substantial holding;

capital gains on shares are tax exempt if the shares are held for more than three years;

if the VCC qualifies as an investment company, dividend income is always tax exempt;

the interest paid to finance the purchase of shares is tax deductible for the individual shareholder.

2. *Major advantages:*

the taxable base of the SME will normally be reduced;

the risk of double taxation (with SME/VCC) does not normally exist;

the capital losses are deductible;

the private shareholder is not confronted with a purchase of shares.

Denmark	Equity			Debt	
	VCC with qualifying participation[1]	VCC without qualifying participation	VCC Investment company[2]		
SME profit before tax	100	100	100	Interest payments deductible with SME	Yes –100
Corporation tax of 38%	–38	–38	–38	Withholding tax	0
Gross dividend	62	62	62	Interest income before tax at recipient's level	100
Withholding tax of 30%[3]	–18.6	–18.6	–18.6	CIT of 38%	–38
Net dividend before tax at recipient's level	43.4	43.4	43.4		
Taxable base	0	40.9[4]	0		
CIT at VCC's level	0	–15.5	0		
Tax withheld at source	18.6	18.6	18.6		
Restitution	Entirely	3.1	Entirely		
Net dividend after tax	62	46.5	62	Net income after tax	62

[1] 25% participation during the entire year in which the dividends are received.
[2] Danish investment companies are exempt from CIT on dividend income if certain conditions are met.
[3] Withholding tax is refundable.
[4] 66% of gross dividend.

III. Other issues

Local and regional authority issues

The vast majority of legislative acts enacted by the Danish Parliament (the Folketing) apply to the whole of the country, with no local or regional variations. This is particularly true in the case of basic legal principles such as legislation governing venture capital finance. Consequently there are no local or regional authority issues which are raised.

IV. Comparative legal and regulatory issues

In order to make a comparative assessment of financial engineering techniques relevant to SMEs, it is necessary first to comment on certain Danish business traditions and characteristics.

Compared with other Member States, a relatively large proportion of Danish business falls under the scope of the Commission's definition of SMEs. Consequently there is no tradition as such for dividing Danish business into the categories SMEs and others although certain tendencies are seen recently as a result of the EC financial engineering impacts.

The financial techniques of venture capital, leasing, factoring and guarantee funds, can all be implemented in Denmark, generally without major problems or complications. Financial engineering for Danish business and industry has predominantly been given either as cash allocations or as loans on favourable conditions. The sectors aimed at are not SMEs but rather specific purposes irrespective of size, such as:

export promotion,
technological development,
product development,
energy saving,
environmental improvement,
entrepreneurial incentives,
network development.

In our opinion the success of a financial engineering technique is based on traditional supply and demand considerations, and if, in advance, it seems uncertain that the introduction of a new technique or a new feature of an existing technique will find any demand amongst SMEs, the implementation of bureaucratic organizations and control procedures does not seem worth the effort.

It is therefore tempting to conclude that, in general, effective financial engineering of SMEs in Denmark could possibly be realized by increasing allocations of funds for the existing purpose-targeted techniques rather than by introducing some of the absent techniques already existing in other Member States.

France

Introduction

France has a highly organized system for providing venture capital support to SMEs, and ranks third as regards venture capital investments after the United States of America and the United Kingdom. The preferred instruments are ordinary shares, convertible bonds and preferred shares; debt finance is very seldom used.

From a tax point of view, an obstacle may be that, generally, capital gains are always taxable (possibly at reduced rates). Also, long-term capital losses can only be set off against long-term capital gains.

On the other hand, the forming of VCCs has been encouraged by providing tax exemptions in case the VCC takes the specific form of, for example, a 'société de capital à risque'. Even if this is not the case, the risk of double taxation is generally excluded, not only in the case of debt but also in the case of equity finance because in the latter, the VCC can either benefit from the dividend exemption or claim the 'avoir fiscal'.

Finally, special tax benefits also exist for certain SMEs.

I. Legal and regulatory issues

1. *Typical investment vehicle used*

The following entities are permitted to participate in venture capital operations under French law:

Sociétés de développement régional (SDRs);

Sociétés financières d'innovation (SFIs);

Instituts régionaux de participation (IRPs) (for the record, all IRPs have been transformed into SCRs further to the Law of 11 July 1985);

Fonds communs de placements à risque (FCPRs);

Sociétés de capital à risque (SCRs);

Specialized institutes or organizations (Instituts de développement industriel – IDI, IDIA, etc.).

Each is governed by a specific set of rules. These are dealt with below.

2. *Applicable legal measures*

Decree No 55-865 of 30 June 1955 as implemented by the ministerial decision of 7 October 1955 relative to 'sociétés de développement régional' (companies for the development of regions).

Law No 72-650 of 11 July 1972 and the Implementing Decree No 73-124 of 7 February 1973 relative to several economic and financial provisions which create 'sociétés financières d'innovation' (financial companies for innovation).

Law No 78-741 of 13 July 1978 relative to the orientation of savings towards the financing of enterprises. This deals with participating loans.

Law No 79-594 of 13 July 1979 implemented by Decrees Nos 81-89 and 85-41 of 8 January 1985.

Law No 83-1 of 3 January 1983 relative to the development of investments and the protection of savings which creates 'fonds communs de placement à risque'. This Law is implemented by Decree No 83-357 of 2 May 1983.

Law No 84-878 of 9 July 1984 implemented by Decree No 85-41 of 8 January 1985.

Law No 85-895 of 11 July 1985, implemented by Decree No 85-1102 of 9 October 1985 relative to several economic and financial provisions, creating the 'sociétés de capital à risque' (venture capital companies).

Decision of 11 December 1985.

Law No 88-1149 of 23 December 1988.

Law No 89-935 of 29 December 1989.

Law No 90-1168 of 29 December 1990.

Law and regulations relating to the second marché (or regional stock exchanges)

General decisions of the Commission des opérations de bourse (COB) of 7 September 1982, as ratified by the decision of the Ministre de l'économie et des finances of 1 January 1983.

Instruction of the COB of 4 January 1983.

Instruction of the COB of 2 September 1986.

Regulation No 88-04 of the COB of 21 June 1988 as ratified by a decision of 1 September 1988.

General regulation of the Conseil des bourses de valeur (CBV) as ratified by decisions of 6 July 1988 and 28 September 1989.

General decision of the CBV No 88-7 of 19 October 1988.

General decision of the CBV No 88-9 of 15 November 1988.

General decision of the CBV No 88-16 of 18 October 1988.

Instruction of the COB of 22 November 1988.

3. *The investment vehicle*

Sociétés de capital à risque (SCRs)

'Sociétés de capital à risque' were created by Law No 85-695 of 11 July 1985 which provides for the following rules:

(a) Nationality

SCRs must be French in order to benefit from the advantages (essentially fiscal) which are attached to their qualification as an SCR.

It must be recalled in this connection that the two criteria which allow the nationality of a company to be determined under French law are, on the one hand, the situation of the head offices (under Article 3 of the Law of 24 July 1966 and Article 1837 of the Civil Code) and, on the other hand, the notion of control under which, in some extreme cases, French courts have disregarded the localization of the head offices and have determined the nationality of a company by reference to the place from which it is actually managed and controlled.

(b) Form

Under Article 1 of the Law of 11 July 1985, SCRs must be organized as 'sociétés par actions' (joint-stock companies).

There are two categories of 'sociétés par actions' under French law: 'sociétés anonymes' and 'sociétés en commandite par actions'.

It should be noted that the number of French companies organized as 'sociétés en commandite par actions' is very limited in practice.

(c) Activities

The object of SCRs must principally be to take interests in unlisted companies.

In this respect, their net assets must constantly consist of a minimum amount of 50% of newly issued shares, stock or convertible bonds in companies which must fulfil the following conditions:

- the target companies must be French or located in the European Community;
- those companies must not be listed on any national or regional stock exchange;
- the target companies must be active in the industrial or commercial field;
- they must be subject to corporation tax.

The amount of the interest which an SCR is permitted to hold in a target company is subject to the following limitations:

- the SCR must not hold directly or indirectly more than 40% of the voting rights in a given company;
- it must not use more than 25% of its capital in acquiring an interest in a given company.

A single individual and his direct relations may not hold more than 30% of the capital of the SCR. This limit does not apply to corporate shareholders.

Sociétés de développement régional (SDRs)

'Sociétés de développement régional' were created by Decree No 55-876 of 13 June 1955. Their exclusive object must be to participate in the capital of industrial enterprises in regions suffering from underemployment and/or insufficient economic development.

In order to improve the development of the said regions, the Decree of 1955 instituted a number of tax advantages for SDRs subject to the following provisions regarding their legal organization:

- SDRs must be French 'sociétés par actions' (joint-stock companies), that is either 'sociétés anonymes' or 'sociétés en commandite par action';
- their share capital must be a minimum amount of FF 250 million and fully paid;
- the maximum allowable participations by an SDR in the capital of the same enterprise is 25% of the SDR's capital and 35% of the enterprise's capital;
- the SDR must sign an agreement with the Ministry of Finance which provides for the appointment of a Commissaire du Gouvernment (emissary of the French Administration) who controls the application of the relevant regulations.

SDRs are created for the development of one specific region and may not intervene outside their territory.

Their share capital is generally held by banks and other financial institutions and by local authorities and other public entities but also directly by the public which generally holds 8 to 50% of the capital since SDRs may be listed on the regional stock exchanges.

Although the capitalization requirements are stringent, this does not present a problem as SDRs are funded from a wide range of sources, as stated above.

SDRs are not subject to significant legal obstacles which hinder their operation or establishment.

Evolution of SDRs, SFIs and venture capital

SDRs and SFIs are subject to evolution. The aim of the government is to facilitate the transformation of SDRs into SCRs (most of the SFIs have already become SCRs) or allow them to benefit from the tax measures applicable to SCRs.

Therefore, ex-SDRs or new SDRs would be subject to the 50% obligation applicable to SCRs to participate in the capital of unlisted companies.

The 'plan global PME-PMI' (global plan SMEs-SMIs) presented by the Prime Minister on 16 September 1991 announced that SFIs and SDRs will be subject very soon to the following modifications:

SDRs:

Give them the benefit of the tax provisions applicable to SCRs;

Authorize them to grant loans for a length of time greater than two years;

Authorize them to participate in the capital of companies to a greater extent than 35%.

SFIs:

Modify the penalty provisions in the law in case of non-respect of their obligations as SFIs;

To mitigate the rules set out under 'Sociétés financières d'innovation' below;

To guarantee the holdings of SFIs in companies by the creation of a new guarantee fund called 'Developpement technologique' managed by the Sofaris.

Sociétés financières d'innovation (SFIs)

'Sociétés financières d'innovation' were created by Law No 72-650 of 11 July 1972.

Their object must be to facilitate the industrial implementation of technological research as well as the development of as yet unexploited inventions.

SFIs are under an obligation to enter into an agreement with the State which contains the following undertakings:

- SFIs must be 'sociétés anonymes' with a minimum capital of FF 10 million;
- no shareholder can hold more than 30% of the shares;
- 60% of the resources of an SFI must be devoted, within the three years following the signature of the resources of the agreement, to innovation deals;

- no investment may exceed 25% of the capital of the SFI.

The control of the SFI's compliance with the above rules is carried out by a Commissaire du Gouvernment appointed by the Ministry of Finance.

The counterpart of those undertakings is a number of tax advantages.

Banks and other financial institutions as well as public local or regional authorities and the public may participate in the capital of SFIs.

Note the conversion of SFIs into SCRs referred to under 'Evolution of SDRs, SFIs and venture capital'.

Fonds communs de placements à risque (FCPRs)

'Fonds communs de placements à risque' stem from Title 2 bis of Law No 79-594 of 13 July 1979 and they are governed by Article 23 of Law No 83-1 of 3 January 1983 and Article 6 of Law No 84-878 of 9 July 1984 known as 'développement de l'initiative économique' (development of economic initiative).

The objective of FCPRs is to allow institutional investors as well as individuals to take interests in small and medium-sized enterprises which may not easily call upon the financial market in order to assist with their development.

FCPRs are not legal persons and they are governed by their 'statuts' (articles). The invested monies may be collected only by banks and other financial entities or by other entities authorized by the Law of 1983 such as SDRs or SFIs which act as depositories, managers and/or investors. Other entities must apply for an authorization from the Ministry of Finance in order to create an FCPR.

The following legal provisions are applicable:

- the assets of an FCPR must be between FF 2.5 and 100 million, at least 50% of which must consist of shares or convertible bonds of unlisted companies;
- at least 50% of the assets must comprise participations in French or EC companies subject to corporation tax;
- an FCPR may not hold more than 10% of the capital of any given company;
- a shareholder, his spouse and their parents or descendants may not hold together, directly or indirectly, more than 25% of the rights in the profits of a given target company;
- the manager of the FCPR must be a participant in the fund and must hold at least 10% of the fund if it is formed by individuals, or 1% in other cases;
- the manager's remuneration may not exceed 20% of the net assets for a given year.

Other entities

Various semi-public or specialized entities also provide financial support for the creation and the development of SMEs, such as the Institut de développement industriel (IDI), and the IDIA for the development of the agro-alimentary sector, through their participation in SCRs.

One or more 'fonds public de venture capital' (State venture capital funds) could be created in the future.

4. The provision of venture capital

French venture capitalists use three major instruments: ordinary shares, convertible bonds and preferred shares.

Debt finance is very seldom used and Law No 78-741 of 13 July 1978 relative to the orientation of savings towards the financing of enterprises, which has established the rules governing participating loans in France, did not meet with the success expected.

4.1. Equity finance

It should be noted that there are no legal or regulatory impediments to equity financing by a venture capital company in France, if tax matters are ignored.

The general rules of French company law, under the Law of 24 July 1966, apply without any licensing, registration or prospectus requirements since venture capital companies are subject to requirements requiring them to invest in unlisted companies.

French law does not provide specific rules with regard to the taking of a minority interest in a listed company with the exception that:

- disclosure may have to be made as to the level of the interest;
- a take-over bid has to be launched where the level of the interest held exceeds 33.33% of the shares or voting rights.

There are no complex application and filing procedures or any special procedures for SMEs.

There are no legal obstacles to the transfer of shares held by a venture capital company.

As mentioned above, the following general rules apply:

(a) Shares

Under Article 263 et seq. of the Law of 24 July 1966, shares may be ordinary or preferred. Preferred shares confer advantages on the shareholder such as an increased right to dividends or profits.

(b) Bonds

Under Article 284 et seq. of the Law of 24 July 1966, joint-stock companies which have been in existence for at least two years may issue bonds as security for a loan.

The following types of bond are mainly used in venture capital operations:

- participating bonds allow for the linking of the amount of the reimbursement obligations of the borrower company to its profits or, as the case may be, to the turnover;
- convertible bonds and bonds with a right to suscribe for shares: these instruments facilitate the realization of the initial investment. The conditions and time of the conversion of bonds into shares is provided at the time of the issue of the bonds in question, which must be approved by an extraordinary meeting of shareholders.

The only stock markets in France are the cote officielle (règlement mensuel, comptant), the second marché and the hors cote. Certain venture capital companies are subject to restrictions on the amount they may invest in the capital of companies listed on either the cote officielle or the second marché (see above). The following is a breakdown of the considerations applying to the use of the second marché by each category of venture capital company referred to above.

Société de capital à risque

As already stated, the investments of an SCR must constantly comprise a minimum of 50% in newly issued shares, stocks or convertible bonds in companies which must not be listed on any national or regional stock exchange, (cote officielle, hors cote or second marché).

Thus, an SCR may participate in the second marché subject to the limit that a maximum of 50% of its assets can be invested in the capital of listed companies.

Fonds commun de placement à risque

The legal provisions applicable to FCPRs are set out above.

At least 50% of the assets of an FCPR must consist of shares or convertible bonds of unlisted companies.

Therefore an FCPR may participate in listed companies but up to a maximum of 50% of its assets.

Sociétés de développement régional

SDRs are not subject to any restrictions on their ability to invest in listed companies. They are bound by the conditions referred to above in Section 1.3.3.

Sociétés financières d'innovation

No legal limitations concerning the amount of the participation in the capital of listed companies, other than the limitations listed in Section 1.3.3 above, apply to participations of an SFI.

Other entities

Entities such as the IDI or IDIA do not participate in the capital of listed companies because of their purpose or activities.

It can be seen from the above that the second marché will assist some of the venture capital companies referred to to dispose of their investments. For the sake of completeness, the basic rules governing the second marché are set out below.

Main features

Cost of entry: between FF 300 000 and 800 000;

No legal limits of turnover or profits in order to be listed;

10% of the capital of the company must be issued for the public;

The company may be listed either in Paris or on one of the six regional stock exchanges.

Application

In order to have its stocks admitted for quotation on the second marché, a company has to file an application with the CBV (Conseil des bourses de valeurs) through an authorized intermediary (stockbroker or bank).

The Société des bourses française gives an opinion to the CBV.

The CBV, within the rules of its general regulation, accepts or refuses the admission of the company on the second marché.

Financial instruments capable of being quoted

Shares, preferred shares, investment certificates, certificates representative of shares, rights to subscribe for shares in listed companies;

Bonds of listed companies;

Bonds convertible into shares or bonds with right to subscribe for shares in companies which undertake to apply to be listed;

Shares of foreign companies; with a ministerial approval for non-EC companies.

4.2. Debt finance

No specific instruments have been created in France for the purpose of improving the conditions of loans to SMEs with the exception of participating loans ('prêts participatifs'), as mentioned above, which were created by Law No 78-741 of 13 July 1978 relative to the orientation of savings towards the financing of enterprises, and are characterized by the subordination provisions which they imply.

Also, guarantee organizations and funds have been created in order to facilitate such loans. This is dealt within the corresponding section of the report.

Law No 84-46 of 24 January 1984 provides regulations concerning banks and financial institutions which carry on banking operations habitually.

The rules relating to bonds are discussed above under 'Equity finance'.

Loans granted to SMEs by banks or financial institutions, such as Crédit national, Crédit d'équipement des petites et moyennes entreprises, Caisse centrale de crédit

coopératif or SDRs on favourable terms, have fallen into disuse because banks are reluctant to grant such loans.

It should be noted that Codevi (Comptes pour le développement industriel, Law No 83-607 of 8 July 1983), which is a mechanism involving banks and the Ministry of Finance and aims to provide funds to SMEs, is expanding.

All these different kinds of loan are subject to the rules relative to credit law.

II. Issues of taxation

1. *Introduction*

The SME is often confronted with the difficulty of attracting financial means from third parties.

Indeed, on the one hand, the SME often has too low an equity with the result that the financial institutions feel rather reticent to grant any loan.

On the other hand, because of the high risk of the investment, only very few persons will be willing to increase the capital (and therewith the loan capacity) of the SME.

The VCC can therefore play an important role in the expansion of the SME.

The VCC and the target company (SME) will have to determine how the capital is to be injected. It may very well be that there is a conflict of interest between both parties in determining how the injection will be executed.

In general, the (tax) differences between debt financing and equity financing can be established as follows:

In the case of debt financing by the VCC, the interest payments are for the SME in principle tax-deductible expenses, which have a negative impact on the results (possibly into a loss position) and on the cash flow of the SME. The VCC will be fully taxable on the interest income.

It may very well be that this situation is not at all desirable. Indeed, the SME will probably be in need of extra means at the time that heavy investments are planned which will already have a negative impact on the results (depreciation of the investment). From a tax point of view, such a situation may also prove to be unwise. The interest deduction cannot be properly used because of insufficient profits (creation of losses) whereas the interest income with the VCC is immediately taxed. To meet both economic and tax demands, two main options are available:

- either the loan agreement is concluded under circumstances where the interest rate is in the beginning rather low (e.g. profit-sharing loan or convertible loan); or
- the VCC decides to participate in the capital of the SME.

In case of equity financing, the following problems arise:

Dividend income: if the VCC is in need of a more or less regular income to finance its own investment, this will have to be done by way of dividend distribution. This may present a lot of problems. Dividends are normally not tax deductible so that the dividend capacity will normally be lower than the interest payment capacity. However, some incentives exist that introduce a system of tax-deductible dividend.

In the case of dividend distribution, both the VCC and the individual shareholder will receive a dividend. The dividend taxation of individuals is often very disadvantageous.

To avoid this problem, the VCC might opt for preference shares, so that dividends can be distributed to the VCC and not to the individual shareholder.

Capital gains income: this way could be interesting since, by doing so, the SME retains all profits.

Problems are:

- if the value of the SME increases, the capital gain will in principle be tax exempt, if the shareholder is qualified to be a French venture capital company and if it meets all the conditions. On the other hand, the interest paid on the loans granted in view of the purchase of the shares is deductible. The problem is that the individual shareholders will normally not have enough means to repurchase the shares.

In the next part (Equity/Debt finance), a summary is given of all important items that could influence the decision-making of the VCC and the SME.

Practical taxation guidance, resulting from the information under 'Equity finance' and 'Debt finance', is given under 'Practical taxation guidance'.

2. *Equity finance*

2.1. Creation of the VCC

Registration tax or other duties

(a) Registration duties

Registration duties only apply to contributions in cash or in kind for shares. Contributions for consideration other than shares are considered to be sales. They will be subject to a registration duty or to VAT depending on the type of goods transferred.

Contributions in cash: a registration duty of 1% is payable on any contribution in cash to the risk-bearing capital. The taxable base is the contribution less the expenses connected with the contribution.

Contributions in kind: a registration duty is generally payable on contributions in kind. The taxable base is the market value of the contribution made.

(b) Other duties

There are no Chamber of Commerce fees payable on the creation of the VCC. However, every enterprise doing business in France must register with the Commercial Registry. France does not impose a stock-exchange tax on the listing of companies on the Stock Exchange. No stamp duties are collected.

Are there limits as to the degree of participation of the VCC in the SME?

The shareholding in the SME may not exceed 40% of the latter's voting shares. The VCC cannot hold more than 10% of the capital of the SME. Other limits apply when the VCC can claim the favourable tax treatment (see Section 2.3 under 'Specific regimes').

Are there any conditions to be met in respect of the legal forms of the VCC? Are there any specific forms available?

When the VCC solicits funds from the public (i.e. when it is quoted on the Stock Exchange or when it markets shares through banks, brokers or other financial institutions), it must adopt the form of an SA (stock corporation). The VCC is then subject to special requirements concerning the capital (at least FF 1 500 000) and the approval of the Commission des opérations de bourse.

The VCC must hold shares, convertible bonds or similar securities of French companies subject to CIT.

The VCC can take the specific form of a 'société de capital à risque', a 'société de développement régional', a 'société financière d'innovation' or a 'fonds commun de placements à risque' (for tax benefits see below).

2.2. Tax situation of the SME

Creation of the company and increase of capital

Are there registration or other duties?

(a) With respect to the duties applying to the creation of the SME: the same duties apply as for the VCC.

(b) With respect to the increase of capital:

In principle, increase of capital is subject to the same duties as when the same property is contributed to the company's initial capital.

Cash increases in capital are exempt from any registration duty.

There is no difference in the indirect tax treatment according to the different types of share.

Corporate tax

The formation expenses (constitution expenses, publicity expenses etc.) are classified as starting-up costs, which may be deducted in the first year or over a maximum period of five years.

The registration taxes are also deductible.

Are there specific regimes for certain regions?

Enterprises which carry out activities which create new, or extend existing industries in the less-developed regions benefit from several tax exemptions and reductions (which are cumulative):

- Underdeveloped areas

Investments in these areas may benefit from partial or total exemption from business tax for a maximum period of five years and from accelerated depreciation (25% rate) of industrial and commercial buildings.

The business tax ('tax professionnelle') is a tax which is imposed on all taxpayers carrying on commercial, industrial or certain professional activities.

The tax base is the cadastral value of fixed assets and the wage bill. The tax rate varies according to the municipality of the establishment, up to 3.5% of turnover.

- Depressed areas (Dunkerque, Aubagne-La Ciotat, Toulon-La Seyne)

A few temporary rules provide incentives for new investments in these areas (company tax holiday). Recently, the deadline for enjoying these regimes has been extended.

- Regime for newly created enterprises

Full and partial exemptions have been granted to new enterprises under rules that have changed from year to year. For companies created after 1 January 1988, a full corporate income tax exemption is accorded for the first 24 months of activity, decreasing to 75, 50 and 25% in the three succeeding periods of 12 months. The exemption applies to the income including capital gains and after deduction of losses carried forward. The company must be a commercial, industrial or artisan business.

Activities such as banking or other financial activities, insurance and administration and the rent of immovable property are expressly excluded. The company must be a genuinely new enterprise and it may, therefore, not have been created as a result of a corporate reorganization. The shares of the new company may not directly or indirectly be held for more than 50% by other companies.

Rates

The normal corporate income tax rate is 34% on undistributed profits and 42% on distributed profits. In future, these rates will be replaced by a unified 34% rate.

Reduced rates apply to long-term non-distributed capital gains:

- general: 19%
- patents, know-how: 15%
- building land, portfolio investments (except shares and warrants): 25%

In future, long-term capital gains on portfolio investments will be taxed as ordinary business income (34%). Other long-term capital gains will be taxed at the unified 18% rate (if realized in account years closed on or after 31 December 1991).

In addition, legal entities which are subject to CIT are liable to an annual lump-sum tax which is a function of the turnover.

This minimum tax is generally creditable against the CIT payable in that year and the two subsequent years. Exemptions apply to newly created companies.

Redemption of shares

If the SME purchases its own shares with retained earnings, French tax law will consider this operation as a hidden profit distribution, to the extent that the cash payments received exceed the original contributions or, if higher, the purchase costs of the shares.

This means that these amounts are added back to the taxable income of the SME for the year of deduction where such deduction has been taken for CIT purposes.

The situation of the VCC: see below.

Dividend distribution

Does a different tax regime apply to dividend distribution to X (individual shareholder of the SME) and to the VCC?

The tax regime applying to dividends distributed to X (individual shareholder) differs from the regime applying to dividends distributed to the VCC under certain conditions (see Section 2.3).

Does a different tax regime apply according to the different types of share: ordinary, preference, redeemable or other shares?

There is no different tax regime applicable according to the different types of share.

Is the tax base affected by the distribution of dividends (deductible dividends)?

In general, the distribution of dividends is not a deductible expense. For some years certain dividends have been deductible against taxable profits of a corporation, but limited to 7.5% of the share capital in a new company or of additional capital in an existing company.

Dividends in respect of new shares issued between 1 January 1983 and 31 December 1987 are fully deductible against profits for a 10-year period.

As of 1988, only 53.4% of the dividend may be deducted during a period of 10, 8 or 6 years if the capital contribution is made in 1988, 1989 or 1990 to 1992, respectively.

Exception:

There is no deduction possible for dividends attributable to the shares owned by a company which holds at least 10% of the stock of the company or whose shareholding exceeds FF 15 million. However, the deduction is still available with respect to distributions to parent companies, when the parent company is subject to French corporate income tax and renounces the benefits of the affiliation privilege (see dividend taxation of the VCC: substantial holding).

The tax rate depends on whether the profits are distributed or not. Recently, this difference was abolished in favour of a unified rate of 34%.

Is a withholding tax withheld? Rate? Exemption for dividends?

No withholding tax is applicable to dividends by a resident company to resident corporate and individual shareholders. The 'précompte' (see below, 'Dividend taxation') may, however, apply if a French company pays a dividend out of income not having borne the full corporate income tax rate.

2.3. Taxation of the VCC

Corporate taxation

Attention must be paid to the specific treatment granted to French venture capital companies that comply with the required conditions (see below).

Are the costs related to the creation of the VCC deductible?

The costs related to the creation of the VCC are deductible (see the creation of the SME).

Are management costs and interest deductible?

- Management costs

In principle, management costs are deductible.

(a) Directors' attendance fees are deductible corporate expenses; however, there is an upper limit. The maximum deduction is 5% of the product of the average remuneration paid to the company's highest paid executives, and the number of members of the board of directors.

(b) Lump sum travel and entertainment allowances, if culminated with reimbursement of the out-of-pocket expenses of directors, are not deductible.

(c) Any remuneration which does not correspond to effective work and is excessive in relation to the service performed is not deductible. The portion of remuneration which is deemed excessive is not deductible for the company and is taxed as a dividend to the directors.

(d) Directors may also be compensated for special duties performed on behalf of the company. In order to be deductible, the amount must be 'reasonable', i.e. what would have been paid to an independent third party.

- Interest deduction

Interest paid to third parties is deductible if the debt is incurred for the business purposes of the company and is accounted for. Interest is deductible in the year it accrues or is payable at the taxpayer's election. Interest paid on loans for the acquisition of a participation in another company is deductible even if the income from the participation is tax exempt.

Dividend taxation

- No substantial holding (the VCC holds less than 10% of the shares of the SME)

When the VCC receives a dividend, it is entitled to a tax credit ('avoir fiscal'). In order to qualify for this tax credit, the following conditions have to be met:

(a) the SME must have its head office in France and be subject to corporate tax;

(b) the amounts in question must be regularly and periodically distributed dividends to which all shareholders are entitled pro rata;

(c) the dividends must be declared by a resolution of a shareholders' meeting (thus, distributions to directors, interest, payments to shareholders, etc. are excluded);

(d) the dividends (grossed up by the 'avoir fiscal') must be included in the shareholders' taxable income in France. This tax credit is equal to 50% of the dividend received and is considered by itself as a taxable item.

To be consistent, i.e. to have an 'avoir fiscal' attached to any regular profit distribution, the 'précompte' (or equalization tax) was created. This is a payment made by the distributing company equal to the 'avoir fiscal' granted to the beneficiary of the dividend. As the rate of the 'avoir fiscal' is 50% of the distributed dividend, the rate of the 'précompte' is 33.33% of the dividend grossed up by the 'avoir fiscal'.

The 'précompte' is due in the case of a distribution of a profit not taxed at the normal rate of the CIT, or of a profit – even normally taxed – made more than five years prior to its distribution.

The dividend grossed up by the 'avoir fiscal' is included in the taxable income of the VCC and the 'avoir fiscal' gives right to a tax credit of the same amount.

If the VCC is qualified as an investment company or if it is a company opting for consolidated taxation, the VCC will be exempt from the 'précompte'.

Examples:

(a) The VCC holds less than 10% of the shares of the SME

SME:	Net taxable income	100
	Less CIT (34%)	–34
	Available for distribution	66
VCC:	Dividend from the SME	66
	'Avoir fiscal'	+33
	Taxable income	99
	CIT (34%)	33.66
	But 'avoir fiscal'	33
	Thus, CIT	0.66

Dividend to individual shareholders: 65.34

(b) The VCC holds less than 10% of the shares of the SME but the SME has exempt income

SME:	Income	100
	CIT	0
	Available for distribution	100
	Income subject to 'précompte'	100
	Less 'précompte'	33.33
	Dividend distributed	66.67
VCC:	Dividend	66.67
	'Avoir fiscal'	33.33
	Taxable income	100
	CIT (34%)	34
	But tax credit ('avoir fiscal')	33.33
	Taxable income	0.66
	Net dividend distribution	66

- Substantial holdings

Specific (more favourable) rules apply when the shareholder company is qualified as a 'parent company'. The parent company must be subject to French corporate income tax. In these cases, only 5% of the dividends are included in the taxable income; this results in a 95% exemption. The corporate tax due on French dividends received can be reduced by the 'avoir fiscal'. The parent company must hold a minimum of 10% of the share capital of the subsidiary at the time of the dividend distribution; the holding may be less than 10% if the shares cost at least FF 150 000 000 or were received in exchange for assets contributed in an authorized merger. Other conditions have to be met: the subsidiary shares held must be registered or deposited with an establishment approved by the tax administration; the subsidiary shares must be either subscribed by the parent company or acquired by it.

Note

The position of 5% is a lump-sum deduction representing deemed expenses connected with collection of the dividend received. If the parent company can substantiate that its total expenses in the year of receipt were less than 5%, the dividend may be exempt from corporate income tax up to 100%.

The company does not qualify for the 'avoir fiscal' on the exempt portion of dividends since this credit applies only where taxable income results. In terms of the 5% taxable portion, it is grossed up by a deemed 50% 'avoir fiscal', so that the amount added to the taxable income equals 7.5% of the gross dividend received in the case of a dividend from a French company.

When the VCC later distributes the exempted dividend received, it has to pay the 'précompte'. However, it can pay this 'précompte' by offsetting the 'avoir fiscal' attached to the exempted dividend. The dividends bearing these tax credits must, however, have been received by the French holding company not more than five years previously. Recently, the French authorities adopted some measures concerning situations where the 'précompte' is not due by French companies holding foreign participations. If the 'avoir fiscal' does not apply, no 'précompte' is due.

Example:

The VCC holds more than 10% of the shares of the SME and is considered as a 'parent company'. The

example ignores the 5% portion of the grossed-up dividend to the VCC.

SME:	Net taxable income	100
	Less CIT (34%)	34
	Available for distribution	66
VCC:	Dividend received	66
	'Avoir fiscal'	+33
	Income subject to 'précompte'	99
	Précompte at 33.33%	33.33
	But 'avoir fiscal'	–33.33
	CIT due	zero
	Available for distribution	66

How is the capital gain taxed if the shares of the SME are sold ?

Capital gains and losses are treated separately depending upon whether they are classified as short- or long-term gains.

Short-term gains are gains made on assets held for less than two years and are treated as ordinary income taxable at the basic rate. They are taxed in the year they arise. Short-term capital losses may be offset against either revenue or capital profits in the future.

Long-term capital gains are profits made on assets held for more than two years. The gain does not necessarily have to represent realized profits, since surpluses on revaluation of assets are also treated as short- or long-term capital gains. The actual long-term gain is the difference between the sale proceeds and the costs of initial acquisition of the assets. In respect of the rates of long-term gains: see above 'Rate'.

In view of these lower rates, and to prevent the 'avoir fiscal' being given in an amount equal to or bigger than the amount of tax actually collected, when the capital gain is distributed to shareholders, the 'précompte' (see above, 'dividend taxation') is payable equal to one third of the gross profits reduced by the tax actually paid.

Long-term capital losses are only capable of being offset against long-term capital gains, but may be carried forward for a period of up to 10 years. Long-term capital gains may, however, be reduced not only by long-term capital losses, but also by short-term losses and even revenue losses of the same year or of earlier years.

Redemption of its shares by the SME

To the extent that the cash payments received exceed the original contributions or, if higher, the purchase costs of the shares, the VCC will be taxed as recipient of dividends, with no right to the 'avoir fiscal'.

Specific regimes

Regional development companies ('sociétés de développement régional') which normally finance subsidiaries of the large French banks operating in less developed areas, are exempt from CIT on their main sources of income under specific conditions. Such companies may also participate in industrial enterprises in other regions provided the following conditions are met: no investor may hold over 25% of an SDR's share capital; an SDR may not hold over 35% of a company; the SDR maintains a local activity.

French venture capital companies ('société de capital risque'), the purpose of which is to participate in non-quoted companies, are now subject to a very favourable tax treatment (provided by Law No 85-695 of 11 July 1985).

The conditions under which this treatment is granted include the following:

(a) the venture capital company must be a stock company;

(b) it must hold shares, convertible bonds or similar securities of French companies subject to CIT;

(c) the shareholding in each company may not exceed 40% of the latter's voting shares.

VCCs are exempt from CIT on their dividend income and capital gains. In addition, the taxation of distributions to their shareholders is minimized as follows: cor-

porate shareholders are subject to the long-term capital gains treatment (i.e. 15%) and individual shareholders are subject to income tax at the flat rate of 16%, rather than the regular progressive rates.

Furthermore, a 'société financière d'innovation' can benefit from an exceptional depreciation method provided certain conditions are met, whereas the tax regime applicable to 'fonds communs de placements à risque' is favourable to the individual shareholder (see below).

Rates:

Normal / reduced rates: see the situation of the SME.

Is there recoverability of the tax withheld by the SME?

In case of distribution of dividends by the SME to the VCC, French law provides for a system avoiding double taxation (see above, 'Dividend taxation').

Distribution of dividends by the VCC

Does a different tax regime apply according to the different types of shares ?

There is no different tax regime according to the different types of shares.

Is the tax base affected by the distribution of dividends (deductible dividend)?

The amount that the company distributes as a dividend generally is not an expense. As an incentive to encourage recapitalization of French companies, a system of temporary rules allows a limited deduction for dividends paid on shares issued in exchange for new capital between 1977 and 1990 (see above).

Is the tax rate affected by the distribution of dividends?

The tax rate depends upon whether the profits are distributed or not. Recently, this twin CIT rate has been replaced by a unified 34% rate.

Is a withholding tax withheld?

No withholding tax is due on dividends paid by a resident company to a resident corporate and an individual shareholder. (Dividends paid to non-resident shareholders are subject to a 25% withholding tax.)

Specific regimes: If the specific regime granted to the French venture capital companies (SCRs) applies, the shareholders can claim a favourable tax regime on their dividends (see above, 'Dividend taxation').

Furthermore, such an SCR, which cannot itself use the tax credits ('avoirs fiscaux') attached to the dividend it receives (on which it is exempt from CIT), can transfer the abovementioned tax credits to its shareholders provided the following conditions are met:

(a) the tax credit is attached to the redistribution of ordinary income, which may not consist of capital gains;

(b) the tax credit is attached to profits realized during the year preceding the distribution (immediate redistribution);

(c) the tax credit is limited to 50% of the net distribution.

Transfer of shares

In case of transfer of shares of the SME, do special taxes apply on this transfer?

(a) A registration tax is levied at a rate of 4.8% on the higher of the sale price or fair market value of sales of shares.

This tax applies to all sales of SARL (limited liability company) or civil company shares. It does not normally apply to sales of SA (stock company) shares, unless a written instrument is executed in France affecting the transfer.

(b) The Stock Exchange tax applies. The rate is 0.3% (up to FF 1 000 000) and 0.15 (over FF 1 000 000).

2.4. Tax situation of X (individual shareholder)

Is the interest paid on the loan granted in view of the purchase of the shares of the SME deductible?

The interest paid on the loans granted in view of the purchase of the shares of the SME is deductible.

How are the dividends taxed?

Taxation of the dividends: see Taxation of the VCC.

Dividends are generally included in taxable income for individual income tax purposes. Dividends (distributed by virtue of regular decision of the general assembly of shareholders) normally entitle the recipient to a tax credit ('avoir fiscal') against his individual income tax equal to one half the net amount of dividends received. The amount of dividends, grossed up by the special credit, is included in taxable income for income tax purposes. Any excess of the tax credit over the income tax due is refunded. Stock dividends are not considered as income and are consequently not subject either to withholding or to income tax.

Furthermore, provided the individual shareholder in a 'fonds commun de placements à risque' is a French resident and he commits to keep the FCPR-shares for a minimum period of five years and to reinvest any dividend, share or amount received from the FCPR in this FCPR during this five-year period, he is exempt from personal income tax on the income (including capital gain) received from the FCPR during this period of five years.

2.5. In case the SME is not a company but an unincorporated enterprise

If the VCC participates in such an enterprise, how does this affect the position of the enterprise?

3. *Debt finance*

3.1. Preliminary remarks

French company law does not contain specific provisions as to minimum debt. The only company law requirements are those relating to minimum share capital. On the other side, the interest deduction for tax purposes is limited. French law applies the following rules concerning thin capitalization:

The general rule is that no interest is deductible on shareholder loans if capital is not fully paid. Certain cooperatives, however, are exempt and may deduct interest on loans to shareholders without their capital being fully paid in.

Interest rates for any taxable year may not exceed the average interest rate on privately quoted bonds.

Special rules apply to shareholders who direct the company or whose economic or voting rights in the borrowing company exceed 50%: interest is deductible on such loans only to the extent that they do not exceed 150% of the company's nominal capital. This rule does not apply to French parent companies which make loans to qualifying French subsidiaries.

What if the ratio is not respected?

Interest in excess of the maximum allowed under the thin capitalization rules is added back to the shareholders in question.

3.2. Tax situation of the SME

Does the choice between the following types of loans granted to the SME have implications for the tax situation of the SME: ordinary loans, convertible loans, profit-sharing loans or other types – if regularly used?

Deduction between the different types of loans: no tax implications.

What is the deduction regime for the different types of loans? Are there specific regimes available?

In general, interest paid to third parties is deductible if the debt is incurred for the business purposes of the company and is accounted for. Interest is deductible in the year it accrues or is payable, at the tax payer's election.

What if the VCC also participates in the SME?

Interest payments to shareholders are deductible, but the rules on thin capitalization and the limitation of the interest rate must be complied with (see above).

The loss is deductible if the purpose is 'commercial', i.e. to maintain access to markets. The forgiven debt is treated as income to the subsidiary. For 'financial' transactions, i.e. when the purpose is to protect a capital investment, the forgiven debt is deductible to the extent that the interest in the subsidiary is not increased in value. For the subsidiary, a non-deductible 'financial' forgiven debt is a contribution to capital; a forgiven debt is income.

What is the withholding tax for each of the different types of loans?

Interest from loans that have been issued since 1 January 1987 is exempt from withholding tax.

3.3. Tax situation of the company that grants a loan to the SME

What is the situation concerning the different types of loans (ordinary loans, convertible loans, profit-sharing loans or other types)?

Taxability of interest: interest income is subject to income tax. There are no exemptions.

Capital gains on receivables: the sale of receivables is in principle subject to the same rules as for other capital gains and losses.

Interest deduction: interest payments on loans for the acquisition of the funds are deductible.

Is there a withholding tax on interest paid by the VCC?

Withholding tax: interest from loans that have been issued since 1 January 1987 are exempt from withholding tax.

3.4. Tax situation of the fund

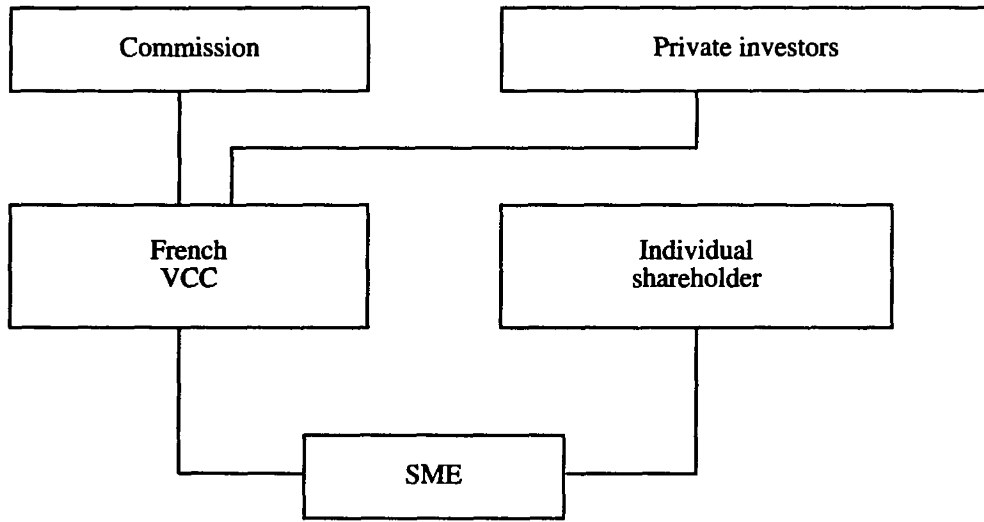
There is no withholding tax on interest.

The interest is taxable.

Practical guidance

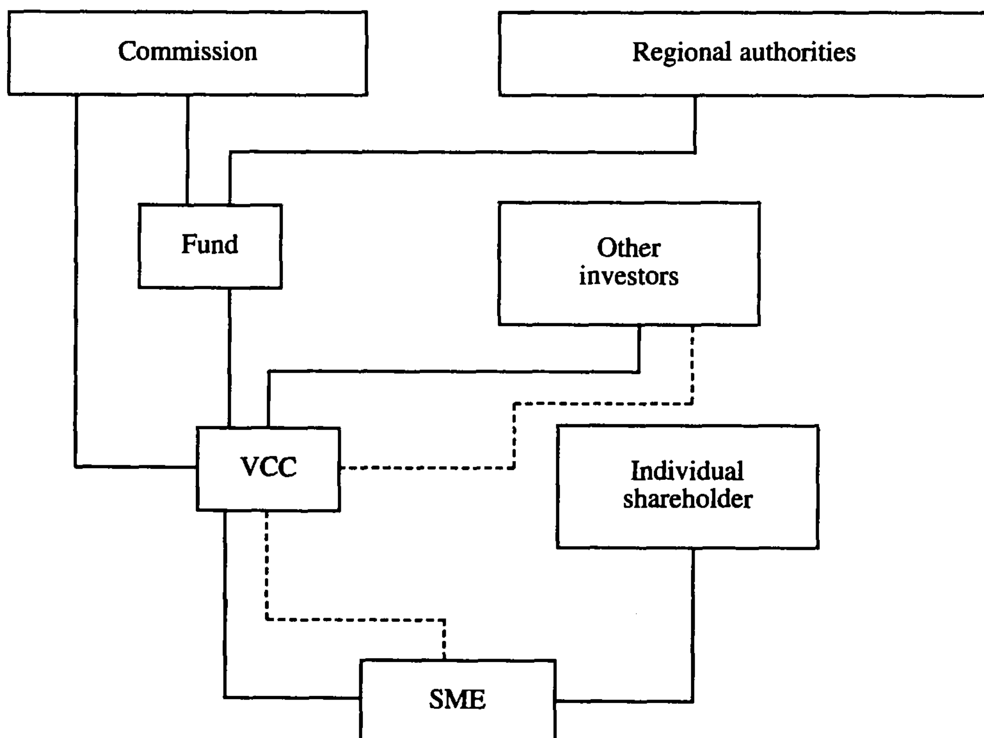
I. Equity finance

1. Scheme



II. Debt finance

1. Scheme



2. *Comments on structure*

2.1. *Position of the SME*

Costs of increasing capital:

Cash increases in capital are exempt from any registration duty.
These costs are tax deductible.

Taxable base:

The profits of the SME are, in principle, not influenced by the capital increase.

If the capital increase leads to a profit situation, this profit is normally taxed at 34%.

Tax rate:

The profits are taxed at 34%. A reduced rate (18%) applies to long-term capital gains (except long-term gains on portfolio investments).

Redemption of shares:

The redemption can lead to taxation for the SME (considered as a hidden profit distribution).

Dividend distribution:

The dividends are part of the taxable base.
On the dividends distributed both to the individual shareholder and the VCC, no withholding tax is applicable (if paid by a resident to a resident). However, if the income has not borne the full corporate income tax rate, the 'précompte' is due.

2.2. *Position of the VCC*

Taxable base:

(a) Dividend income

2.1. *Position of the SME*

Costs of granting loan are deductible.

Taxable base:

The interest payments are normally deductible expenses that have a negative impact on the results and the cash flow.

Tax rate:

The deductible interest payments save a taxation of 34%.

Reimbursement of the loan:

Has normally no impact on the taxable result.

Interest payment:

The deductible interest from loans that have been issued since 1 January 1987, paid to the VCC, is normally exempt from withholding tax.

2.2. *Position of the VCC*

Taxable base:

(a) Interest income

The gross income (including tax credits) is tax exempted for 95% under the condition that the VCC has a substantial holding (10% and over) during the entire year. Otherwise, a (refundable) tax credit ('avoir fiscal') of 50% of the dividend received can be claimed which can lead to a compensation of the corporate tax paid by the SME (certainly under the future unified rate of 34%). Under very restrictive circumstances the VCC can be exempted (specific regime) from tax on dividends.

(b) Capital gains taxation

Short-term gains (shares held for less than two years) are treated as ordinary income. Long-term gains are taxed at a reduced rate.

(c) Capital loss on shares

Long term capital losses can only be offset against long term capital gains, but may be carried forward for a period up to ten years.

Dividend distribution:

The normal rules apply except for the VCCs which qualify for the specific VCC tax system.

Transfer of shares:

A registration tax at the rate of 4.8% on the higher of the sales price or fair market value of sales of most shares. No registration tax on the transfer of SA shares provided no deed is signed in France (1% tax with a maximum ceiling of FF 20 000 otherwise).

2.3. *Position of the individual shareholder*

Dividend income:

This income is fully taxable at 34%.

(b) Capital gains taxation

The capital gain realized at the moment of converting the loan into capital is fully taxable.

(c) Capital loss on loans

The sale of receivables is in principle subject to the same rules as for other capital (gains) and losses.

Interest payment to fund:

No withholding tax applies.

Transfer of loans:

No special tax applies.

2.3. *Position of the individual shareholder*

Dividend income:

After having been taxed by the SME, the individual shareholder has to declare the dividend (the net dividend and 'avoir fiscal') that is taxed at the progressive rates. This tax credit can be set off against the income tax.

See left side.

Purchase of the shares:
The individual shareholder can normally not deduct the interest burden.

There is no transfer of shares to the extent a loan is granted.
The interest burden remains thus with the SME.

2.4. *Position of the fund*

No dividend income (see scheme).

2.4. *Position of the fund*

The interest income from any loan granted to a VCC or SME is fully taxable. Apparently no special vehicles exist for interest income.

3. *Unincorporated SME*

The VCC may not take advantage of this participation to meet the required conditions in order to benefit from the specific VCC tax regime.

3. *Unincorporated SME*

If the VCC grants a loan, the interest is deductible by the SME and fully taxable for the VCC.

Conclusion

Equity finance

1. *Major disadvantages*

A registration tax applies on the sale of most shares.

2. *Major advantages*

The dividend income for the VCC is (95%) tax-exempt, if the VCC has a substantial holding. Otherwise, the VCC can claim the 'avoir fiscal'.

Debt finance

1. *Major disadvantages*

The deductible interest payments may lead to a loss position of the SME, whereas the interest income with the VCC is immediately taxable.

The costs of granting a loan vary between 1 and 4%. These costs are not deductible.

Capital gains are taxable.

2. *Major advantages*

The taxable base of the SME will normally be reduced.

Long-term capital gains on shares are taxed at a reduced rate.	The risk of double taxation (with SME/VCC) does normally not exist.
	The capital losses are deductible.
If the VCC qualifies as an SCR or an SDR dividend-income is always tax-exempt.	The private shareholder is not confronted with a purchase of shares.
The capital losses on the transfer of shares are deductible, even in case of long-term gains.	
The costs related to the increase of capital and the registration taxes are deductible.	

France	Equity				Debt	
	VCC[1]	VCC with qualifying participation[2]	VCC without qualifying participation	SME has no taxable income		
SME profit before tax	100	100	100	100	Interest payment deductible with SME	Yes (– 100)
Corporation tax 34%	–34	–34	–34	– 0	Withholding tax	0[3]
Gross dividend	66	66	66	100	Interest income before tax at recipient's level	100
Income subject to 'précompte'	0	0	0	100	CIT 34%	–34
Less 'précompte' (33.33%)	0	0	0	33.33		
Net dividend before tax at recipient's level	66	66	66	66.67	Interest income after tax	65
'Avoir fiscal' (50% of received dividend)	0	33	33	33.33		
Taxable base	0	0[3]	99	100		
CIT due (34%)	0	0	33.66	34		

France	Equity				Debt	
but 'avoir fiscal'			– 33	–33.33		
Thus, CIT is due	—	—	0.66	0.67		
Dividend after tax	66	66	65.34	66		

[1] VCC complying with certain conditions, (e.g. shareholding of VCC in SME may not exceed 40% of the latter's voting shares) are exempt from CIT on dividend income (and the capital gains attached to their portfolio).

[2] Minimum 10% shareholding/FF 150 million.

[3] Normally, only a 95% exemption applies; 5% is a lump-sum deduction representing deemed expenses relating to the dividends received. If the VCC can substantiate that its total expenses were less than 5%, the dividend may be exempt from CIT up to 100%. Therefore, the 5% portion of the grossed-up dividend is ignored in the example.

III. Other issues

1. *Local and regional authority issues*

Local or regional authorities are limited in their participation in the financing of SMEs by means of venture capital companies.

The limitation on such participations is as follows:

Under Article 5 of Law No 82-213 of 2 March 1982 regarding the rights and liberties of communes, departments and regions, the State has the sole responsibility for the conduct of economic and social policy as well as for the protection of employment.

It is therefore provided in Section 3 of Article 5 that communes are forbidden, except when a specific authorization is granted by a decree submitted to the Conseil d'Etat, to take any participations in the capital of a commercial company or of any other lucrative organization whose activity would not be in the sphere of communal services or a general interest activity. The same prohibition applies to departments under Article 58-3 of the same law, but several departments have been authorized to participate in the capital of SDRs.

Regions may participate in SDRs and in regional SCRs.

Communes (Article 6.2 of the Law of 2 March 1982), departments (Article 49-2 of the Law of 2 March 1982) and regions (Law No 72-619 of 5 July 1972, Article 4.1,point 2) may also participate in the capital of a credit institution acting as a guarantee fund for loans to newly formed enterprises.

2. *Impact assessment*

According to a representative national association of venture capitalists, France now ranks third, after the United States of America and the United Kingdom as regards venture capital investments.

The creation of FCPRs and SCRs was a major cause for the growth of venture capital in France mainly because of the successful tax incentives applied.

It should be noted by comparison that the law creating participating loans, which included only legal and no tax measures, did not have a favourable effect on the development of those loans.

As far as regional development is concerned, it would appear from available statistics that venture capital incentives are not sufficient to correct the adverse effects on investment of existing local factors. Data from the Association française des investisseurs en capital risque will be provided separately.

The intervention of local authorities through SDRs and other entities is the most influential counterfactor.

IV. Comparative legal and regulatory issues

1. *Absent positive features*

It should be noted that France is well organized concerning venture capital and financial support to SMEs and SMIs. Consequently most of the features and techniques developed in the other European countries already exist in similar or identical form in France.

Thus, there are only a few positive features raised in other Member States which are relevant in France, and which are absent there. These are listed below.

1.1. Local and regional authorities issues

In Belgium the NIM/SNI is entitled to give a State guarantee for high risk ventures which are clearly in the public interest. It also has the function of carrying out economic projects in the name and on behalf of the State. The financing is then directly provided by the State.

The Flemish and the Walloon Investment Agencies seem to have a direct influence on the development of the regional economy especially by granting loans under favourable conditions.

Absence of positive feature

SDRs, banks or financial institutions are reluctant to grant loans or to guarantee the activities of venture capital companies. The SCRs are not entitled to grant loans as financial institutions are.

There is no system of State guarantee for venture capital companies.

Relevance of absent feature

The support of venture capital companies by State organisms would certainly develop venture activities.

An organized system of State or regional guarantees would probably incite SDRs and financial institutions to grant more loans than at present.

Introduction into national law

Such features could be introduced by statute or decree. However, it should be noted that it also depends on the goodwill of financial institutions.

1.2. Grants

In Greece venture capital companies receive grants for their participations in the equity of enterprises undertaking investments in high technology and innovation which amount to 30% of these participations (see Greece, Section I.5). The grant has to be approved by the Minister for the National Economy.

Absence of positive feature

No such grants are available in France.

Relevance of absent feature

Grants of such an amount could be helpful to venture capital companies in France which might sometimes be reluctant to participate in the capital of a new company as seed capitalists.

Introduction into national law

The introduction of this feature depends on the will of State or local authorities to grant any amount of money to SCRs which are private companies mainly controlled by banks or financial institutions. Up to now, the idea has rather been to grant direct subsidies to the enterprise which needs funds.

'Subsidies' are given by way of loans granted at low interest rates or by direct participations in the capital of the company made by SFIs or SDRs.

1.3. Venture capital investment certificates

Under the Law of 3 April 1989, the Luxembourg Government is authorized to issue, during the period 1988 to 1992, venture capital investment certificates for shareholders or associates in proportion to their participation in the registered capital of a finance company located in Luxembourg and approved by the Government (see Luxembourg, Section I.3).

Participants will be able to benefit from a tax reduction up to 30% of the taxpayer's taxable income.

Absence of positive feature

No similar regime exists in France.

Relevance of absent feature

If French venture capital is encouraged by favourable tax measures, such a reduction up to 30% should promote venture capital in France.

Introduction into national law

This positive feature could be introduced in France by a statute.

1.4. Investment guarantees

In the Netherlands, private venture funds operate under the Garantieregeling particuliere participatie maatschappijen 1981 (see the Netherlands, Section I.3).

The purpose of the Garantieregeling is to stimulate the establishment of SMEs. The means for achieving this purpose is compensation by the Nederlandsche Bank BV (the Dutch Central Bank) to private venture funds ('particuliere participatie maatschappijen') of a maximum of 50% of the investment where the investment is lost. There is a maximum compensation of HFL 1 250 000.

Absence of positive feature

No such guarantees are available in France.

Relevance of absence feature

According to the Dutch study the Garantieregeling has been successful. There is no doubt that such a measure would stimulate French venture companies as the lack of guarantes is the most important hindrance to the development of venture operations.

Introduction into national law

A system of guarantees could be created by statute or by the development of existing structures.

1.5. Loan guarantees

Under certain conditions the Dutch State enters a 'borgstellingsovereenkomst' (see the Netherlands, Section I.3). By this means the State guarantees a bank repayment of the 'borgstellingskredieten' (loans) to be granted by the bank to an SME.

Absence of positive feature

The French government intervenes in the loans granted to SMEs-SMIs by banks or other financial institutions but the guarantees are insufficient to promote the development of loans granted under favourable conditions (see the example of 'prêts participatifs').

Relevance of absent feature

It should be recalled that banks and even financial institutions created to support SMEs and SMIs are reluctant to grant loans to support venture operations especially in terms of seed capital.

Introduction into national law

The development of guarantee mechanisms could be introduced either by new statutes or by the development of existing structures.

1.6. Capital holding companies and (public) enterprise holding companies

In the context of capital holding companies, the silent partnership contract allows a person to make a capital investment in a company in which he has no right to share in the management (see Germany, Section I.3.1). Such a partnership in some respects is close to the French 'Société en commandite par actions' but it appears that the silent partnership is only a means of acquiring an interest in the profits (or losses) of the company for a limited length of time.

(Public) enterprise holding companies acquire, manage and sell participations as silent partners in enterprises which are not able to attract public capital because they are unlisted (see Germany, Section I.3.4).

Absence of positive feature

As such, those kinds of companies do not exist in France.

Relevance of absent feature

There are no real reasons for the absence of silent partnerships other than that they do not correspond to the concept of French company law.

Public enterprise holding companies do not exist mainly because banks and financial institutions are the main actors in providing financial support to SMEs-SMIs and they collect public funds which are not mainly used in venture activities.

When a bank or a financial institution wishes to carry on venture capital activities, it creates or joins an SCR.

Public funds are attracted by secure participations and as such would not easily enter holding companies whose purpose is to intervene in venture capital, especially in unlisted companies.

Introduction into national law

Those 'techniques' or new types of companies could be very efficient in providing capital for unlisted venture companies. But it seems unrealistic to consider that modifications could be made to French company law to introduce these types of company unless banks agree to be the main actors in such companies.

1.7. Trusts

The 'technique' of trust is a way to split the legal and the beneficial ownership of property. Trustees hold the property and operate the trust on behalf of the beneficial owners (see Ireland, Section I.3 and United Kingdom, Section I).

Absence of positive feature

Trusts known as 'unit trusts' which operate undertakings for collective investment in transferable securities are not used in France. Those activities are conducted by SICAV (Société d'investissement à capital variable), which are companies and not trusts, or by FCPs (Fonds commun de placement) which are collective organisms close in structure to a trust. They do not operate in high risk capital. The sole collective organisms which are not companies dealing with venture capital are FCPRs.

All those organisms are managed by banks or authorized financial institutions.

The system of trust does not exist under French law.

Introduction into national law

A new bill has been prepared in order to introduce the system of trusts in France under the name of 'fiducie'. However, it is too soon to describe what the final form of this 'fiducie' will be and what its influence on ven-

ture capital will be, especially because of the existence of the FCPRs.

2. General recommendations

Set out below are a number of general recommendations. These do not refer to specific provisions in other Member States which are absent in France. They deal with general issues of importance to the success of venture capital in France.

It appears from statistics that French venture capitalists do not intervene to a large extent either in seed or start-up capital because of the high level of risk. Thus in order to compensate for the lack of initiative on the part of private venture capitalists the State, SDRs and SFIs should concentrate on this kind of capital.

More generally, State or regional aid might be extended both by financing SMEs and SMIs and venture capitalists directly and by an extension of the guarantees given to banks or financial institutions with respect to the reimbursement of the loans they grant to SMEs-SMIs.

It should be noted that the tax aspects are crucial in the attraction that venture capital has for investors. Consequently any favourable measures in that field would have a great influence on investments.

It should also be noted that the French policy towards the problems of financing SMEs and SMIs is the following:

- to grant direct subsidies to SMEs and SMIs or loans on favourable conditions by means of specialized institutions or SDRs;
- to promote private venture capital by means of tax provisions.

It does not seem that this policy could be modified as it would imply a completely different way of looking at the whole question of venture capital.

Germany

Introduction

The German venture capital market provides a wide range of investment vehicles and has been in expansion since the mid-1980s. Total invested capital has risen from DM 785 million in 1983 to DM 3 341 million in 1990. A major psychological disadvantage to the participation of venture capitalists in SMEs has been the traditional refusal of family owners to admit new shareholders. However, this tendency has dwindled over recent years.

As far as tax matters are concerned, no major obstacles appear. However, the fact that double taxation for 'Gewerbesteuer' and 'Vermögenssteuer' purposes may arise if no substantial holding exists (10%) is rather disadvantageous. On the other hand, in case the VCC takes the form of an 'Unternehmersbeteiligungsgesellschaft' it is exempt from the abovementioned trade tax and net worth tax (i.e. regardless of the percentage of shareholding).

Other disadvantages are that capital gains on shares are always taxable and interest payments by the SME are partially included in the taxable base in computing trade tax on income.

I. Legal and regulatory issues

The procuring of risk capital for SMEs can be carried out by increasing proprietary capital or by debt financing.

The preferred form of raising capital for SMEs in Germany is still by way of self-financing (financing out of retained earnings) from withheld profits of the enterprise. The expansion of enterprises and the fact that production (being extremely capital intensive) has become increasingly technical, taken together with the simultaneous sinking of returns on capital investments, results in the fact that the traditional financing techniques no longer sufficiently cover the enormously growing need for capital. The result has been the much discussed 'gap in proprietary capital' with respect to SMEs which can be filled by the use of the following financing techniques.

1. *Typical investment vehicle used*

Holding companies ('Beteiligungsgesellschaften') have experienced a revival in Germany since the middle of the 1960s. Such companies acquire an interest in an SME in a variety of forms and thereby serve to increase the proprietary capital in the enterprise. The reason for their development was the growing need for proprietary capital which the small and medium-sized businesses could no longer cover by way of the favoured traditional self-financing methods.

There are now basically four different types of holding companies:

- capital holding company ('Kapitalbeteilungsgesellschaft');
- venture capital company;
- investment company ('Kapitalanlagegesellschaft');
- public enterprise holding company ('Unternehmensbeteiligungsgesellschaft').

A brief description of each holding company is given in Section 3 below.

The differences are traced to the differing investment policies or to the special legal status which a particular holding company enjoys.

2. *Applicable legal measures*

- Capital holding company

There are no special rules regarding these companies. They must respect the applicable company law provisions and also those governing the participations they take. These include:

§ 230 et seq. HGB (Commercial law code) on silent partnerships;

§ 161 et seq. HGB on limited partnerships ('Kommanditgesellschaften');

GmbHG Law of 20 April 1892 (RGBl p. 477) in the proclaimed version of 20 May 1898 (RGBl p. 846) (BGBlIII 4123-1).

- Venture capital company

There are no special rules governing venture capital companies. The rules outlined above in relation to participations by capital holding companies are equally relevant here.

- Investment companies

KAGG Law of 16 April 1957 in the proclaimed version of 14 January 1970 (BGBl I 127; BGBl III 4120-4).

- Public enterprise holding companies

UBGG Law of 17 December 1986 (BGBl I p. 24882, BGBl III 4126 -1) which entered into force on 1 January 1987.

3. *The investment vehicle*

There are four basic types of investment vehicle. These are described below.

3.1. Capital holding company ('Kapitalbeteiligungsgesellschaft')

Short description

Capital holding companies were the first holding companies and, according to their numbers, are still the most widely propagated. These can be further divided into those operating on a profit basis and those operating on a non-profit basis. They are therefore either predominantly profit- oriented or predominantly promotion-oriented.

The preferred form of participation by capital holding companies in SMEs was in former times, and remains today, the 'silent partnership' as defined in § 230 et seq. HGB (Commercial law code). The situation has however loosened up in recent years and all other forms of participation (with the exception of the position of the fully liable partner in a partnership) are currently being practised.

Capital holding companies strive exclusively for minority interests and, as a rule, leave the complete management of the enterprise in the hands of the operator of the enterprise. They do, however, offer their advice concerning management issues.

Sharing in the profits by the capital holding company is, for the most part, limited to a certain amount. The return on investment for the capital holding company operating on a profit basis is realized out of the increased value of its interest when sold, and the operator of the enterprise is often accorded a preferential right to purchase.

To a large extent capital holding companies operate in the legal form of a private limited company (GmbH). The shareholders and the capital lenders are predominantly banks. Also important are participations by trade associations, insurance companies and the State itself (comprising 6.5 to 9%).

Silent partnerships

The participations which capital holding companies take by way of silent partnership are governed by the rules on this form of partnership. They are found in § 230 et seq. HGB. These rules are to a large extent non-mandatory so that the silent partnership can be adapted to the needs of both the holding company and the enterprise which is being participated in. This is done by way of a contractual agreement.

§230 HGB defines the silent partner as a person who makes a capital investment in an enterprise which is operated by another party. It is the operator of the enterprise, and not the silent partner, who is both obliged and authorized to transact business within the commercial area of the enterprise. For these reasons, when we speak of the silent partnership we are actually dealing with the so-called subpartnership/undisclosed association.

There are a number of basic rules which must be respected. According to statutory regulations the silent partnership enjoys the profits, and suffers the losses, of the enterprise. Its ability to control the enterprise is limited to the right to audit the year-end financial statement. Its participation cannot be transferred to a third party without the consent of the enterprise which is being participated in. As a result of this regulation, long-term 'silent investments' are being attributed by the banks to proprietary capital.

The entering into of a silent partnership contract does not, even when dealing with partnerships, affect the underlying basis of the corporate relationships. The conclusion of the contract is considered simply an extraordinary management measure. The taking of this measure requires only the consent of the shareholders/ partners of the enterprise which is being participated in

unless the need for such consent is disposed of under the articles of association, etc.

According to the law, the silent partner possesses no rights to share in the management similar to those rights enjoyed by a limited partner or by shareholders in a limited company. The enterprise being participated in can alter its memorandum/articles of association or partnership agreement without the consent of the silent partner, provided that the fundamental basis (e.g. the legal form) of the enterprise is not affected.

At the termination of the relationship with the silent partnership the silent partner only receives, according to §235 HGB, the book value of its investment. Such book value does not, however, include an amount representing increases in the value of the goodwill of the business.

The latter is in practice often dealt with in the contract entered into between the holding company and the enterprise being participated in since it is precisely there, in the increased value of the business, that the possibility of receiving an investment return lies. In this regard, preferential rights to purchase in favour of the enterprise being participated in, as well as provisions protecting against competition, are of importance. It is common practice that the holding company and the enterprise being participated in agree to a long-term duration of the silent partnership ranging anywhere from 5 to 10 years.

Other contractual provisions, which could include the silent partner's right to control and manage the enterprise, could also be agreed to. There must in all cases, however, be clarity with respect to the computation of profits and losses. In particular, the issue arises as to whether the tax balance sheet or the commercial balance sheet will be authoritative.

No significant obstacles emerge from the above rules. They merely reflect the capital holding company's status *vis-à-vis* the enterprise being invested in.

Forms of shareholding

In recent years, capital holding companies have begun to make use of forms of participation other than the silent partnership, through which they become copartners of the enterprise being invested in. Depending on the legal form of the enterprise being invested in, they become either a limited partner ('Kommanditist') or a co-shareholder ('Mitgesellschafter') in a limited company.

The one activity, however, which capital holding companies do not become involved in is the assumption of the role of a fully liable partner in a partnership.

The rules governing limited partnerships ('Kommanditgesellschaften') are found in § 161 et seq HGB. Those governing private limited companies are found in the GmbHG (the law dealing with private limited companies) of 20 April 1892 (RGBl. p. 477) in the proclaimed version of 20 May 1898 (RGBl p. 846) (BGBl III 4123-1).

The special role of the capital holding company, as a shareholder/partner of the enterprise which is being participated in, quite often requires it to be given a special shareholder status. The principle of equal treatment of the limited partners/shareholders (which applies equally to private limited companies and limited partnerships) is not a bar to such an objectively justified differentiation of such shareholders/partners. Limitations to such differentiation are only imposed so as to prevent chicanery, certain mandatory legal provisions, and the fundamental principles relating to the treatment of shareholders.

As far as the selling of the participation is concerned, the law on limited partnerships demands that the consent of all partners be obtained. The partnership agreement may however contemplate a relaxation of this rule. On the other hand, shares in a limited company may, according to law, be freely transferred (§15 I GmbHG). The memorandum/articles of association can here, as well, provide for a modification of this.

Of further importance are contractual regulations covering certain specified reasons for the expulsion of a

shareholder/limited partner and for the claim to settlement for the termination of a shareholder/limited partner.

Next to the aforementioned forms of participation in an existing enterprise, many SMEs prefer to establish a new joint company. This was the result of a survey carried out by a working collaboration of independent enterprises (Arbeitsgemeinschaft selbständiger Unternehmer eV). This is particularly recommended if the increased need for capital is for the implementation of a sole new product. In particular, problems related to share valuation connected with the later retirement of the capital holding company would thereby be avoided. This is so because the enterprise being participated in often carries on business activities in addition to those for which capital funding was sought. By establishing a new, joint company the enterprise which is being participated in remains independent with respect to these additional business activities and the aforementioned problems of valuation do not exist. Exactly how profitable such a venture is for the capital holding company remains to be seen.

Participating loans

These types of loan will be briefly discussed since they are only occasionally transacted by capital holding companies.

Also from the viewpoint of the enterprise which is being participated in such loans simply constitute debt capital. Participating loans fall within the regulations governing loans in § 607 et seq. BGB (the German Civil Law Code). What distinguishes this type of loan is that the counterperformance for receiving it is not, or not exclusively, the payment of fixed interest rates. Payment is rather dependent upon profits. A participation in losses cannot on the other hand be connected with a participating loan. If this is the case then the loan would be viewed as a silent partnership.

An important component of the loan contract is the exclusion of short-term termination possibilities (§ 609 BGB), a prohibition on assignment and pledging (§ 399, 1247 BGB) and a tight definition of 'profits'.

3.2. Venture capital companies

Short description

In terms of the legal structure, the structure of the shareholders and the different forms of participation, there are no differences between a capital holding company and a venture capital company. Venture capital companies are distinguished, however, by the stress placed on risk in the policy of participation which is aimed mostly at financially weak and young SMEs. They seek to support these enterprises in the realization and marketing of innovative and above-average products or product ideas.

The aim of the venture capital company is the multiplication of the value of the invested capital within a relatively short time period (5 to 10 years). They do not seek to take advantage of ongoing profits.

The realization of the capital gain on the invested capital is normally made by the introduction of the enterprise onto the stock market and the subsequent selling of the participation quota on the capital market. This is done to avoid problems of valuation and shortages of liquid funds. An intensive and strategic management consultation is usually connected with the participation.

3.3. Investment companies ('Kapitalanlagegesellschaft')

Short description

Investment companies are, according to § 1 I KAGG (the law dealing with investment companies), only those enterprises which take in investments/money contributions from their customers and subsequently (in compliance with the principle of diversification of risk), re-

invest them. The re-investment is made on their own behalf and is made in securities and in participations as silent partners or by the purchasing of real estate. The investment must be kept apart, as separate funds ('Sondervermögen'), from their other assets. The investment is carried out for the common account of the clients. The investor will be issued a share/participation certificate ('Anteilsscheine') which describes his interest. Only if these prerequisites have been fulfilled may an enterprise carry on business under the legally protected title of an investment company.

It has only been since 1 January 1987 that investment companies have been allowed to enter into silent participations for their clients. In the past only securities listed on the Stock Exchange could be acquired.

Legal considerations

The legal principles governing the activities of investment companies are found in the KAGG of 16 April 1957 in the proclaimed version of 14 January 1970 (BGBl I p. 127; BGBl III 4120-4).

Investment companies are credit institutions which manage separate funds held apart from their own. The separated funds are kept in custody (upon request by the investment company) by another credit institute (depository bank). Where the investment concerns real estate or silent participations (which cannot be kept in custody) these will be supervised by the depository bank.

The investment company issues share/participation certificates which mirror the value/interest of the separate fund. Although the share/participation certificates are considered securities and can be traded they are not listed on the Stock Exchange. Their price is not determined by supply and demand but is rather calculated by the inventory value of the particular separate funds.

The holder of the shares has no influence on the management of the funds. The KAGG therefore provides protection for these funds by way of numerous regulations. Included therein is the principle of diversification of risk and a strong supervision by the Federal Banking Supervisory Board in Berlin.

The principle of the diversification of risk is put into effect for participating separate funds in that the silent participation may only comprise, in total, a 30% share of the entire separate fund (§25 b III KAGG).

The remaining 70% of the fund must comprise securities, cash, etc. Also, the silent participation in a single enterprise or several enterprises in a group may only make up 5% of the total volume of the separate funds.

The protection offered to the enterprise being invested in from excessive influence by the investment company is considerably weaker for silent participations than it is where shares are acquired. Acquiring shares in an enterprise is restricted to 10% of the total par value of the issued and non-voting stock capital or to 10% of the voting rights with respect to any other types of stock capital (§8 a II 4, III KAGG). This provision is, however, pursuant to § 25 b V KAGG, expressly excluded from the application to silent partnerships (§25 a KAGG). The reason is that the danger of a power concentration by way of a silent participation is considered less threatening than it is in the case of a share acquisition. The silent partner has no voting rights but rather possesses simply the right to control and the right to be provided with information as well as the right to take part in decision-making. (The latter is a matter which would have been agreed to in the participation contract.) The protection offered to the enterprise being participated in is limited to a duty of the investment company to use the aforementioned rights only in the best interest of the holder of the shares ('Anteilinhaber') and not in their own or in the interest of a third party (§25 c I 1 lit. g KAGG). In addition, the shareholders in an investment company must be ascertainable (§1 III, IV KAGG).

3.4. (Public) enterprise holding companies ('Unternehmensbeteiligungsgesellschaft')

Short description

Due to their structure as private limited companies, it was not possible for capital holding companies and venture capital companies to mobilize the existing large amounts of private savings capital necessary for the financing of SMEs. In particular, they were not allowed to act as a link between SMEs and the organized capital market of the Stock Exchange. In order to do away with this problem, the legislator enacted the UBGG (law concerning (public) enterprise holding companies), which came into force on 1 January 1987. The UBGG applies only to those holding companies which, under the designation 'Unternehmensbeteiligungsgesellschaften' acquire, manage or sell participations as a silent partner in an enterprise which is not listed on the Stock Exchange. The activities of the holding companies which do not operate under the legally protected title remain unaffected by the UBGG.

The aforementioned designation may only be used by a holding company which:

- has the legal structure of a public (limited) company ('Aktiengesellschaft');
- has carried out an 'Anerkenntnisverfahren' (an officially recognized procedure); and
- submits itself to the supervisory and organizational regulations of the law.

In connection with recognition as a 'Unternehmensbeteiligungsgesellschaft' there are certain tax advantages which are meant to ensure that, for the investors concerned, the indirect participation in an SME through the 'Unternehmensbeteiligungsgesellschaft' does not yield a lower return on their investment than it would by a direct participation in an enterprise listed on the Stock Exchange.

In contrast to the abovementioned investment companies which also direct themselves to the general public, 'Unternehmensbeteiligungsgesellschaften' are allowed not only to participate in silent partnerships but may also acquire shares in limited companies and limited partnerships. In addition, they do not have to restrict themselves to participation in enterprises already in existence but may also be involved in the formation of new enterprises.

Legal considerations

The pertinent rules concerning 'Unternehmensbeteiligungsgesellschaften' are found in the UBGG of 17 December 1986 (BGBl. I 2488) (BGBl. III 4126-1).

In order to better serve the needs of the SMEs, 'Unternehmensbeteiligungsgesellschaften' must hold shares or silent participations in at least 10 enterprises (§ 4 I UBGG). This diversification requirement provides, at the same time, a minimization of risk in favour of the investor. The participation in at least 10 enterprises is a mandatory prerequisite to the public offering of share certificates by the 'Unternehmensbeteiligungsgesellschaft' (§ 23 II UBGG).

§ 2 I UBGG prescribes for 'Unternehmensbeteiligungsgesellschaften' the mandatory legal form of the public (limited) company. The reason for this was that 100 years of experience with the legal form of the public (limited) company had proved that it was the best means of reaching the broadest spectrum of the public. In order to achieve the desired spread of shareholdings, the founder of an 'Unternehmensbeteiligungsgesellschaft' is obliged, according to § 9 et seq. UBGG, to publicly offer 70% of the share certificates within 10 years from the conclusion of the 'Anerkennungsverfahren'.

A further prerequisite for the public offering is, *inter alia*, the official admittance to the Stock Exchange or to a regulated market in a national stock market (§ 10 I UBGG). If an 'Unternehmensbeteiligungsgesellschaft' does not duly comply with this duty *vis-à-vis* the public offering or does not comply within the statutory time-limits, then the supervisory board may revoke the recognition of the designation 'Unternehmensbeteiligungsgesellschaft'.

The limitation of the assumption of credit found in § 5 UBGG should furthermore serve to protect the investor. The 'Unternehmensbeteiligungsgesellschaft' may only procure credit if at least 80% of its capital is invested in participations. In addition, the total amount of the credit at the point in time when a credit is assumed, must not exceed 30% of the proprietary capital. To avoid a conflict of interests, the members of the executive board or of the supervisory council of the 'Unternehmensbeteiligungsgesellschaft' may not personally participate in an enterprise which is being participated in (§ 6 UBGG). § 12 and 13 UBGG oblige the 'Unternehmensbeteiligungsgesellschaft' to file detailed statements of account in order to ensure the correctness of the information to the public.

The recognition procedure ('Anerkenntnisverfahren') takes place on the basis of a written application which must include the items required by § 15 II UBGG. The application is made at the competent 'Landesbehörde' and will only be processed once the prerequisites contained in § 2 UBGG have been fulfilled (§ 16 I UBGG). The 'Unternehmensbeteiligungsgesellschaft' must have the legal form of a public (limited) company, must be resident and have its business management in Germany and must have a registered capital of at least DM 2 million. In addition, the articles of association of the 'Unternehmensbeteiligungsgesellschaft' must state that the object of the enterprise is exclusively the acquisition, management and selling of participations in enterprises which are not listed on the Stock Exchange and whose residence and business management are located in Germany.

In summary it can be said that all four categories of entity do not meet significant legal obstacles other than those referred to above. The same applies to the access of SMEs to investment capital.

Other factors – The Stock Exchange

In the above sections the characteristics of the four different investment vehicles described were examined. In addition to these vehicles, however, there are other factors which require a mention.

The Stock Exchange – Regulated market

Another method of raising capital is represented by the Stock Exchange. The traditional way, however, of changing the corporate form to a public (limited) company ('Aktiengesellschaft') with a listing on the Stock Exchange is not a plausible route for most SMEs. The legal form of the public (limited) company is, for various reasons, simply not a possible vehicle. Reasons for this include such things as the strict formalities which a public (limited) company must comply with, the costs of setting up the company, the increased co-management rights enjoyed by employees and the disclosure requirements required by the law covering the guidelines for financial statements. Furthermore, the admittance requirements of the official Stock Market ('Amtliche Markt') are hardly suitable for SMEs.

The segment of the German Stock Exchange proper for SMEs is the so-called regulated market ('geregelte Markt') and the unofficial Stock Market ('Freiverkehr') both of which were introduced pursuant to the law dealing with admittance to the Stock Exchange ('Börsenzulassungsgesetz') of 16 December 1986.

The regulated market is a quasi-official market. What characterizes this market is the fact that exchange prices for the securities are not officially laid down, but are rather determined by official stockbrokers or by the so-called 'Freimakler' (stockbrokers who are not officially connected with the Stock Exchange) who have been appointed or selected by the Stock Exchange Committee and who operate under their supervision.

The rules governing the regulated market are found in § 71 et seq. of the Börsengesetz (BörsenG: German Stock Exchange Act (of 1896 as amended in 1975)). The material provisions (e.g. admittance procedures and the Stock Exchange requirements concerning issuers and traded securities) are found in the Stock Exchange regulations ('Börsenordnungen') passed by the Stock Exchange authorities. Such authority is found in § 27 BörsenG.

The regulated market, with its considerably less demanding admittance requirements, offers, to SMEs, a

very attractive alternative to the official market, which, for most of these companies, remains inaccessible. For example, the costs of admittance to the regulated market are 50% lower than those for admittance to the official Stock Exchange. Furthermore, the legal form of the enterprise need not be altered to a public (limited) company.

The regulated market is nevertheless, due to the required volume of securities which must be issued, the costs and the publication requirements, only suitable for SMEs of a certain (i.e. larger) size.

The unofficial market ('Freiverkehr')

According to § 78 BörsenG, prices of securities which are neither officially listed nor admitted to the regulated market may, in compliance with the tight provisions of the Stock Exchange regulations, be proclamated, determined or published on the Stock Exchange if it is assured that a proper trading on the Stock Exchange will take place. The incorporation of this provision into the BörsenG in 1987 gave legal sanction to these transactions. Such transactions had formerly been merely tolerated on the Stock Exchange.

The unofficial stock transaction remains therefore a matter of private law without an official determination of exchange rate. Since, however, unofficial stock transactions have been integrated into the self-governing system of the Stock Exchange, they also, in some respects, fall within the ambit of public law. When dealing in unofficial stock transactions, the Stock Exchange regulations, with respect to conditions of trading and the process of determination of the exchange rate, must be adhered to.

The determination of the price is established in accordance with the Stock Exchange guidelines on the trading floor. The Stock Exchange Committee can stop trading if a grievance is declared or if there is a fear of such. The determined exchange rates must be published either in an appendix to the official price list (*Amtlichen Kursblatt*) or in the Stock Exchange journal (*Börsenzeitung*).

In any case, the admittance to the unofficial market remains a matter of private law. The Unofficial Market Committee decides whether or not a security shall be admissible. The members of this committee are chosen or appointed from the 'Börsenträgerverein' or from other private associations (bank and broker associations). Where the admittance is denied, suit is broad against the Börsenträgerverein as the representative (senior officer) of the Unofficial Market Committee. The action is heard in the civil courts and not in the administrative courts.

The most important component of the application is an exposé of the issuer which should contain information concerning the issuer and the most current business report. Only the approved application will be displayed on the trading floor and not the exposé.

Legal liability for the statements in the prospectus according to § 45 et seq. BörsenG does not apply to this exposé. Liability can only be found according to the general civil law provisions. Since publication is not required, liability for the statements made in such can only occur if the issuer voluntarily makes 'prospectus-like' publications.

The State has even less influence on the unofficial market (being almost exclusively a matter of private law) than it has with respect to the regulated market.

Since the admittance requirements for the unofficial market, in contrast to the regulated market, are clearly less onerous, the entry into the market for SMEs is considerably easier. The result of this is that the protection offered to the investor is reduced which means that the number of capital investors that can be reached is lower than it is on the regulated market.

II. Issues of taxation

1. *Introduction*

The SME is often confronted with the difficulty of attracting financial means from third parties.

Indeed, on the one hand, to contract a loan with a bank, the SME has most of the time to low an equity, so that the financial institutions feel rather reticent to grant any loan.

On the other hand, because of the high risk of the investment, only very few persons will be willing to increase the capital (and therewith the loan capacity) of the SME.

The VCC can therefore play an important role in the expansion of the SME.

The VCC and the target company (SME) will have to determine how the capital is to be injected. It may very well be that there is a conflict of interest between both parties in determining how the injection will be executed.

In general, the (tax) differences between debt financing and equity financing can be established as follows:

In case of debt financing by the VCC, the interest payments are for the SME in principle tax-deductible expenses, which have a negative impact on the results (possibly into a loss position) and on the cash flow of the SME. The VCC will be fully taxable on the interest income.

It may very well be that this situation is not at all desirable. Indeed, the SME will probably be in need of extra means at a time when heavy investments are planned which will already have a negative impact on the results (depreciation of the investment). From a tax point of view such a situation may also prove to be unwise. The interest deduction cannot be properly used because of insufficient profits (creation of losses) whereas the interest income with the VCC is immediately taxed. Furthermore, for 'Gewerbesteuer'purposes, the interest is only 50% deductible, which leads to double taxation.

To meet both economic and tax demands, two main options are available :

- either the loan agreement is concluded under circumstances where the interest rate is in the beginning rather low (e.g. profit-sharing loan or convertible loan); or
- the VCC decides to participate in the capital of the SME.

In case of equity finance, the following problems arise:

Dividend income: if the VCC is in need of a more or less regular income to finance its own investment, this will have to be done by way of dividend distribution. This may present a lot of problems.

Dividends are not tax-deductible, so that the dividend capacity will be lower than the interest payment capacity.

In case of dividend distribution both the VCC and the individual shareholder will receive a dividend. The dividend taxation of individuals is treated in the same way as for companies, but because the tax rates for individuals are higher, their position may be very disadvantageous. To avoid this problem, the VCC might opt for preference shares, so that dividends can be distributed to the VCC and not to the individual shareholder.

Dividends received constitute taxable income for the VCC. Withholding tax on dividends and underlying corporate income tax, however, are fully creditable by the VCC against its total income tax liability. To the extent no 10% participation exists, a double taxation in respect of trade taxes and net worth tax is possible.

Capital gains income: this way could be interesting since, by doing so, the SME retains all profits. If the

value of the SME decreases, the capital loss realized on the sale of the shares is tax-deductible.

A problem is that if the value of the SME increases, the capital gain will, in principle, be taxed, although a deferral of capital gains taxation is possible under certain conditions.

Therefore, one could consider a redemption of shares. This means that the SME purchases its own shares. However, this technique is unknown under German company law.

Because the participation a VCC will take in an SME will normally be lower than 50%, the 'Organschaft' is not treated here. The 'Organschaft' has amongst other things advantages for 'Gewerbesteuer' and net worth tax purposes.

In the next part (Equity/Debt finance), a summary is given of all important items that could influence the decision-making of the VCC and the SME.

In the last part (Practical taxation guidance), practical guidance, resulting from the information in the above-mentioned parts, is given.

2. *Equity finance*

2.1. Creation of the VCC

Registration or other duties

Contributions in cash on first acquisition of membership rights in a resident company or certain other entities organized for profit, whether incorporated or not, are subject to a formation tax of 1% of the value of the contribution.

Contributions in kind (e.g. property) for shares or other membership rights of a domestic company are subject to the 1% formation tax. The tax is levied on the value of the contributed property. This registration tax has been abolished as of 1 January 1992.

Additional costs of creating a company are:

- notarial fees;
- commercial register fees;
- rates for publication in the Official Gazette.

Are there conditions to be met in respect of the legal forms of the VCC? Are there specific forms available?

German company law provides no special legislation concerning VCCs.

A VCC will most likely operate in Germany under the form of a public limited company (Aktiengesellschaft, AG) or a limited liability company (Gesellschaft mit beschränkter Haftung, GmbH). The GmbH is favoured because of the low minimum capital required for formation, the flexibility of the GmbH law, and the legal status of the GmbH which is somewhere between the incorporated and unincorporated organization.

A VCC can also operate as an investment company in the form of an 'Unternehmensbeteilungsgesellschaft' (recognized participation company). These companies must be in the form of a stock corporation (see below).

A VCC may also operate in the form of a 'Personengesellschaft'. These companies are taxed transparently.

Are there limits as to the participation degree of the VCC in the SME?

No. However, if more than 50% of the shares is held by the VCC, a consolidated tax return may be possible ('Organschaft').

2.2. Tax situation of the SME

Creation of the SME or increase of capital

Are there registration or other duties?

See Section 2.1.

Are there exemptions for certain zones, projects, activities?

No, except to the extent that the contribution covers previous losses.

Is the indirect tax treatment different for the following types of shares: ordinary, preference, redeemable or other?

No.

Corporate tax

Are the costs related to the creation or the increase deductible?

Expenses directly connected to the formation of a company are considered deductible business expenses in the year they are incurred provided the new company is obliged to bear these expenses.

Are there specific regimes for certain SMEs?

No specific regimes are available that are directly related with equity finance.

Rates

- Normal tax rate

Fifty per cent on non-distributed income and 36% on distributed income.

- Reduced rates

Special rules govern the qualification of Berlin-source profits for reduced rates. Companies must have both their seat and place of management in West Berlin, or one or more permanent business establishments in West Berlin, one of which must regularly employ an average of 25 persons. The rates are 43.25% for undistributed and 31.68% for distributed income. This tax advantage will be partially eliminated in 1993 and 1994 and fully from 1995.

How does a redemption of shares affect the tax position of the SME?

The redemption of shares is a technique, not a common practice in German company law.

Dividend taxation

Does a different tax regime apply to dividend distribution to X (shareholder of the SME) on the one hand and to the VCC on the other?

No. Dividends are in general taxed at a 36% rate plus a withholding tax of 25%.

Does a different tax regime apply according to the different types of shares?

No.

Is the tax base affected by the distribution of dividends (deductible dividend)?

No. All types of dividends, including hidden profit distributions, are not deductible.

Is the tax rate affected by the distribution of dividends?

Dividends are normally taxed at the rate of 36%. However, dividends distributed by West Berlin companies or by resident non-Berlin companies which can attribute their income to a West Berlin branch are taxed at a 31.68% rate in 1992.

Is a withholding tax withheld? Rate? Exemptions?

Yes, at a 25% rate. There are no exemptions available.

Trade tax (Gewerbesteuer)

Trade tax on income

Taxable income for trade tax on income purposes is equal to taxable income for corporate tax purposes, increased by certain additions and decreased by certain deductions. The most important item is that 50% of the interest paid on long-term debts is not deductible.

This tax is deductible for corporate income tax purposes. The rate varies from 9 to 19%. If the SME is a KG, the interest the VCC has to pay for the acquisition of the participation is up to 50% deductible with the KG.

Trade tax on capital

Trade capital (the taxable base) is the assessed value as determined for net worth tax purposes, subject to certain additions (e.g. 50% of long-term debts exceeding DM 50 000) and deductions (e.g. participations that qualify for the affiliation privilege). An exemption exists for the first DM 120 000. The rate goes from 0.4 to 1.0%. This tax is deductible for corporate income tax purposes.

Net worth tax (Vermögensteuer)

The SME will be taxed on the basis of the assessed value of total net assets. Only 75% of the taxable net worth of a business in excess of DM 125 000 will be subject to net worth tax. Excluded from the taxable base are participations that qualify for the affiliation privilege and held for at least 12 months prior to the end of the accounting year. The tax rate amounts to 0.6%. This tax is not deductible for corporate income tax purposes.

2.3. Taxation of the VCC

Corporate taxation

Are the costs related to the creation of the VCC deductible?

Yes, all expenses directly connected to the formation of a company are deductible if the new company is obliged to bear these expenses. In some circumstances, these are considered to be a hidden profit distribution.

Are management costs and interest deductible?

Yes. But only 50% of the interest on long-term debts is deductible for trade tax on income.

How are dividends taxed?

For corporate income tax purposes, there is no distinction between minor, substantial and 100%-holdings. However, for trade tax on income and on capital and for net worth tax, an exemption exists for participations of at least 10%. Dividends received by the VCC constitute taxable income in its hands. Taxable income is the net dividend, grossed-up with both the withholding tax (25%) and the underlying corporate income tax at the distribution rate of 36%. These two taxes, borne at the source, are fully creditable by the resident shareholder against his total corporate income tax liability. Any excess credit is refundable in cash by the tax authorities.

Example:

SME: Profit before tax	100
Distributed corporate income tax	–36
Net dividend	64
Withholding tax 25%	–16
VCC: Net dividend	48
Withholding tax	+16
Corporate tax	+36
Taxable	100

What is the capital gains taxation if the shares of the SME are sold?

All gains from the sale or other disposition of business property (which includes the sale of capital) are taxed as business income of the company at normal rates.

What about capital losses?

Losses suffered on disposal of business assets constitute part of the ordinary losses.

What is the tax position of the VCC in case of redemption of the shares by the SME?

The redemption of shares is not a common practice in Germany.

Are there specific regimes?

No, with the exception of 'Unternehmensbeteiligungsgesellschaft'.

The main tax advantage of this type of company is an exemption from trade tax on income, net worth tax and trade tax on capital. This is, however, an advantage in comparison to normal investment (holding) companies only if the participations are below 10% so that the affiliation privilege does not apply.

Rates:

Fifty per cent or 36%. Special rates apply on Berlin source income (see Section 2.2).

Is there recoverability of the withholding tax withheld by the SME?

Yes.

Distribution of dividends by the VCC

Does a different tax regime apply according to the different types of shares: ordinary, preference, redeemable or other?

No.

Is the tax base affected by the distribution of dividends (deductible dividend)?

No.

Is the tax rate affected by the distribution of dividends?

The tax rate of 36% instead of 50% applies in case of the distribution of dividends. A similar reduction applies to dividends distributed by companies located in West Berlin (see Section 2.2).

Is a withholding tax withheld? Rate? Exemptions?

Yes, 25%.

Are specific regimes available?

No.

Transfer of shares?

No special tax applies.

2.4. Tax situation of X (individual shareholder)

Is the interest paid on the loans granted in view of the purchase of the shares of the SME deductible?

Yes, if under long-term aspects the dividend income exceeds the interest expenses.

How are dividends taxed?

Dividends from domestic companies are generally included in taxable income for individual income tax purposes. For dividends paid by resident companies, resident shareholders are entitled to a 'special tax credit' equal to 36/64 of the dividend received, corresponding with the 36% rate of corporate income tax on distributions.

The aggregate of the dividend and the attached 'special tax credit' are included in taxable income, the amount of the tax credit being set off against the income tax due. Any excess of the 'special tax credit' over the

amount of the tax due is refunded. Through this system, there is in principle complete elimination of 'economic double taxation' of distributed corporate profits.

2.5. In case the SME is not a company but an unincorporated enterprise

If the VCC participates in such an enterprise, how does this affect the position of the enterprise?

When the VCC participates in such an enterprise a variety of partnerships can be created (e.g. the KG).

Is a transparent company (partnership) created?

Yes.

If so, what are the tax implications (both for the enterprise and the VCC)?

The partnership (SME) is subject to trade tax on income and trade tax on capital in the same way as a corporation, whereas the partners, including a VCC and an individual, are taxed on the income and net worth of the partnership. The income and net worth of the partnership are calculated as in the case of a corporation with the exception that certain businesses between partners and partnership are disregarded, e.g. loans granted by partners and interest expenses of the partnership thereon.

3. *Debt finance*

Preliminary question: is there a debt/equity ratio to be respected?

Yes. A debt/equity ratio of 9.1. should be respected by German companies.

What if the ratio is not respected?

If the company's total debt is higher than 10% of its gross assets any excess, if provided by a non-resident parent or a non-resident related company, may be disallowed as a liability for capital tax purposes and the connected interest expenses may be disallowed as a deductible expense for income tax purposes.

3.1. Tax situation of the SME

Does the distinction between the following types of loans have implications for the tax situation of the SME: ordinary convertible profit-sharing loans or other types (if regularly used)?

Yes, interest on convertible and profit-sharing loans is considered as dividend distribution and therefore not tax-deductible.

What is the deduction regime for the different types of loans? Are there specific regimes available?

What is the situation if the VCC also participates in the SME?

Interest payments on the different types of loans are deductible. Interest on convertible loans and profit-sharing loans are usually also tax-deductible.

It should be noted that interest paid on long-term loans, while fully deductible for corporate income tax purposes, is only 50% deductible for purposes of the trade tax.

Specific regimes are not available. When the VCC participates in the SME and grants the loan to the SME, the interest would partially be considered as 'hidden profit distributions' if the loan is granted at excessively high rates. The part of the interest that is deemed to be excessive would be treated as a dividend and would not be deductible.

What is the withholding tax in each case of the different types of loans?

There is no withholding tax on interest paid on ordinary loans. However, interest payments on convertible loans and profit-sharing loans are subject to a withholding tax of 25%.

3.2. Tax situation of the company that grants loans to the SME

What is the situation concerning the different types of loans: ordinary loans, convertible loans, profit-sharing loans, other types?

All interest income is in principle fully taxable.

In respect of the taxability of the interest, are there exemptions or reductions for certain zones or activities?

No.

How are the capital gains on receivables taxable? What if the loan is converted into capital with capital gains or losses?

The gains are fully taxable.

Are capital losses on receivables realized by the VCC deductible?

Yes.

Are interest payments deductible (for the acquisition of the funds)?

Yes, with exception of

- 50 % of the interest for trade tax purposes;
- non-deductibility to the extent of tax exempted income.

Is there a withholding tax on interest paid by the VCC? Are there exemptions available (e.g. in case of payments to the European Commission)?

There is no withholding on interest in Germany. However, interest received from profit-sharing loans or convertible loans are subject to a withholding tax of 25%. No exemption is available for payments to the Commission.

3.3. Tax situation of the fund ('Unternehmensbeteiligungsgesellschaft')

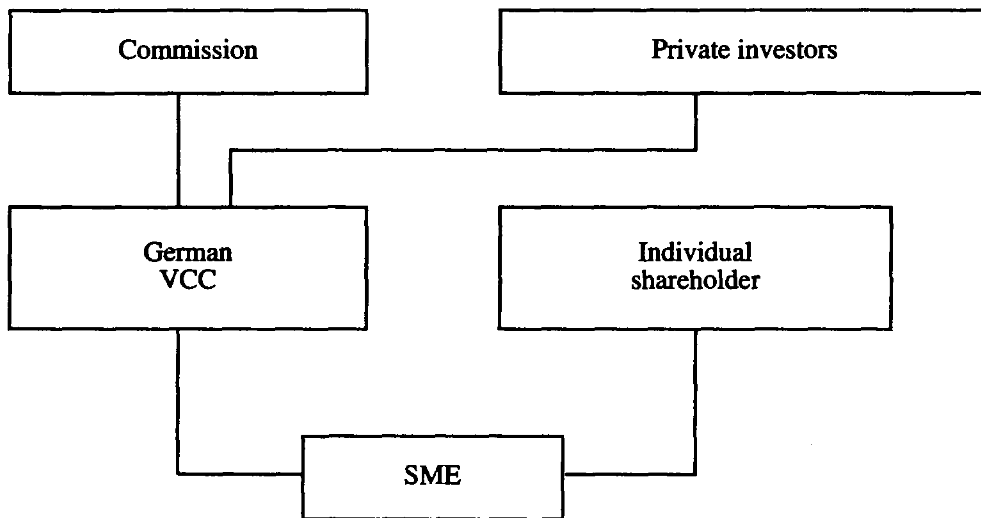
The main tax advantages of this type of company is an exemption from trade tax on income, net worth tax and trade tax on capital. This is, however, an advantage in comparison to normal investment (holding) companies only if the participations are below 10% so that the affiliation privilege does not apply.

This type of company, however, is subject to corporation tax.

Practical guidance

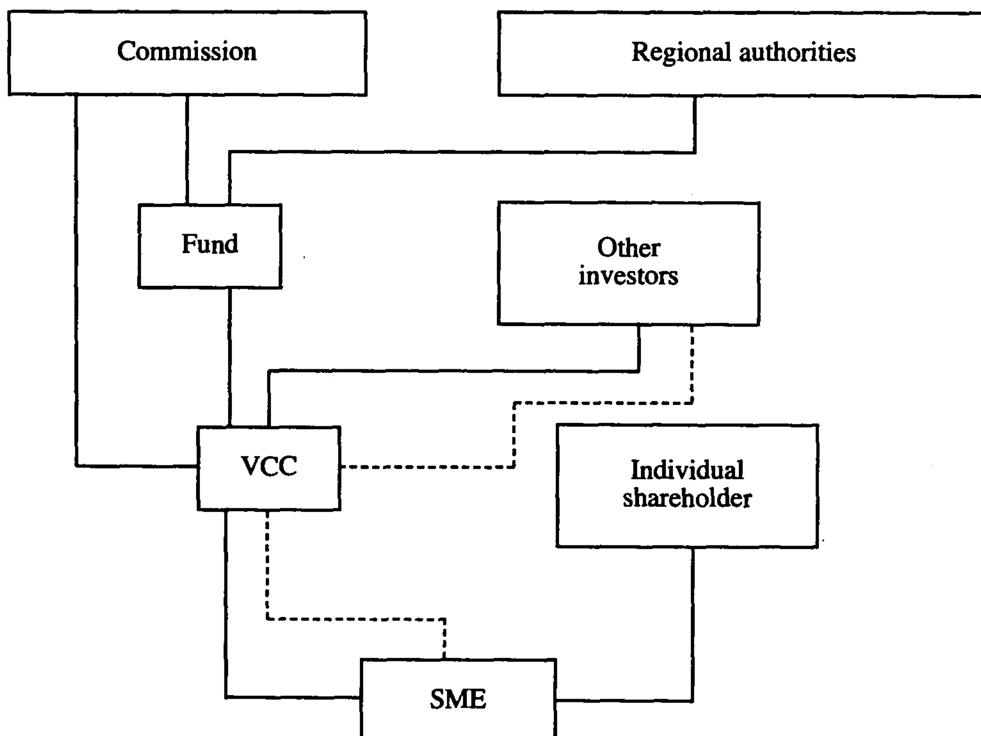
I. Equity finance

1. Scheme



II. Debt finance

1. Scheme



2. *Comments on structure*

2.1. *Position of the SME*

Costs of increasing capital:

Capital duty of 1%; notarial fees. These costs can in absolute figures be an obstacle, although they are relative, rather limited and tax-deductible. These costs, being tax-deductible for the SME, have a negative impact on the results.

The capital duty is abolished from 1 January 1992.

Taxable base:

(a) Corporate income tax

The profits of the SME are positively influenced by the capital increase. This means that if normally losses would have occurred, because of the capital increase a better result can be shown.

If the capital increase leads to a profit situation, this profit is normally taxed at 50% (if not distributed) and 36% (if distributed).

Special tax rates exist for West Berlin source income.

(b) Trade taxes and net worth tax

Both taxes will be equally higher.

2.1. *Position of the SME*

Costs of granting loan:

No costs.

Taxable base:

(a) Corporate income tax

The interest payments are normally deductible expenses that have a negative impact on the results and on the cash flow.

This situation may prove unwise because a loss position may be created (no immediate use of interest deduction) and other advantages related to profit are lost (e.g. reconversion status).
This disadvantage may partially disappear if it is a profit-sharing loan.

In case the VCC participates in the SME to which the VCC also grants a loan, the interest payments are not deductible in so far interest rates are excessively high. That portion of interest which exceeds market rates constitutes a hidden profit distribution.

(b) Trade taxes

Fifty per cent of interest on long-term loans will not be tax-deductible for trade tax on income purposes. For trade tax on capital, 50% of the long-term loans are not deductible.

Tax rate:

The profits are subject to corporate income tax at 50% (if not distributed) and 36% (if distributed) and to trade tax on income of between 9% and 19%.

The additional equity capital is subject to trade tax on capital of 0.4 to 1% and net worth tax of 0.45% (75% of 0.6%).

Redemption of shares:

Does not exist under German company law.

Dividend distribution:

The dividends are part of the taxable base.

On the dividends distributed to the individual shareholder, a withholding tax of 25% applies; on the dividends distributed to the VCC, the same withholding tax applies. Exemptions are not available (see above).

2.2. *Position of the VCC*

Taxable base:

(a) Dividend income

This income is grossed up with both the withholding tax and the corporate income tax. These two taxes are fully creditable (and refundable) by the VCC against its total income tax liability.

If the participation does not benefit from the affiliation privilege, trade taxes and net worth tax apply, which leads in this case to a double taxation.

Tax rate:

The deductible interest payments save a taxation of corporate income tax and partially (50%) of trade tax on income.

The deductible loan saves taxation of net worth tax and partially (50%) of trade tax on capital.

Reimbursement of the loan:

Has normally no impact on the taxable result.

Interest payment:

The deductible interest paid to the VCC is normally exempt from withholding tax.

However, interest from convertible and profit-sharing loans is subject to a 25% withholding tax.

2.2. *Position of the VCC*

Taxable base:

(a) Interest income

This income is fully taxable at 50 or 36%.

(b) Capital gains taxation	(b) Capital gains taxation
In principle taxed. Deferral of capital gains tax is possible.	The capital gains realized at the moment of converting the loan into capital is in principle fully taxable. Deferral is not available.
(c) Capital loss on shares	(c) Capital loss on loans
Tax-deductible.	In principle deductible.
	Interest payments of 50% on long-term loans and other loans which are an extension of capital are added to the taxable base for trade tax on income purposes. The long-term loan itself is only for 50% deductible for trade tax on capital purposes.
Dividend distribution:	Interest payment to the UBG:
The normal rules apply. However, an exemption of withholding tax applies on dividend distribution to the Commission.	Tax-deductible.
Transfer of shares:	Transfer of loans:
No special tax applies.	No special tax applies.
If the VCC is a UBG, it is only subject to corporation tax.	If the VCC is a UBG, it is only subject to corporation tax.
2.3. *Position of the individual shareholder*	2.3. *Position of the individual shareholder*
Dividend income:	Dividend income:
Dividends received grossed up with underlying corporate income tax and withholding tax are included in the individual shareholder's taxable income. Any excess is refundable.	See left side.
Purchase of the shares:	
The financing of this operation may be difficult since the individual shareholder can normally not deduct the interest burden.	There is no transfer of shares in case a loan is granted. The interest burden remains thus with the SME.

However, interest expenses are deductible if, under long-term aspects, the dividend income exceeds the interest expenses.

2.4. *Position of the fund*

No dividend income.

2.4. *Position of the UBG*

The interest income is taxable.

3. *Unincorporated SME*

If the VCC participates in the SME (sharing of profits and losses), an equivalent part of the profits/losses is as such attributed to the VCC which is normally taxed on this income.

For trade tax purposes the KG and the OHG are considered as taxable persons. The participation that the VCC holds is exempted from trade tax. The KG can set off 50% of the debt of the VCC for financing the participation against its taxable base.

3. *Unincorporated SME*

If the VCC grants a loan, the loan is treated as capital for tax purposes. Interest paid on the loan is treated as profit share of the VCC.

Conclusion

Equity finance

1. *Major disadvantages*

Costs related to increase of capital (capital duty abolished as from 1 January 1992);

The capital increase will normally lead to a higher taxable base and and thus a higher tax burden with the SME;

The dividend exemption does not apply in case of corporate income tax; however, the same result is achieved by the imputation system;

If no substantial holding (< 10%) exists, double taxation is possible for 'Gewerbesteuer' and 'Vermögensteueu' purposes;

Debt finance

1. *Major disadvantages*

The deductible interest payments may lead to a loss position of the SME, whereas the interest income with the VCC is immediately taxable;

Excessive interest payments are treated as hidden profit distribution to the extent they are not at arm's length;

Capital gains on loans are taxable;

Interest from profit-sharing and convertible loans is subject to a withholding tax of 25%;

Capital gains on shares are fully taxable;

Redemption of shares is not a common practice in Germany;

Dividends distributed by UBGs underlie a 36% taxation.

2. *Major advantages*

Double taxation is avoided for corporate income tax by the credit system applicable to dividends received.

Interest payments will for 50% be included in the tax base for trade tax on income purposes; 50% of the long-term loans is not deductible for trade tax on capital.

2. *Major advantages*

No costs are related to the granting of the loan;

The taxable base of the SME will normally be reduced;

The risk of double taxation (with SME/VCC) does normally not exist, with the exception of trade tax;

The capital losses are deductible for corporate income tax purposes;

The private shareholder is not confronted with a purchase of shares.

Germany	Equity	Debt		
	VCC[1]		Interest payments on ordinary loans	Interest payments on convertible and profit-sharing loans
SME profit before tax	100	Interest payment deductible with SME	Yes (–100)	Yes (–100)
Corporation tax 36%	–36	Witholding tax 25%	0	-25
Gross dividend	64			
Withholding tax 25%	–16	Interest income before tax at recipient's level	–100	75
Net dividend before tax at recipient's level	48	Withholding tax withheld at source	0	- 25
Taxable base[2]	100	CIT 36%	- 36	- 36
CIT at recipient's level[3]	–36	Interest income after tax	64	64
Tax borne at source	52			
Restitution	16			
Net dividend after tax	64			

[1] VCC taking the form of an 'Unternehmensbeteiligungsgesellschaft' is exempt from trade tax on income and capital and from net worth tax, not from CIT.
[2] Net dividend is grossed-up with withholding tax and underlying CIT; both are fully creditable against the VCC's CIT liability and any excess is refundable.
[3] In case of distribution of profits.

III. Other issues

1. *Local and regional authority issues*

The role played by the State in the procurement of risk capital through holding companies extends only as far as the regulation of the role of the shareholders/limited partners in the non-profit equity participation enterprises: it acts as a co-investor. In addition, the State assumes participating guarantees or grants to the companies holding participations favourable refinancing possibilities.

With respect to non-profit capital holding companies, the particular state *(Bundesland)* holds an interest of up to 25% in the company. The remaining shareholders are generally self-help and self-management organizations, for example the Chamber of Tradesmen or the Chamber of Industry and Commerce. They can also, however, be credit institutions. Capital holding companies exist in all of the 'old' states (western Germany). They have also broadened their activities into the 'new' German states (eastern Germany) so long as there are no such companies already in existence there.

In particular, the non-profit capital holding companies have the special task of distributing the financial resources available for the promotion of participations in SMEs which have been made available by various public programmes. The non-profit capital holding companies make use of the aforementioned resources for those capital holding companies which are not, to a sufficient extent, in demand by the capital holding companies which are operating on a profit basis.

A specific variation is the co-investor model which is in existence through the efforts of the Bundesminister for Research and Technology. In compliance therewith the technological participation holding companies have been established as subsidiaries of the Deutsche Ausgleichsbank. This company commits itself to silent participations of up to DM 1 million in young technological enterprises if another capital investor also participates to the same amount.

The non-profit capital holding companies are, by contrast to those operating on a profit basis, typified by the considerably higher number of participations they take. The volume of the participations is, however, clearly lower than in the case of participations by holding companies operating on a profit basis.

There are no statutory principles governing these types of participations. The particular states take advantage of their freedom to act within the commercial-political sphere. The legal basis for state participation stems solely from the memorandum/articles of association of the capital holding company.

2. *Impact assessment*

After a difficult launching period, the German participation market finds itself, since the middle of the 1980s, in a state of expansion. An analysis of all the individual types of holding companies is not possible in this section. What can be established, however, is that venture capital companies (resulting from the diversification of risk) have gained considerably in importance *vis-à-vis* the remaining types of holding companies.

According to statements made by the National Association of German Capital Holding Companies, the total invested capital by its members has risen from DM 785 million in 1983 to DM 3 341 million in 1990.

The number of participations rose from 1 069 in 1983 to 1 983 in 1990. Gross investments reached, in 1990, almost DM 1 billion.

A survey was carried out in the 'new' *Bundesländer* (former GDR) by chosen members of the national association on 30 June 1991, the result of which was that four participation holding companies have invested special funds with a total volume of DM 330 million. Until

this point in time 15 direct participations have been realized (with a volume of DM 43.4 million) and 41 indirect participations (via West German cooperation partners). The number of inquiries in the East German states totalled 598, of which 105 are still in the assessment stage.

The major obstacle for the development of participation entities in Germany was the traditional refusal of the SMEs, which were often held in family ownership, to take on new shareholders. Even with respect to silent participations, they were afraid of a loss of independence. The participating holding companies have tried to counter this type of thinking by way of intensive dissemination of information and through the use of a standard contractual form. As can be seen from the development in this market, these efforts are now bearing fruit. Also, in the meantime, many family-owned enterprises, which were established after the Second World War, are finding themselves in a state of radical change. The founders of these companies are being replaced by the younger generation and in some cases by the directing management for whom the aforementioned psychological fear of loss of independence exists to a much lesser extent.

As a result of the negative opinion on holding companies which many enterprises held, holding companies were only considered in cases of emergency when traditional bank credit was unavailable because the enterprise could not supply the necessary collateral security which was being demanded by the bank. As the holding companies also did not want to enter into inestimable risks, there were times in which only 3 out of 100 enquiries led to an actual participation even though only 30% of the capital was being invested in a participation.

Looking at the (public) enterprise holding companies in particular, several legal obstacles are currently being removed with the aid of parties supporting their interests. Obstacles, however, continue to exist. For example, profits resulting from the proceeds of sale are considered normal revenue and are therefore subject to corporate tax. The effect of this is to defeat the aims of the UBGG which was to treat shareholders of (public) enterprise holding companies equally with those who participated directly in an enterprise which was listed on the Stock Exchange. What can also be negatively criticized is the restriction of permissible participations in § 3 I UBGG in national enterprises. Furthermore, the financial flexibility of the (public) enterprise holding company is unnecessarily restricted by way of the limitations concerning the assumption of credit in § 5 UBGG.

IV. Comparative legal and regulatory issues

1. *Absent positive features*

In Germany, the venture capital market disposes of a wide range of investment vehicles (see Section I.2) with a detailed underlying legislation. They are owned by private banks, commercial associations, individuals and the State. Their existence has proven to be a fundamental and effective instrument for the raising of venture capital for SMEs. In comparison to the other EC Member States, only the grant given in Greece to venture capital companies, whenever they take an equity stake in a SME which invests in high technology or innovation, seems to be a positive feature which is absent in Germany.

(a) In Germany, such direct cash grants for venture capital companies investing in high-technology undertakings are absent. However, the SME itself may benefit directly from State aid (investment grants) given by the State or the region pursuant to the programmes for improvement of certain regional economic structures.

(b) Giving a direct cash grant will certainly stimulate venture capital companies as well as all other holding companies to invest in certain high risk industries.

(c) To create a similar scheme in Germany, the competent authorities, be it the federal or state governments, would have to amend their respective legislation on economic expansion.

2. *Absent techniques*

None identified.

Greece

Introduction

The legal and regulatory environment for venture capital in Greece is too restrictive. The activity is limited to specialized institutions which, in turn, are limited to equity financing of high-technology or innovative investments. The activity should be extended to other areas, given that Greece is not a country with a solid industrial basis.

If the VCC does not satisfy the conditions of Law 1775/1988 (concerning activities, participating in SMEs, performing high technology, innovation businesses, amount of capital, etc.) or is not an investment holding company, it cannot benefit from the specific tax benefits that exist for both these forms.

A negative aspect is that capital gains are only tax exempt when put in a special reserve account used to cover future capital losses, unless the VCC operates as an investment holding company.

Furthermore, several exclusions from the taxable base and reduced rates apply for SMEs meeting certain conditions.

I. Legal and regulatory issues

1. *Typical investment vehicle used*

- The société anonyme (public limited company)

Venture capital vehicles are required by Greek law to be incorporated in the form of a société anonyme. No other corporate structure will allow a company to act lawfully as a venture capital company.

These sociétés anonymes can be established by any entrepreneurial group. Banks, both domestic and foreign, which operate in Greece engage in the provision of venture capital by setting up specialized institutions for this purpose.

2. *Applicable legal measures*

- Law 1775/24-05-1988 on venture capital companies. This is the main implementing legislation governing the activities of venture capital companies.
- Greek company law. Since the vehicle adopts the structure of a public limited company, company law, in general, is also relevant. Where company law and Law 1775/24-05-1988 conflict, the latter will prevail.

3. *The investment vehicle*

The law requires that the capital stock of venture capital companies should comprise only registered shares. This is the rule which applies to all types of companies offering financial services. However, in contrast to other financial institutions, venture capital companies may be listed on the Stock Exchange markets.

The minimum capital requirement for venture capital companies is DR 500 million of paid-up share capital. This is not a very strict requirement when compared with the capital requirement of leasing companies, which is DR 4 billion, or factoring companies, which is DR 2 billion.

With regard to the establishment of venture capital companies, there are no specialized licensing requirements, apart from the ones that every corporation is obliged to satisfy, namely the approval of the company's articles of incorporation by the prefect, which is a typical procedure to ensure that the articles of incorporation are compatible with Greek company law. It is noteworthy that, in contrast to the established practice with other financial institutions, venture capital companies are not authorized by the country's monetary authorities (the Bank of Greece). However, the Bank of Greece is still vested with supervisory authority over venture capital companies. While carrying out this task, it can impose reporting requirements on venture capital companies and exercise powers of enforcement.

If a bank sets up a venture capital company, the capital to be contributed by it to the venture capital company cannot exceed 20% of the bank's capital stock.

The one big restriction imposed on the establishment of a venture capital company by Greek legislation is the requirement that these companies deal exclusively with venture capital finance and not with any other type of financial services.

Greek legislation on mutual funds and investment companies sets restrictions on their portfolio as far as the stock and bonds of companies which are not listed on the Stock Exchange market or the parallel market are concerned. More specifically, mutual funds and investment companies are obliged to include such stock in their portfolio. Its value cannot exceed 10% of their own capital stock. It is obvious that Greek legislation precludes the establishment of specialized investment

trusts for investment in SMEs, at least not SMEs which are not big enough to obtain a listing on the Stock Exchange market or the parallel market.

4. *The recipient of venture capital*

Greek legislation limits the scope of provision of venture capital to financing investments of high technology and innovation. This is not restricted to pre-existing hi-tech companies. The investments meeting these criteria are determined on a case-by-case basis by ministerial decisions issued by the Minister for the National Economy in consultation with the Minister for Industry.

The terms 'high technology and innovation' are used inseparably and their meaning is furthermore defined in Ministerial Decision No C. 3923/01-03-1989, issued by the Minister for the National Economy in consultation with the Minister for Industry. Pursuant to this Decision investments of high technology and innovation are the ones which aim at the production of:

- new or improved products or services;
- new or improved production methods;
- new or improved organization methods;
- new uses of existing products and services.

In addition to the above, the law further defines the recipients of venture capital. It should be provided only to companies, not individuals, and, more specifically, only to corporations and limited liability companies (Article 1(4)). The rationale behind these rules is to distinguish the area in which venture capital companies are called to participate from the areas covered by other institutions offering financial services (e.g. bank finance).

The services to be provided through venture capital corporations are listed in the law as follows (Article 1(1)):

- setting up new enterprises which undertake investments of high technology and innovation,
- participation in the equity of existing enterprises when they increase their capital with the intention of undertaking investments of high technology and innovation,
- guaranteeing loans extended to the aforementioned enterprises,
- rendering consulting services to the aforementioned enterprises for market research, analysis of investment programmes, business planning and, in general, every kind of service aiming at the accomplishment of their objectives.

While this is not an exhaustive list, it should be mentioned, however, that debt financing is almost absent from the list except for the third item. The legislator seems to favour equity financing as the most appropriate technique for venture capital companies.

The restrictions imposed on venture capital companies under the above rules are highly obstructive and prevent the use of this technique in relation to many SMEs.

5. *The provision of venture capital*

Venture capital companies cannot have an interest in a company that exceeds 20% of their own capital (Article 2(4)). Another restriction is that venture capital companies are forbidden to extend loans to the companies which they have set up or in which they have a participation (Article 2(3)). In other words, simultaneous equity and debt financing is forbidden.

Venture capital can be provided by way of debt financing. The legal text (Article 1(h)) refers to the permissible activities of venture capital companies without including debt financing. But this is a non-exhaustive list which obviously means that venture capital companies can engage in other financing activities as long as these are within their scope as defined by the law. All possible forms of debt financing are permitted for venture capital companies.

It should be mentioned that a venture capital company is not required to obtain the approval of the Minister in order to undertake a financing project. This approval is necessary only when a venture capital company applies for a grant. Approval of the ruling authorities whenever required always gives rise to significant delays and, additionally, it leaves the way open to political pressure and subsequently to scepticism about the new institution.

As far as venture capital companies are in need of financing themselves, they cannot assume liabilities which exceed their own capital and, if this ever occurs, the companies will have to increase their capital within six months (Article 2(5)). A 1:1 debt-to-equity ratio imposes a fair standard of prudence.

The law provides incentives not only for venture capital companies but also for co-investors, that is companies and individuals who participate in financing the investments indicated to them by venture capital companies.

Venture capital companies receive grants for their participations in the equity of enterprises undertaking investments of high technology and innovation which amount to 30% of these participations. The grant has to be approved by the Minister for the National Economy (Article 3, paragraphs (1) to (3)).

Two main obstacles to the provision of venture capital must be mentioned.

Firstly, it is certain that venture capital should be structured in such a way that the features which distinguish it from traditional financing methods are highlighted. Nevertheless, under Greek law, the scope of the services offered by venture capital companies is too restricted. It should not comprise only equity financing of high technology investments, given that Greece is not a country with a solid industrial basis, where high technology flourishes. Therefore, the scope of their activities should be extended to other areas as well, such as mergers and acquisitions, reorganization of insolvent units, etc.

Secondly, at the present stage of introduction of venture capital, the requirement of its provision through specialized institutions undermines the dissemination of the new technique. Until Greek entrepreneurs get acquainted with the new financial techniques venture capital should also be provided through well-established financial institutions, especially banks.

II. Issues of taxation

1. *Introduction*

The SME is often confronted with the difficulty of attracting financial means from third parties.

Indeed, on the one hand, to contract a loan with a bank, the SME's equity is often too low, so that the financial institutions feel rather reluctant to grant any loan.

On the other hand, because of the high risk of the investment, only very few persons will be willing to increase the capital (and therewith the loan capacity) of the SME.

The VCC can, therefore, play an important role in the expansion of the SME.

The VCC and the target company (SME) will have to determine how the capital is to be injected. It may very well be that there is a conflict of interest between the parties in determining how the injection will be executed.

In general, the (tax) differences between debt financing and equity financing can be established as follows:

In case of debt financing by the VCC, the interest payments are for the SME in principle tax-deductible expenses, which have a negative impact on the results (possibly into a loss position) and on the cash flow of the SME. The VCC will be fully taxable on the interest income. It may very well be that this situation is not at all desirable. Indeed, the SME will probably be in need of extra means at a time when heavy investments are planned which will already have a negative impact on the results (depreciation of the investment). From a tax point of view such a situation may also prove to be unwise.

The interest deduction cannot be properly used because of insufficient profits (creation of losses) whereas the interest income with the VCC is immediately taxed. Furthermore, due to the negative impact on the results, some profit-related incentives remain unused.

To meet both economic and tax demands, two main options are available:

- either the loan agreement is concluded under circumstances in which the interest rate is in the beginning relatively low (e.g. profit-sharing loan or convertible loan); or
- the VCC decides to participate in the capital of the SME.

In case of equity finance, the following problems arise:

Dividend income: if the VCC is in need of a more or less regular income to finance its own investment, this will have to be done by way of dividend distribution.

Dividends are tax-deductible, so that the dividend capacity will be equal to the interest payment capacity.

The dividends distributed by the SME will be taxed in the hands of the recipient (the VCC), although the withholding tax is withheld at the distributing company level. The dividend is treated gross in the books of the VCC and a tax credit for the dividend tax is obtained if the shares are registered. In cases where the reduced rates do not apply, this tax (up to 50% on non-registered (i.e. bearer) shares) could be a problem.

It is worth noting that the government has presented draft legislation where it is proposed that corporate and dividend tax rates (combined) will be reduced to 35% for all categories.

If, however, the VCC is an investment holding company (see below), an exemption of withholding tax applies. We believe that this will be the proper tax treatment although the Ministry of Finance has not yet issued its interpretation circular on the new legislation concerning investment holding companies.

Capital gains income: this method could be interesting since the SME retains all profits.

Problems are:

- if the value of the SME decreases, the capital loss realized on the sale of the shares is in principle only tax-deductible from capital gains realized on the sale of other shares and securities. Such losses can be applied to reduce gains in the current year or those set aside in a special reserve, if any, created from previous years' gains. Alternatively, they may be set aside in a special reserve and used to reduce gains realized in the future. No deduction can be taken;
- if the value of the SME increases, the capital gain will in principle be tax-exempt. Individual shareholders do not pay tax on capital gains realized on the sale of shares whereas for corporate shareholders and other shareholders who must maintain double entry books, such gains are considered regular trading gains but remain untaxed if placed in a special reserve to be used to set off future losses from similar transactions. A problem may be that the individual shareholder, who purchases the shares held by the VCC, will normally not have enough means to purchase the shares.

In the next section (Equity/Debt finance), a summary is given of all important items that could influence the decision-making of the VCC and the SME.

In the last section (Practical taxation guidance), practical guidance is provided, resulting from the information in the sections Equity/Debt finance.

2. *Equity finance*

2.1. Creation of the VCC

Registration tax and other duties

Contributions to the capital in cash for shares upon the formation of an SA, i.e. a corporation ('Anonymos Eteria' or Société anonyme, hereafter 'SA') are subject to capital concentration tax of 1%. Contributions to various funds also apply but they are insignificant, except for the lawyers fund. Stamp duty of DR 150 000 is payable on the commencement of business operations.

For an EPE, i.e. a limited liability company, its capital is also subject to capital concentration tax of 1% and the same contributions outlined above also apply but they are all percentages of the capital which is usually less than that of an SA. Stamp duty is also payable on the commencement of business operations. It is DR 50 000 for the EPE plus DR 30 000 for each partner. Although an SME could take the legal form of an EPE, it is not likely that the VCC would take any form other than an SA.

Contribution to capital in kind for shares upon the formation of a company is subject to the same duties as described above. Where real estate is involved, it is also subject to transfer property tax. This transfer tax is imposed on the sale of land, buildings and attached machinery and equipment if sold as part of the building. The rate is 11% of the market value of the property based on the objective scales of rates for values up to DR 4 000 000 and 13% on the value in excess of DR 4 000 000. In districts where there are no fire protection facilities the rates are reduced to 9 and 11% respectively.

The 1% capital concentration tax is also payable on the issue of other securities but not bonds issued by both an SA and an EPE. There are no stamp duties payable on the transfer of shares in an SA nor on the transfer of EPE-parts.

Additional costs of creating a company are:

- notarial fees,
- Chamber of Commerce fee,

- publication in the Official Gazette,
- charges for listing on the Stock Exchange.

A specific regime exists for investment holding companies:

Greek legislation (Law 1969/1991) favours the formation of investment holding companies. They are exempt from all taxes on their capital and their revenue. The conditions to be met in order to qualify as an investment holding company are:

- a capital of DR 500 000 000 and the sole purpose of acting as a holding company for securities;
- the share capital must consist of contributions in cash and limited amounts may comprise contributions of certain securities as well as assets required in the operation of the company;
- the shares of investment companies must be quoted on the Athens Stock Exchange.

Are there conditions to be met in respect of the legal forms of the VCC? Are there any specific forms available?

In order to enjoy all the benefits provided for by the legislation on VCCs (Law 1775/1988), the VCC must operate under the form of a 'Société anonyme' (SA); such an SA requires a share capital of at least DR 500 000 000. The minimum capital requirement must be fully subscribed for in cash at the time of formation. As with all corporations, the company's charter of incorporation must be drawn up before a Greek notary and then filed with the Ministry of Commerce. It must be approved by the Ministry and then published in the official government gazette. Its objects must be to promote and effect investments in high technology and innovations. Such companies enjoy the following tax benefits and other advantages:

- eligibility for State subsidization of up to 30% of their investments in high technology or innovation businesses (subject to joint approval by the Ministries of National Economy and Industry);
- they may claim a tax deduction of 3% of their investments and guarantees in high technology or innovation businesses, which must be placed in a special tax-free reserve to be used for further qualifying investments and guarantees;
- gains realized from the sale of its participation in high technology and innovation businesses are not subject to income tax and are placed in a special tax-free reserve to cover future losses from sales of such participation.

Interest earned from bonds issued by such companies is not subject to tax.

However, if the SME cannot qualify under the definition of high technology and innovation, the VCC will not be able to benefit from the tax benefits. Moreover, both companies will be excluded from the technique of venture capital in this case (see previous comments in Section 1.4).

Any individual or corporation participating with a venture capital company in effecting qualifying investments may deduct 50% of their investment. However, only up to 25% of the investment may be deducted in any one year and the amount deducted may not exceed 50% of the annual income.

The VCC could also take the form of a regular SA in which case the minimum share capital is DR 500 000 but no special benefits apply.

It is not likely that the VCC takes the form of an EPE.

Are there limits as to the degree of participation of the VCC in small and medium-sized enterprises?

The participation by a VCC formed pursuant to Law 1775/1988 in any company carrying out the specified qualifying investments, all of which relate to high technology or innovation (or the value of a guarantee granted by it to any one such company) may not exceed 20% of its own net assets. Other than this, there are no limits.

2.2. Tax situation of the SME

Creation of the company and increase of capital

Are there registration or other duties? Are there exemptions for certain zones, projects, activities?

For the SA, the increase of capital does not bear any stamp duties. However, there is the capital concentration tax of 1% when the capital is increased, plus the contributions and costs mentioned above.

For an EPE, there are contributions and charges as mentioned above under Section 2.1. Increase in capital is also subject to capital concentration tax of 1%.

Are there exemptions for certain zones, projects and activities?

There are no exemptions which concern the creation and increase of capital.

Is the indirect tax treatment different for the following types of shares (ordinary shares, preference shares or founders' shares)?

These shares are not treated differently as far as the capital concentration tax payable on creation of capital or stamp duties is concerned. Founder shares do not have any capital value and consequently are not part of capital and do not have any costs.

Taxes on the transfer of shares/parts

The transfer of shares, including founder shares in an SA and EPE-parts in general, is exempt from VAT and stamp duty. Any gain arising from the sale of EPE-parts is subject to a special tax at the flat rate of 20%.

Corporate taxation

The basic tax on the SA is corporate income tax. EPEs as such are not subject to tax on their income, which is taxed in the hands of the partners. EPEs are subject to a withholding tax on their profits, which is for the partners' account but is, however, deducted from the partners' individual return.

Are the costs related to the creation or increase of the capital deductible?

With the exception of income tax, tax penalties and the annual tax on real estate, all taxes incurred by a business during the taxable year may be deducted from its gross income. Capital concentration tax and other costs paid on formation are capitalized and deducted over a period of one to five years.

Are there specific regimes for certain SMEs (certain zones, activities, projects)?

The following items of income, *inter alia*, are excluded from the taxable income for corporate income tax purposes:

- profits from sales of real estate used as fixed assets;
- profits from ships operating under the Greek flag;
- interest earned from bank deposits in foreign currency with banks operating in Greece;
- interest on loans raised by the government or the European Investment Bank;
- interest paid by enterprises qualifying under the incentive legislation are eligible for various exemptions;
- dividends paid on quoted shares are subject to limited exemptions.

In order to obtain the benefits provided by Law 1892/1990, the investment by the SME must be a qualifying investment made by a qualifying enterprise in a qualifying region. There are four regions which can each

benefit from accelerated depreciation, investment grants, government interest subsidies and tax-free allowance rates.

Tax-free allowance rates apply to the value of new productive investment and the percentage of annual net profits to which such allowances may be applied are graduated depending on the area of the investment (60 to 100% of the profits). It is clear that from this point of view equity finance is preferable to debt finance. These tax-free allowance rates do not apply on profits distributed as dividends.

Also, export incentives are offered to domestic and foreign enterprises which export from Greece. For equity finance, it is important to note that there is a 1% deduction from taxable profits calculated on total export sales for industrial enterprises without formal justification. Exceptionally, for the years 1988 to 1991, this allowable deduction has been increased to 3% on exports of up to DR 1 billion and 2% on exports between DR 1 and 3 billion. Oil-export companies are granted a flat 1% deduction. It is not certain yet whether the increased incentive will remain valid after 31 December 1991.

Rates

SAs

The normal rate of corporate income tax is 46% for SAs. A 10% discount is granted when taxes are fully paid. This discount effectively reduces the rate to approximately 41.4%. The corporation is only taxed on retained profits. If it decides to distribute all profits, it pays no corporation tax. As noted, it is anticipated that this rate will soon be reduced to 35% on all profits and the dividend tax will be abolished.

EPEs

These companies are, as mentioned, subject to a withholding tax on their profits at a 15% rate. The EPE-partners include the profits in their income tax returns. The tax paid by the EPE for the partners' account is, however, deducted as a credit from the partners' individual returns. It is anticipated that, in 1992, the EPEs will be taxed like the SAs (i.e. 35% tax on profits).

Reduced rates apply in the following cases:

- for industrial, mining and quarrying companies, the rate is 40%;
- the rate is reduced to 35% for industrial, mining and quarrying companies whose shares are quoted on the Athens Stock Exchange or if they invest amounts exceeding DR 50 million or if they meet certain conditions pursuant to the investment laws (1262/1982 or 1892/1990);
- the rate is 40% for all other companies incorporated in Greece, or if they meet certain conditions pursuant to the investment laws (1262/1982 or 1892/1990).

These reduced rates reduce the withholding tax on distributed profits.

Are there specific regimes for certain SMEs (certain zones, activities, projects)?

None exist.

How does a redemption of shares affect the tax position of the SME?

Greek tax law does not provide for the issue of redeemable shares. Furthermore, it prohibits a company from acquiring its own shares. Therefore, a redemption of shares would be treated like an ordinary sale/transfer of shares, combined with a reduction in share capital. Any amount paid out in excess of the par value of the shares (i.e. in excess of the capital reduction) is subject to dividend tax.

Dividend distribution

Does a different tax regime apply to dividend distribution to X (shareholder of the SME) on the one hand and to the VCC on the other hand?

No. Dividends paid by a resident company are not subject to any preferred treatment. Income from the SME

(SA or EPE) or other forms of general partnership are taxed in the hand of the shareholders/partners and not in the hand of the distributing companies.

Does a different tax regime apply according to the different types of shares: ordinary, preference, founders' or other shares?

Yes, slightly different rates apply. The rates for dividends from shares quoted on the Athens Stock Exchange are different from those for dividends not quoted on the Stock Exchange (see below).

Is the tax base affected by the distribution of dividends (deductible dividend)?

Yes. Only the undistributed profits of a corporation are liable to tax at the corporate level. All dividends which are distributed are deductible from corporate net profits in determining the tax liability of the company.

Is the tax rate affected by the distribution of dividends?

No (unified rate of 46% or 40% depending on the activity of the company).

Is a withholding tax withheld? Rate? Exemptions?

In the case of distributed dividends, a withholding tax is retained at the company level.

Distributed dividends for an SA are taxed in the hands of the recipient, but tax is withheld by the company. The withholding tax is normally a final tax, subject to the comments in the following paragraphs.

The dividend tax withholding rates are:

(a) for dividends from shares quoted on the Athens Stock Exchange:

42% for distribution of registered shares;
45% for distribution of bearer shares;

(b) for dividends from shares not quoted on the Stock Exchange:

47% for distribution of registered shares;
50% for distribution of bearer shares.

As noted, it is anticipated that dividend tax will be abolished and a corporate tax of 35% will be introduced. However, until such time, companies quoted on the Athens Stock Exchange enjoy a reduced tax rate on both retained earnings and dividends. The taxpayer may include such dividends in income tax declaration and may claim a credit for the tax withheld or treat the tax as final tax. Dividends received on shares quoted on the Athens Stock Exchange are completely exempt up to an amount of DR 50 000 annually per listed company and up to an aggregate amount of DR 200 000 annually if the dividends are received from more than one company.

An important exemption is that dividends distributed to investment holding companies are not subject to withholding tax.

Example for SAs:

Profits	8 000 000	
Dividends distributed		– 4 000 000
Retained earnings		4 000 000
corporate income tax 46 %		– 1 840 000
Net profits after tax		2 160 000
Dividend withholding tax e.g. 47%	4 000 000	1 880 000
Net dividend		2 120 000

EPEs

The partners of an EPE effectively suffer a withholding tax of 15%, which is refundable if they do not have enough income to reach that tax level. EPE-parts cannot be listed on the Athens Stock Exchange.

If previously retained earnings (taxed) are subsequently distributed as dividends, dividend withholding tax is still applicable; however, corporate tax previously paid can be set off against the dividend withholding tax to be remitted (i.e. the dividend declaration is at the gross amount). A refund (to the company) will be made if the ultimate dividend rate is lower than the corporate tax previously withheld.

2.3. Taxation of the VCC

Corporate taxation

Are the costs related to the creation of the VCC deductible?

Yes.

Are management costs and interest deductible?

Interest on loans incurred for purely business purposes is deductible if placed with Greek banks or authorized branches of foreign banks. Interest paid on the share capital of an SA is considered to be a distribution. However, interest paid on loans from shareholders can be deducted as a normal cost of finance. Interest paid by an EPE on loans from the partners is deductible for the purpose of computing the amount subject to the withholding tax of 15% on profits.

Management costs are deductible as long as they are considered a productive expense.

How are dividends taxed?

Dividends from the SME are taxable in the hands of the shareholders (VCC). What does this imply? Is the net dividend grossed-up with the withholding tax of 47% and then taxable?

When the VCC operates as an investment holding company, the dividends remain untaxed.

What is the capital gains taxation if the shares of the SME are sold? What about capital losses?

Profits resulting from the sale of securities are considered regular trading gains (income) unless put in a special reserve account used to cover future losses from the sale of other securities.

Capital gains resulting from buying and selling of shares by enterprises are considered regular trading gains (income), unless put in a special reserve account. If such gains are distributed or if the company is dissolved, the gain becomes subject to income tax.

If the VCC operates under the form of an investment holding company, capital gains (and other income) earned by similar gain will not be subject to any tax.

Capital losses are deductible from the profits of the year in which the capital losses are realized or used to reduce the above referred to reserve (see previous comments).

What is the tax position of the VCC in case of redemption of the shares by the SME?

See previous comments.

Are there specific regimes?

A VCC can operate under the form of an investment holding company in which case the VCC will be exempted from all taxes on its capital and its total income. When the VCC operates as an investment holding company, the VCC will be obliged to send a declaration to the company in which it has investments, so that no withholding tax is paid on the dividends paid to these investment holding companies. When the VCC operates under Law 1775/1990, certain benefits are provided. If the VCC does not operate either as an investment holding company, or under Law 1775/1988, the normal rules apply.

Rates

See above (situation of the SME).

Is there recoverability of the tax withheld by the SME?

Yes. However, when the VCC is an investment holding company, the SME will not withhold any withholding tax.

Distribution of dividends by the VCC

Does a different tax regime apply according to the different types of shares: ordinary, preference, redeemable, other shares?

No.

Is the tax base affected by the distribution of dividends (deductible dividend)?

Yes, since domestic corporations are not subject to income tax on distributed profits. In case of an investment holding company, the VCC is fully tax-exempted.

Is the tax rate affected by the distribution of dividends?

Yes (see Section 2.2 'Tax situation of the SME'). In the case where the VCC operates as an investment holding company no VCC will be fully tax-exempt.

Is a withholding tax withheld? Rate? Exemptions?

(See Report about leasing)

In case the VCC is an investment holding company, withholding tax is withheld under the following conditions:

- Dividends of up to DR 200 000 paid in a financial year to shareholders of one or more investment holding companies are exempted from income tax. This exemption can be used in application of provisions which exempt dividends of up to DR 50 000 per year per shareholder from any company quoted on the Stock Exchange, but whether used alone or in combination, the maximum total exemption cannot exceed DR 200 000.
- Investment holding companies distributing dividends of less than DR 200 000 will not withhold tax as long as the shareholder declares that he has not been granted another exemption from the tax.
- Dividends distributed by an investment holding company are exempt from income and other taxes, levies, contributions, rights, and all other charges for the benefit of the State or third parties up to the amount that such dividends are derived from sales of securities or shares at a profit, the income from which is exempted from tax according to the existing provisions.
- In case the VCC is not an investment holding company, dividends of up to DR 50 000 per year per shareholder from any company quoted on the Athens Stock Exchange, up to a maximum total of DR 200 000 for dividends received from more than one corporation, are exempt from income tax.

Are specific regimes available?

(See Report about leating, II.2.4)

Transfer of shares

In case of transfer of the shares of the SME, do special taxes apply on these transfers?

Transfer of shares in general is exempt from VAT and from stamp tax.

2.4. Tax situation of X (individual shareholder)

Is the interest paid on the loans granted in view of the purchase of the shares of the SME deductible?

Yes, but only against income (dividends) arising from the shares and only where the loan is from prescribed lending institutions.

How are the dividends taxed?

The withholding tax on dividends is normally a final tax, although the shareholder may elect for income tax liability, with a credit for the tax withheld, in the case

of dividends on shares which are quoted on the Athens Stock Exchange or which are registered non-quoted shares.

The withholding tax withheld, rates and exemptions discussed apply here as well.

What is the capital gains taxation like if the shares of the SME are sold? What about capital losses?

In principle, there is no capital gains tax in Greece and these gains are tax-exempt. If the individual is required to maintain double entry books, the treatment will be the same as that described under 2.3. (taxation of the VCC). Otherwise gains are exempt and losses are of no effect.

2.5. In case the SME is not a company but an unincorporated enterprise

If the VCC participates in such an enterprise, how does this affect the position of the enterprise?

A limited partnership can be created. However, such a partnership must have at least one partner with unlimited liability. An investment holding company by definition cannot participate directly in an unincorporated enterprise.

Is a transparent company (partnership) created?

Yes.

If so, what are the tax implications (both for the enterprise and the VCC)?

The profits are taxed in the hands of the partners in their income tax category.

3. *Debt finance*

Preliminary question: Is there a debt/equity ratio to be respected?

Loan financing of business in Greece is generally not governed by any legal rules as such. It is guided by general economic conditions and the amounts granted depend on what can be negotiated with the lender and on the guarantee under which a particular business offers to undertake the loan.

3.1. Tax situation of the SME

Does the distinction between the following types of loans have implications on the tax situation of the SME?

- *ordinary loans,*
- *convertible loans,*
- *profit-sharing loans?*

No.

What is the deduction regime for the different types of loans?

Are there specific regimes available?

What is the situation if the VCC also participates in the SME?

Interest due or paid on loans incurred for purely business purposes is deductible.

Interest paid on the share capital of an SA is considered to be a profit distribution. However, interest paid on loans from shareholders can be deducted as a normal cost of finance.

If the VCC participates in the SME, excess interest paid to the shareholder (the VCC) will be considered as a hidden distribution and taxed as dividends.

Interest paid by enterprises qualifying under the incentive legislation is eligible for an interest grant. The Government has undertaken to subsidize the interest paid on loans made for the purpose of the investment. This subsidy will be in the same proportion to the interest paid as the ratio of the grant given to the total investment.

Interest subsidies will not be granted if the investment qualifies for tax-free investment allowance.

What is the withholding tax in each case of the different types of loans?

The withholding tax on non-exempt interest paid to a resident company is 25%. In addition to the withholding tax, a stamp duty is imposed on the payment of interest on loans at the rate of 1 to 4%. However, from 1991, only a 10% withholding tax is levied on interest received from bank deposits and from other interest-bearing securities issued by private banks and certain companies. If this condition is met, the SME shall only withhold 10% withholding tax.

Is an exemption of withholding tax applicable to interest payments by the SME to an investment company, shareholder of the SME?

No.

3.2. Tax situation of the company that grants a loan to the SME

What is the situation concerning the different types of loans: ordinary loans, convertible loans, profit-sharing loans, other types?

In respect of the taxability of the interest, are there exemptions or reductions for certain zones or activities?

No.

How are the capital gains on receivables taxed? What if the loan is converted into capital with capital gains or losses?

These capital gains are taxable at a flat rate of 30%.

Is a deferral of capital gains tax possible?

No.

Are capital losses on receivables realized by the VCC deductible?

If the taxpayer is in a position to prove that certain debts have become uncollectable and that they have been written off, then they are deductible.

Are interest payments for the acquisition of the funds deductible?

These interest payments are deductible.

Is there a withholding tax on interest paid by the VCC? Are exemptions available (e.g. in case of payments to the European Commission)?

Interest paid to a resident company is, in principle, subject to a withholding tax at the rate of 25%. However, a 10% rate can be applicable (see above). Interest payments to the Commission are not subject to any withholding tax.

3.3. Tax situation of the fund

Can the fund recover the withholding tax on interest, withheld by the VCC?

Yes, the withholding tax is similar to an advance tax. The gross interest is included with all other income of the enterprise and is taxed at the full rate with credit for the tax withheld at source.

Is the interest taxable?

Yes.

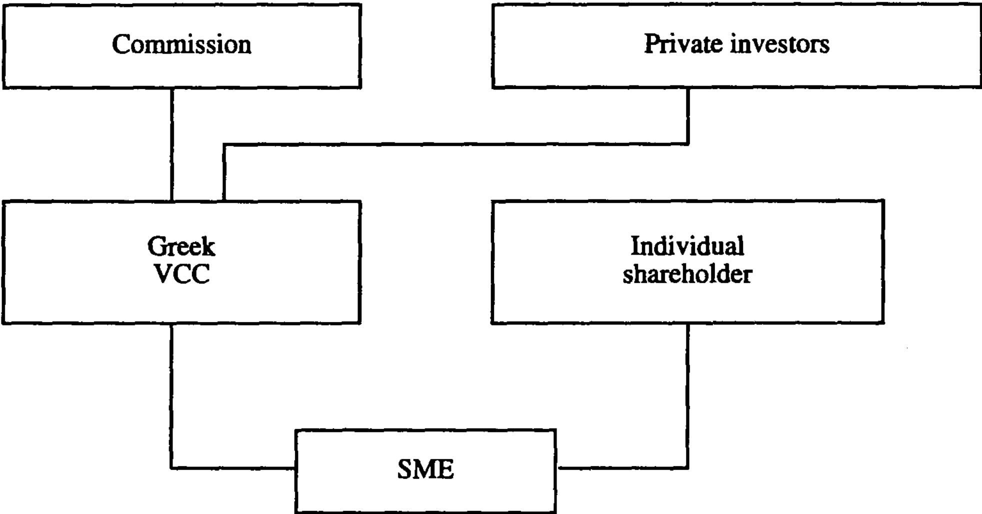
Is there a specific regime for funds?

No.

Practical guidance

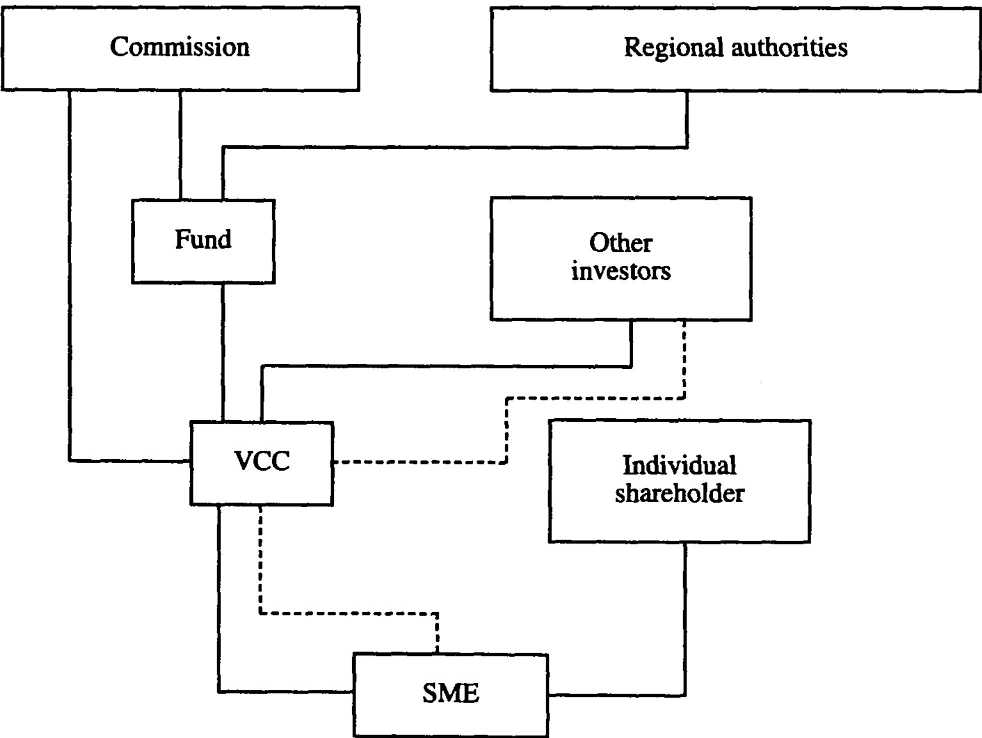
I. Equity finance

1. Scheme



II. Debt finance

1. Scheme



2. *Comments on structure*

2.1. *Position of the SME*

Costs of increasing capital:

For an SA, a capital concentration tax of 1% is due on contributions in cash; contributions in kind may be subject to the transfer property tax (9 to 13%).

For an EPE, similar capital duties are due.

These costs are tax-deductible.

Taxable base:

The profits of the SME (SA) are positively influenced by the capital increase.
This means that if normal losses would have occurred, because of the capital increase a better result can be shown.

The profits of an EPE are subject to income tax at a 15% rate. The partners, irrespective of whether such profits have actually been distributed or not, have to include these profits also in their tax returns. The tax borne by the EPE is credited against the invididual income tax liability of the partners.

Incentives exist which are profit-related. A higher capital may therefore be useful.

Tax rate:

The profits are taxed at a maximum of 6%. The SME (SA) is only taxed on retained profits.

Reduced rates are available depending on investment or nature of activity of SME.

Redemption of shares:

Not provided for under current provisions.

2.1. *Position of the SME*

Costs of granting loan:

1 to 4% stamp duty depending on the precise nature of the loan document concerned. These costs are tax-deductible.

Taxable base:

The interest payments are normally deductible expenses that have a negative impact on the results and the cash flow.

This situation may prove unwise because a loss position may be created (no immediate use of interest deduction).
Furthermore, some profit-related incentives may remain unused.

Tax rate:

The deductible interest payments save a taxation of 46%.

Reimbursement of the loan:

Has normally no impact on the taxable result.

Any gains resulting to shareholder are treated as a dividend distribution.

Dividend distribution:

The dividends are deductible from corporate net profits.

On the dividends distributed both to the individual shareholder and the VCC, a withholding tax ranging from 42 to 50% applies.

Tax rates may be reduced in certain circumstances.

Interest payment:

The deductible interest paid to the VCC is subject to a withholding tax at the rate of 25%. However, under certain conditions a 10% rate can be applicable.

2.2. *Position of the VCC*

Taxable base:

(a) Dividend income

A withholding tax is retained at the SME company level. This withholding tax can be a final tax for the VCC. When the VCC is an investment holding company the SME will not withhold any withholding tax.

If the SME is an EPE, the VCC is taxed on the profits of the EPE with the possibility to offset the 15% tax against its own tax liability. An investment holding company cannot participate in an EPE.

(b) Capital gains taxation

Investment holding companies are tax-exempt. For other VCCs, treated as regular trading gain but exempt if placed in a special reserve.

2.2. *Position of the VCC*

Taxable base:

(a) Interest income

This income is fully taxable at 46%.

(b) Capital gains taxation

The capital gain realized at the moment of converting the loan into capital is fully taxable.
Tax exempt in case of an investment holding company.

(c) Capital loss on shares	(c) Capital loss on loans
Deductible, but only from the gains on the sale of shares and securities in the same year or which have been or will be transferred to the special reserve.	In principle deductible.
Dividend distribution:	Interest payment to fund:
The normal rules apply. For an investment holding company distributed dividends are exempt from withholding tax to a certain extent. For listed companies, to a lesser extent.	A withholding tax at the rate of 25% or 10% applies.
Transfer of shares:	Transfer of loans:
Exempt from VAT and stamp duty.	No special tax applies.
2.3. *Position of the individual shareholder*	2.3. *Position of the individual shareholder*
Dividend income:	Dividend income:
The withholding tax, withheld at the level of the SME, is normally a final tax. However, he can opt for a full taxation of this income in which case he can offset the withholding tax against his own tax liability. Excesses are refunded.	See left side.
Purchase of the shares:	There is no transfer of shares to the extent a loan is granted. The interest burden remains thus with the SME.
The individual shareholder can normally deduct the interest burden against income arising from the loan proceeds.	
2.4. *Position of the fund*	2.4. *Position of the fund*
No divided income (see scheme).	The interest income is fully taxable. Apparently no special vehicles exist for interest income.

3. *Unincorporated SME*

The profits/losses of the SME are attributed as such to the VCC.
The VCC cannot be an investment holding company.

3. *Unincorporated SME*

If the VCC grants a loan, the interest is deductible by the SME and fully taxable for the VCC.

Conclusion

Equity finance

1. *Major disadvantages*

Costs related to increase of capital;

The capital increase will normally lead to a higher taxable base and thus to a higher tax burden with the SME;

For VCCs other than investment holding companies, the withholding tax, withheld at the SME level, can be a final tax for the VCC, but the rate (up to 50%) may be very disadvantageous;

The capital losses on the transfer of shares are only tax-deductible, in effect, from gains arising from similar transactions.

2. *Major advantages*
Costs related to increase of capital are deductible for tax purposes;

Some incentives are profit related. A higher equity will therefore be preferable. Furthermore, reduced rates are applicable;

Capital gains on shares realized by individuals are tax-exempted;

Debt finance

1. *Major disadvantages*

The deductible interest payments may lead to a loss position of the SME, whereas the interest income with the VCC is immediately taxable;

The issuance of some loan agreements may give rise to indirect taxes;

Interest payments are subject to withholding tax and a stamp duty of 1 to 4%. This stamp duty is an additional cost;

Due to a lack of profits, some incentives will remain unused.

2. *Major advantages*
The taxable base of the SME will normally be reduced;

The risk of double taxation (with SME/VCC) does normally not exist;

The capital losses are deductible;

If the VCC qualifies as an investment holding company, dividend income is always tax-exempted and the SME does no have to withhold any taxes;

The transfer of shares is tax-exempt;

In case of financing the purchase of shares, the individual shareholder can normally deduct the interest burden.

The private shareholder is not confronted with a purchase of shares.

Greece	Equity		Debt		
	VCC normally taxed	Investment holding company[1]		VCC normally taxed	Investment holding company[1]
SME profit distributed as dividend	100	100	Interest payment deductible with SME	Yes[4] (–100)	Yes[4] (–100)
Corporation tax[2]	0	0	Withholding tax	–25[5]	0
Withholding tax e.g. 50%[3]	–50	0	Interest income before tax at recipient's level	75	100
Net dividend at recipient's level	50	100	Taxable base	100	0
Taxable base	100	0	CIT 46%	– 46	0
CIT at recipient's level 46%	– 46	0	Tax borne at source	25	0
Tax borne at source	50	0	Tax still due	21	0
Restitution	4	0			
Net dividend after tax	54	100	Interest income after tax	54	100

[1] Investment holding companies are exempt from any taxation on received dividends (and on its total income).

[2] For the time being, corporation tax is not due on distributed profits.

[3] Rates vary from 50 to 42% depending on whether the shares are registered or bearer shares and whether they are quoted on the Athens Stock Exchange or not (lower rates apply in case of quoted shares). Withholding tax can be credited against CIT liability of the VCC; any excess is refundable. For dividends coming from an SA (corporation), the VCC may opt for the withholding tax to be the final taxation.

[4] However, when the VCC participates in the SME, excessive interest is considered hidden distribution and is taxed as dividends.

[5] Reduced to 10% under certain circumstances.

III. Other Issues

1. *Local and regional authority issues*

Local or regional authorities are allowed to participate in the provision of venture capital to SMEs as long as they comply with the rules. Thus there are no special rules applicable to such authorities.

2. *Impact assessment*

Venture capital legislation is still in its infancy in Greece.

At present, the main venture capital companies operating in Greece are:

- Alpha Ventures SA, the subsidiary of Credit Bank, the largest Greek bank in the private sector. Some well-known Greek entrepreneurs have participations in the capital of this venture capital company.
- Hellenic Participations SA, the subsidiary of Eteva, a Greek investment bank in the public sector controlled by the largest Greek bank, the National Bank of Greece.

A certain interest has been expressed by other banks in establishing venture capital companies.

Venture capital still is relatively unknown and, therefore, an undeveloped financial technique in Greece in spite of the fact that the Greek market could profit from it. Very often Greek entrepreneurs have original ideas about starting or expanding a business but lack the capital, which is the exact situation for which venture capital is appropriate. The main reason for this delay is not to be attributed to the legal framework, which, in general, is favourable to the new technique. It is principally due to the unsophisticated Greek financial system and to the serious problems that the Greek economy is encountering.

The law on venture capital introduces a flexible framework as to the establishment procedures and the regulatory and supervisory standards, if compared to other institutions offering financial services. Grants and taxation incentives are also considerable. Financing of venture capital companies is facilitated, since the Greek legislation has rendered the debt instruments issued by them most attractive.

However, the system is still characterized by deficiencies. The most important deficiency of the legal framework is the absence of any provision limiting venture capital companies' power to liquidate their portfolio. Certain limitations should have been enacted because the mission of venture capital companies is not confined to financing newly established or growing companies but comprises also management assistance and strategy consultation. Besides, imposing the obligation on venture capital companies to retain the stock of the companies they finance for a specified period of time excludes the danger of hostile takeovers at prices below the market value of this stock by larger companies engaging in the same business.

The main reasons, however, for the limited expansion of venture capital are not the legal impediments, but the financial environment. The first negative fact to be mentioned is the absence of well-organized capital markets, especially of an 'over-the-counter' market, where venture capital companies will have the possibility to 'recycle' their portfolios. The Greek over-the-counter-market, the so-called 'parallel market', has been established very recently and it lacks the necessary breadth. (At present, only seven companies are listed!) The development of the Greek capital markets will also increase the potential sources of financing for venture capital companies – it will not be confined to institutional investors but it will also comprise individuals.

Factors that cannot be forgotten with respect to the delay of the development of venture capital in Greece are the slow pace of Greek industry, the severe deterioration of the basic indexes of the Greek economy (high inflation rate, budget deficit, balance of payments deficit) and political instability.

Venture capital has definitely a long way to go in Greece. Nevertheless, it is a financing technique which can offer a great deal to Greek enterprises and this will show that it has favourable future prospects.

IV. Comparative legal and regulatory issues

1. *Absent positive features*

Below we deal with the positive measures in other Member States but which are absent in Greece.

1.1. Greek legislation is more restrictive with regard to the providers of venture capital

In most EC Member States several venture capital vehicles exist, while in Greece there is only one, that is the société anonyme which specializes in this type of financing. One should not ignore, however, that the wide array of vehicles in other EC Member States is due to the absence of specific venture capital legislation.

Relevance of absent feature

The best approach to this issue as far as Greece is concerned is to follow the British concept (see United Kingdom, Section I.1), that is, while maintaining specialized venture capital vehicles, to expand the offer of venture capital to other investment vehicles, which would engage in the venture capital financing technique marginally along with other investment activities.

Introduction into national law

The transformation of the Greek venture capital market with the above aims in mind gives rise to the following considerations:

(a) The existent specialized venture capital vehicle, the venture capital company, should be maintained as it is the most appropriate legal form to play this role. Venture capital companies, however, are unsuccessful legal forms in one respect, that is they are incapable of directly attracting savings from the public. As a result, under the existing structure of the Greek venture capital market, only savings of sophisticated investors are channelled to venture capital companies. This deficiency could be corrected by the introduction of funds specialized in venture capital, such as the French 'Fonds communs de placements à risque' (France, Section I.3) or the Spanish 'venture capital funds' (Spain, Section I.3). The same function could also be performed by companies which still have access to the savings of the public, such as the German 'public enterprises holding companies' (Section I.3).

(b) Provision of venture capital through other vehicles would be advisable but only to a limited extent, that is to the extent the investment policy pertinent to their nature permits. This could be accomplished if the existent non-banking financial institutions, mainly mutual funds and investment companies, had access to the grants provided by the Minister for the National Economy when undertaking venture capital investments.

1.2. Greek legislation is more restrictive with respect to the recipients of venture capital

Absence of positive feature

Venture capital in Greece can only be received by two types of companies, namely by sociétés anonymes and by limited liability companies. By contrast, other EC Member States provide venture capital to partnerships as well.

Relevance of absent feature

This would be a positive feature to be introduced in Greece, since many entrepreneurs choose the legal form of partnerships within which to operate. The German way of venture capital provision to partnerships, which is based on the establishment of a silent partnership relationship between the provider and the recipient of

venture capital (Section I.3), is considered the best example for Greece to follow.

1.3. Greek law is more restrictive regarding the activities which are eligible for venture capital financing

Absence of positive feature

Under Greek law, venture capital is provided only for the financing of investments in high technology and innovation, whereas such a restriction is absent from the legislation of other EC countries. Given that Greece is not an industrialized country, it is clear that the aforementioned restriction is more severe than it may appear.

Introduction into national law

It is, therefore, suggested that the criteria under which an investment is eligible for venture capital financing are phrased in a generalized way in the law. A good example to follow would be the eligibility criteria for the activities to be financed by the French 'sociétés de capital risque' (Section I.3). These determine as target companies for venture capital finance French or EC companies not listed on any stock exchange, subject to corporate taxation and active in the industrial or commercial field. A further definition of the scope of the investment policy of venture capital vehicles could be imposed on them, obliging them to include this definition in their articles of association, statutes, etc.

A more relaxed approach to the investment policy of venture capital vehicles could be taken, if supplemented, by the following measures:

(a) A liberalization of the investment policy should not mean that venture capital vehicles are free to adopt unsound management practices. The State's intervention in this respect is not only meaningful but also necessary. Rules introducing safe accounting standards, such as ceilings, ratios, etc., prohibitions of transactions from which conflict of interest situations might arise and penal sanctions in cases of violation of these standards should be enacted in a more detailed way than the ones already in effect. French and Irish law seem to have strongly emphasized sound management rules and could serve as an example (see France, Section I.3, Ireland, Section I.5).

(b) It is understandable that the existing legislation on grants given to eligible investments could not be applied in the same way as the scope of the eligible investments becomes broader and as venture capital is provided by more vehicles. The restriction of grants to a smaller circle of venture capital investments will be necessary. The criteria of eligibility for grants will have to be stricter than those defining eligible investments. It is, therefore, suggested that the high technology and innovation criteria are abandoned in this case too and that they should be replaced by the criteria applied by Ireland, a country of comparable economic profile. In such a case eligible investments would be, in addition to those regarding advanced technology, those regarding products for sale primarily on world markets, products of sectors of the economy which are subject to international competition and products of specified service industries (Ireland, Section I.4).

2. *General recommendations*

Greek local or regional authorities should continue not to provide venture capital.

The absence of local or regional authorities as providers of venture capital is not to be overestimated in a country like Greece where the efficiency of the public sector is very poor and consequently the confidence it enjoys is very weak. Therefore, the fact that other EC member countries have used regional and local institutions in order to serve their regional development policy schemes is not to be considered as a positive measure to be introduced in Greece. As long as the Greek local and regional administration has inherent deficiencies, it had better leave the venture capital industry to the private sector.

Ireland

Introduction

The Irish venture capital market is relatively sophisticated, with an availability of a wide range of vehicles and methods. There are no significant obstacles to venture capital financing in Ireland, although compliance costs are significant.

As far as tax matters are concerned, no real obstacles present themselves. A disadvantage, however, is that capital gains on shares are in principle always taxable.

On the other hand, it can be considered advantageous that reduced rates apply to certain SMEs and that double taxation is avoided because dividend income is exempt with the receiving VCC.

I. Legal and regulatory issues

1. *Typical investment vehicle used*

There are a large number of vehicles used for the operation of venture capital in Ireland. The list is as follows:

- individuals;
- partnerships;
- limited partnerships;
- trust;
- private limited company;
- unlimited company;
- public limited company;
- State agencies and local authorities;
- collective investment schemes.

2. *Applicable legal measures*

Different legal measures are applicable to the different vehicles listed above.

- General

Central Bank Acts 1946-89

Bills of Exchange Act 1882 (as amended)

Exchange Control Acts 1954-90

Money-lenders Acts 1900-33, as amended by the Central Bank Act 1989

case law

- Individuals

Case law

Exchange Control Acts 1954-90

Money-lenders Acts 1900-33, as amended by Central Bank Act 1989

These legal measures impose restrictions on the denomination of both equity capital and debt capital in which individuals may invest.

- Partnerships

Partnership Act 1890

Case law

- Limited partnerships

Limited Partnerships Act 1907

Case Law

Partnership Act of 1890 (in so far as it does not conflict with the 1907 Act).

- Trust

Trustee Act 1893

Trustee (authorized investments) Act 1958

Case law.

- Private limited company, unlimited company, public limited company

Companies Act 1963-90

European Community directives

Case law

- State agencies and local authorities

Industrial Development Act 1986 (as amended)

Local Government Act 1991

Both of the above apply generally. As examples of local measures adopted we may cite:

Shannon Free Airport Development Company Limited Act 1959, as amended

Udaras na Gaeltachta Act 1979 (as amended)

- Collective investment schemes

European Communities (Undertakings for collective investment in transferable securities) Regulations 1989

Unit Trusts Act 1990

Companies Act 1990

Notices issued by the Central Bank, which is the entity in Ireland responsible for the authorization and supervision of the funds

Designated Investment Funds Act 1985

3. *The investment vehicle*

There do not appear to be any significant legal obstacles to the operation of venture capital vehicles. They have to comply with certain formalities, however, as described below.

General

Exchange control imposes restrictions on the denomination of both equity capital and debt capital investments. The Exchange Control Acts 1954-90 restrict an Irish resident (whether an individual or other entity) from owning equity capital or debt capital denominated in a currency other than Irish pounds. The issuing of bearer securities in Ireland requires consent under this legislation. It is doubtful whether private limited companies may issue bearer equity securities because the transferability of equity capital in private limited companies must be restricted.

With regard to debt capital, the Money-lenders Acts 1900 to 1933 (as amended by the Central Bank Act, 1989) oblige a person engaged in the business of lending money to obtain a money-lenders' licence and to comply with matters such as maximum interest, restrictions on advertising and the use of canvassers, prohibition of compound interest or default interest, restrictions on the form and content of the money-lending contract and prevention of the borrower being obliged to pay the costs and expenses of the transaction. The legislation only applies if the person is engaged in the business of making loans. There is an exemption for anyone carrying on banking or insurance or any business which does not have lending money as its primary objective.

The licensing authority is the District Court, which is the lowest court in Ireland. Application is preceded by an advertisement in a local newspaper followed by a court hearing at which anyone can make an objection to the granting/renewal of the licence. The annual licence fee is IRL 200.

If one uses a name other than one's surname, that other name must be registered under the Registration of Business Names Act 1963. The register is a public document. Details of the business and the person running the business must be disclosed and kept up to date. A fee of IRL 10 is payable on registration and IRL 4 on any change of particulars. The Register of Business Names is kept by the Registrar of Companies.

There is no obligation on individuals to publish accounts.

Partnerships

The partnership does not have separate legal personality. Partnership is defined as the relationship which subsists where persons are carrying on business in common with a view to profit. Partners are jointly liable in tort and severally liable in contract and are bound by acts done on behalf of the 'firm', as a partnership is often known. Internally it is up to the partners to decide how their business is to be regulated and profits divided. In the absence of agreement to the contrary, the law will imply certain matters, such as that all must agree before a new partner is admitted and that decisions are to be taken by simple majority.

As the partnership is only a group of individuals, the same restrictions and registration requirements apply as with individuals (see above). In particular, if the firm uses a name other than the surnames of all the partners, then details of the partners and the firm's business must

be registered on the Register of Business Names and kept up to date.

At present there is no obligation on the partnership to publish accounts. However, a Council Directive, when implemented, will require certain partnerships with partners having limited liability to publish accounts.

Limited partnerships

The limited partnership does not have separate legal personality.

A limited partnership consists of one or more persons known as general partners who are liable for all debts and obligations of the firm and one or more persons called limited partners who are not liable above a certain specified amount. A limited partner may not take part in the management of the firm's business. The general partners have control over the business. Subject to agreement to the contrary (a) consent does not have to be obtained from existing limited partners to introduce a new partner, (b) a limited partner cannot dissolve the partnership by notice and (c) a limited partner cannot assign his share without getting the consent of the general partners.

Certain information must be delivered to the Companies Registration Office. The partners must be listed, detailing which are general partners and which are limited partners. The amount of contribution must be disclosed in the case of the limited partners and on any increase of such amount.

An entity with limited liability, such as a private limited company, may be a general partner and therefore it is possible at present for individuals to achieve limited liability without the necessity of publishing accounts albeit that separate legal personality is not achieved and that the individuals in case they are limited partners cannot take part in the management of the business.

The register of limited partnerships is a public document.

There is no obligation on a limited partnership to publish its accounts. However, a Council Directive, when implemented in total, will require certain partnerships with partners having limited liability to publish accounts.

Trust

In a trust the legal and beneficial ownership of property is split. Trustees hold the property and operate the trust on behalf of the beneficial (in effect the real) owners. Some of the beneficial owners may also be the trustees. The trust does not have legal personality.

A trust may arise because of the unilateral act of the person creating it or by agreement or by operation of law. In the business context, the relationship usually arises as a result of an agreement between the beneficiaries. For example, a private limited company must convert to a public limited company if its registered membership exceeds 50. However, it is possible for one person to act as trustee for a number of beneficial owners, thereby enabling the company to maintain a registered membership below 50 and yet have more than 50 beneficial owners. Likewise one person could be the registered owner and trustee of debt securities for a number of beneficial owners.

The trust deed should set out all matters to do with appointment, resignation, reappointment of trustees and the day-to-day management of the trust. The words in the document creating the trust must be imperative, the subject matter of the trust must be certain and the 'objects' (those to be benefited) must be certain. In the absence of a provision in the trust deed for reappointment then there are statutory powers for the surviving or continuing trustees to appoint a replacement or alternatively for the personal representative of the last surviving or continuing trustee to make the appointment. An application may be made to the High Court if necessary for a new trustee to be appointed.

There is no obligation on a trust to publish its accounts.

Private limited company

A private limited company has a separate legal personality from the time it is incorporated.

To incorporate it, the following is required:

- two members (who may also be the directors if they are individuals and/or the secretary);
- two directors (both of whom must be individuals as distinct from corporate entities);
- a secretary (who may be one of the directors or alternatively which may be a corporate entity);
- a memorandum of association listing the objects for which the company is established;
- articles of association specifying how the company is to be regulated internally;
- capital duty statement outlining the authorized and issued equity capital.

The requirement for two members will be reduced to one when the 12th Directive is implemented. The applicable legislation contains a standard set of articles of association known as Table A. Table A applies to the extent that the particular articles of association of the company do not exclude it. The incorporation fee is IRL 166. Capital duty is levied at the rate of 1% of the market value of the equity capital being issued. There is no minimum issued equity capital requirement for a private limited company but the minimum capital duty payable is IRL 1. Incorporation is a relatively quick and cheap procedure.

A private limited company must be subject to an audit each year and statutory accounts must be filed in the Companies Registration Office. Since 1987 all private limited companies must disclose accounting information.

There must be an annual general meeting where the members may review what has been happening in the business and (if appropriate) elect directors and decide on a dividend.

Companies must keep registers of various categories of information, such as a register for equity capital, a register for debt capital, copies of any security granted by the company, a register of a director's interest in contracts with the company and most importantly a register of any interest of a director or connected person in any equity capital or debt capital in the company.

The creation of any charge must be registered in the Companies Registration Office within 21 days. Therefore, if secured loan stock is being issued, the security as a charge on the company assets must be registered to be effective. The filing fee is IRL 12.

Equity capital constitutes the fund of last resort for creditors and equity capital owners in the company. If the net assets of a company are half or less of the called-up share capital then the directors must convene an extraordinary general meeting of the members to consider what steps should be taken to deal with the situation. On the basis that capital maintenance should prevent the company from financing an acquisition of its own shares, such financing may only take place if the company is a private limited company and is solvent after giving the financial assistance.

A private limited company may, since the implementation of the Companies Act 1990, buy back its own equity capital if it finances the transaction either by making a fresh issue of equity capital for the purpose or from profits. Previously, equity capital had to be in the form of redeemable preference shares.

Unlimited company

An unlimited company has separate legal personality once it is incorporated.

The major drawback of an unlimited company is, as the name suggests, that there is no limitation on the liability of the members or persons who have been members within one year of liquidation. The liability arises only after liquidation, not before. The advantages are that there is no capital duty payable on allotment or transfer and (at present) there is no requirement to publish accounts.

Public limited companies

In addition to the applicable legal measures referred to in section 2 above, companies whose securities may be dealt with on the Stock Exchange are subject to supplementary regulation. A public limited company has separate legal personality once it is incorporated.

The major advantages that a public limited company has over a private limited company are that there is no need for it to limit its registered membership to a maximum of 50, it usually does not have any restrictions on the transferability of its equity capital or debt capital, and it may offer equity capital and debt capital to the public.

Because of the extra privileges that a public limited company has, it must also meet extra requirements. The public limited company must have a paid-up share capital of IRL 30 000 before commencing trading. It cannot issue an invitation to the public to subscribe for equity capital or debt capital until it has published a prospectus, or in the case of a company whose securities are on the official list, listing particulars.

The rationale behind the prospectus is to ensure that potential investors in the company have sufficient information to enable them to make a decision as to whether or not to invest. Substantial details of the company's financial commitments, material contracts entered into by the company during the previous years and statements by experts about company assets must be given. Details of any allotments made must be disclosed. A full description must be given of any options in respect of equity or debt capital. Any capital issued for non-cash consideration must be detailed. Matters such as commission and expenses must also be outlined. Any interest of a director in any relevant transaction must be disclosed. The auditors must report not only on profit and loss but also on rates of dividends on shares in previous financial years. The number of years for which such information must be furnished varies between three and five years depending on the market (if any) of the Stock Exchange on which the securities are to be traded.

Usually a company which is making an offer to the public will wish to obtain a quote for its securities on the Stock Exchange to enable the securities to be freely transferable and marketable. The International Stock Exchange in the United Kingdom and the Republic of Ireland Ltd fulfils this function. The European Communities (Stock Exchange) Regulations 1984 implemented three European Community Directives on listing requirements, namely the Admission Directive, the Listing Particulars Directive and the Interim Reports Directive. The Committee of the Irish unit of the Stock Exchange is the competent authority for the Republic of Ireland. The European Communities (Stock Exchange) (Amendments) Regulations implemented the Directive on mutual recognition of listing particulars.

Detailed company information must be given in the listing particulars. Once securities have received a quote on the Stock Exchange then further information must be published to keep investors up to date. For a company's securities to be admitted to the official list, the company must have a minimum market value of IRL 7 000 000 and at least 25% of the listed securities of the company must be in the hands of the public. The listing particulars must be lodged in the Companies Registration Office before publication. As well as the official list, there are other markets which enable companies to obtain marketability of their capital without having to comply with the full requirements of the official list.

The unlisted securities market (USM) is not subject to the 1984 Regulations and Directives but is subject to Companies Act prospectus requirements and Stock Exchange rules regarding the USM. Once again the rationale is to ensure that investors have the necessary trading and financial information to enable them to judge the value of the company. To get a quote on the USM accounts covering two years must be disclosed. Minimum capitalization is IRL 2 000 000.

The smaller companies market (SCM) has less onerous requirements than either the official list or the USM. The SCM is designed for three categories of entities, namely an existing small Irish company, a new company or body which has not commenced trading and companies approved under the business expansion scheme. It is up to the company's sponsor to ensure that

the company is properly organized and also to ensure that the company's securities are readily marketable. The minimum capitalization is IRL 200 000. The company must be incorporated and managed and operated in Ireland. The disclosure requirements are similar to those imposed on USM companies. The Stock Exchange will not allow a company to enter the SCM if it considers it to be more suitable for the USM or official list.

Finally there is what is known as the mineral exploration market which consists entirely of oil and exploration companies, which in fact constitutes a group of companies whose securities are traded under Rule 535 of the Stock Exchange rules.

Misstatements in the prospectus or listing particulars give rise not only to civil but also to criminal liability. It is therefore a very time-consuming and expensive task to prepare a flotation in that all statements made in the prospectus/listing particulars must be checked and substantiated or 'verified' wherever possible by documentary evidence and expert reports.

Collective investment schemes

These may take the form of a trust (known as unit trust) or a company (known as an investment company). Either form may be utilized to operate a UCITS. The Regulations have no application to undertakings whose investment policy provides for the placing of 25% or more of their net assets in high-risk capital.

A scheme may be constituted under the Unit Trust Act 1990. This is an unincorporated (no separate legal personality) fund established by a trust deed with a management company and a trustee. The assets are held in the name of the trustee but are beneficially owned by the unit holders.

An investment company with a variable share capital may be set up under the Companies Act 1990 or the UCITS Regulations. The share capital of the company is equal to the assets of the fund owned by the company in which the investors hold shares. The UCITS Regulations and the Central Bank notices require that the assets be held by a trustee, rather than directly by the company.

Central Bank notices outline requirements to be met before the Central Bank will authorize unit trusts and investment companies. The notices set out trustees' obligations, require the publication of a prospectus and limited permissible investments. Monthly returns must be made to the Central Bank so that it may monitor the performance of the entity. Reports must be published half-yearly.

Designated investment funds

These are trust funds established to take advantage of tax relief afforded to individuals under the Business Expansion Scheme (BES) (initiated in the Finance Act 1984) where tax relief is given to investors in manufacturing and other specified activities. The Business Expansion Scheme relief has been restricted in the last year following the development of schemes, particularly in the area of tourism, that were not seen as genuine risk capital ventures. Since 1984 approximately IRL 80 million has been invested in manufacturing companies under the BES relief.

The Designated Investment Funds Act 1985 provides that these funds are not subject to the Unit Trust Act. In a designated investment fund each subscriber owns a specific share in the company receiving the investment, though the share will be held by a nominee for an initial period of five years. All subscriptions must be paid by a specific date, after which no new subscribers may join the fund. The Act provides strict rules (and penalties) on the circulation of prospectuses which must be approved by the Minister for Industry and Commerce.

The trustees of a designated investment fund must enter into an agreement with a private company prior to investing money in that company to enable a subscriber to have the shares transferred into the participant's name, after the initial five-year period. This could mean that the number of members in the company increases above 50 and accordingly the agreement must provide the specific steps that the company will undertake to convert

itself into a public company, i.e. make alterations in its memorandum and articles of association.

Equity finance

A company may obtain venture capital through direct investment from its shareholders. The interest of a shareholder in a company and the rights attaching to his shares are defined by the memorandum and articles of association of the company. These documents in effect constitute a contract between the various shareholders, and subject to the overall statutory framework the parties are free to create different types of share with varying rights attaching to them. The share capital must be divided into fixed amounts though different classes of shares can have different fixed amounts.

A wide variety of shares can be issued by an SME wishing to benefit from venture capital finance. These include:

- ordinary shares;
- deferred shares;
- non-voting or restricted shares;
- redeemable shares;
- preference shares;
- cumulative preference shares;
- participating preference shares.

These shares are all subject to Irish company law. There appear to be no significant legal obstacles which would give rise to difficulties for SMEs seeking equity finance.

Debt capital

In its simplest form, debt capital is a promise to repay money lent. Commercial paper, consisting of promissory notes and bills of exchange on which value may be obtained before the due date by discounting, are common forms of such debt capital.

With regard to companies, the usual terminology used to describe medium or long-term debt is debentures or loan stock.

Redeemable or perpetual debentures may also be created. Redeemable debentures need not be redeemed out of profits. A transfer of a debenture must not be registered by the company until an appropriate instrument of transfer has been registered.

A development of debt capital is the convertible which may be changed into equity on the happening of a specified event or at the option of the holder.

These various forms of debt capital are all subject to Irish company law. There appear to be no significant legal obstacles which would give rise to difficulties for SMEs seeking debt capital finance. However, public offers of commercial paper are subject to Central Bank regulation and supervision.

State agencies and local authorities

The usual methods of State agencies becoming involved in assisting enterprises is through grants, training and subsidies. However, various agencies have the power to engage in venture capital investment and a recent amendment to national law enables local authorities to become active.

The primary State agency in the area of industrial development is the Industrial Development Authority (IDA) which is regulated by the Industrial Development Act 1950 as amended. Since 1977 the IDA has had the power to purchase equity or preference capital in certain enterprises.

Shannon Free Airport Development Company Limited, while being a State agency in the development of the mid-western region of Ireland, is nevertheless a private limited company and the legislation consisting of the Shannon Free Airport Development Company Limited Act 1959 as amended is to enable government investment through grants.

Udaras na Gaeltachta is a State agency charged with the development of the Gaeltacht areas of Ireland. These areas are spread along the western seaboard in the main. Udaras has power to hold equity capital.

Until the Local Government Act 1991 local authorities had to adduce specific statutory authority for each action they wished to take. However, when the 1991 Act is brought into force it will enable local authorities to take action to promote the interests of their local communities. Various measures, including loans or other financial aid, are specifically authorized by the 1991 Act.

4. *The recipient of venture capital*

There are no restrictions on the recipients of venture capital in Ireland. However, private limited companies cannot raise money by means of an offer of equity capital or debt capital to the public.

With regard to limits on entities in which the IDA may invest, the following is the position.

The entity in which the capital investment is to be made must satisfy the IDA that it will:

- produce products for sale primarily on world markets;
- produce products of an advanced technological nature for supply to internationally trading or skilled sub-supply firms within Ireland;
- produce products for sectors of the Irish market which are subject to international competition, or
- is a specified service industry, and

the entity must also satisfy the IDA that:

- the financial assistance is necessary to enable the establishment or development of the undertaking;
- the investment is commercially viable;
- the entity has an adequate equity base;
- the entity has prepared a suitable company development plan, and
- the entity will provide new employment or maintain employment in Ireland that would not be maintained without the assistance and increase output and value-added within the economy.

The IDA must obtain the approval of the Minister for Industry and Commerce if the acquisition would result in the IDA, whether alone or with any other State sponsored bodies, holding more than half of the voting rights in the company. The IDA cannot spend more than IRL 1 500 000 in acquiring shares in an entity with prior government approval.

5. *The provision of venture capital*

In general, there are no significant restrictions on the provision of venture capital finance in Ireland. The following formalities, however, have to be complied with.

General

A notice of the Central Bank made under the Central Bank Act 1989 restricts the power to issue debt securities to the public to certain entities which satisfy certain capital adequacy requirements and limit the maximum amount that can be issued. This arises because of the definition of 'banking business' as including the raising of money from the public through the issue of debt securities.

- Individuals, partnerships and limited partnerships

No particular issues arise under these three structures.

- Trusts

The property which is the subject of the trust vests in the trustees. The trustee must operate the trust in conformity with the trust deed, ensure that all the trust property is under its control and operate the trust property in the best interests of all the beneficiaries. If there is no power of investment in the trust deed then the trustees are limited to authorized investments. It is there-

fore important that the investment provisions in the trust deed are suitable for the transaction or a particular situation. Authorized investments include specified bank deposits, government securities, securities of State guaranteed entities such as the Agricultural Credit Corporation plc, certain local authority securities and certain types of debt capital (but not equity capital) of publicly quoted industrial and commercial companies registered in Ireland provided that the total of such debt capital does not exceed the paid-up share capital and that a dividend of at least 5% has been paid on the ordinary shares in each of the preceding five years. It should be noted that not only are ordinary shares in publicly quoted companies excluded from the list but also matters such as unit trusts, investment trust and insurance bonds are excluded.

- Private limited company

A capital duty of 1% is paid on the value given for any equity capital issued to the public and it must restrict the transferability of its equity capital.

The potential for abuse of limited liability has been restricted by the Companies Act 1990. Transactions between directors and connected persons on the one part and the company on the other part in the area of debt are severely restricted. The only other avenue for investment is equity capital investment. While the restrictions have laudable objectives some have suggested that it would be better if the test was one of whether the company was solvent when the transaction was taking place rather than whether the type of transaction was one which gave rise to the possibility of abuse. The difficulties which directors and connected persons are finding in carrying out transactions involving debt are in many cases hampering legitimate business.

The major restrictions on the marketability of equity capital and debt capital in a private limited company are that its membership cannot go above 50 (in terms of registered membership), and it cannot offer equity capital and debt capital.

- Unlimited company

No capital duty applies. The restrictions imposed by the Companies Act 1990 to control abuse of limited liability also (paradoxically) apply to unlimited companies.

- Public limited company

While the fees incurred in bringing a public limited company to market or in bringing a new issue to market depend on the market which the company or issue is being brought and the amount which is being floated. The following figures can give some indication as to the costs incurred in raising capital in this way:

(i) capital duty of 1%;

(ii) legal and accountancy fees: IRL 100 000 to IRL 500 000;

(iii) underwriter's fees: 2% (of which 1.25% is paid to sub-underwriters);

(iv) broker's fees: variable;

(v) Stock Exchange fees.

Equity finance

- Issue of share capital

Under standard form memorandum and articles it is the directors of the company who have the power to allot shares. However, there are statutory restrictions imposed by the 1983 Act (which implemented the second Directive) on the exercise of these powers.

Section 20 of the 1983 Act prevents directors issuing shares for cash (or share options or convertible securities), other than shares issued in pursuance of an employee share scheme, unless they have been authorized to do so by:

(i) the shareholders in a general meeting, or

(ii) the articles.

This authority cannot extend beyond a five-year period but it may be renewed. The authority when given can be in a form which restricts it to a particular issue(s) of shares.

In addition, Section 23 of the 1983 Act gives existing shareholders pre-emption (first refusal) rights over new issues of 'equity securities'. Equity securities do not include bonus shares. Preference shareholders and shares held or allotted in pursuance of an employee share scheme do not qualify for pre-emption rights. In private companies the pre-emption rights can be excluded by the memorandum or articles. If shares are to be issued as part of an employee share scheme, the general body of shareholders have no pre-emption rights over that issue.

Shares can be allotted for 'money or money's worth including goodwill and expertise' but cannot be allotted at a discount. Within one month of an allotment the company must deliver to the Registrar of Companies a return of allotments stating:

(i) the number and nominal value of the shares allotted;

(ii) the names, addresses and occupations of the allottees;

(iii) the amount, if any, paid, or due and payable, on each share.

Capital duty must be paid at the rate of 1% of the value of the shares being issued. When shares are allotted for a non-cash consideration the company must deliver to the Registrar of Companies the written contract (or written particulars, if no written contract exists) constituting the allottee's title to the shares. In private companies there is no examination into the adequacy of the consideration. Stamp duty of 6% is payable if shares are allotted for the acquisition of real or leasehold property and certain assets. However, for public companies an independent expert is required to value any non-cash consideration.

There are additional restrictions imposed on public limited companies. They may not allot shares:

(i) if it is return for an undertaking to do work or perform services for the company or any other person; or

(ii) if it is return for a deferred payment which can be made more than five years after the allotment; or

(iii) unless it is paid up to at least 25% of the nominal value of the shares together with the whole of any premium.

Public limited companies may not make an allotment unless the following conditions are met:

(i) there has been a minimum response to the invitation to the public to subscribe;

(ii) the company must allow a short period between the issue of the prospectus and the issue of the shares;

(iii) if it has been stated that a Stock Exchange quotation will be sought, it must be obtained.

- Transfer of shares

One of the essential differences between public and private companies is that the right to transfer shares in a private company must be restricted. This is usually done in Ireland by the adoption of a standard provision in the articles giving the directors a discretion to refuse to register a transfer. This can enable the directors to block a transfer to a person they do not approve of as their only duty in exercising this power is to act in good faith in the interests of the company. It may be very difficult to establish evidence of bad faith on the part of the directors.

The other means generally used to restrict the free transfer of shares is by inserting pre-emption rights requiring the person wishing to transfer shares to offer them first to the existing shareholders. If these rights are

not taken up then the directors' discretion to refuse to register a subsequent transfer to a non-shareholder is not applied.

The Stock Transfer Act 1963 provides a form to be used to transfer fully paid shares in a limited company. It needs only to be signed by the transferor. In the case of a transfer of a partly paid share, it is the practice to require both parties to sign the instrument. The share transfer must be stamped by the transferee with *ad valorem* stamp duty at the rate of 1%. The duly stamped transfer must be delivered to the company along with the relevant share certificate. The company may not enter any transfer in the register of members which is not a 'proper instrument of transfer'.

Collective investment schemes

A UCITS fund may not invest more than 10% of its assets in securities which are not traded in or dealt on a market which is approved by the Central Bank or in securities issued by the same body. If the sole object of the fund is investment in venture capital or development capital the minimum subscription must be IRL 10 000, the fund may invest up to 20% of net assets in any one company or group, the title of the fund must make it clear that it is a venture capital fund and the prospectus must contain prominent risk warnings. At present, no venture capital funds have been established, although there are a number in preparation which may be authorized in the near future.

Debt capital

A Central Bank notice, made under the 1989 Act (see section 2 above), restricted the power to issue debt securities to the public to certain entities which satisfy capital adequacy requirements and limits the maximum amount that can be issued. The Bills of Exchange Act 1882 also applies. The only formality required for the promissory note is a 7p revenue stamp. A promissory note is an unconditional written promise to pay an ascertainable amount at an ascertainable time in the future to a specified person or bearer. A bill of exchange must also have a revenue stamp and is an unconditional order directing the addressee to pay a third party. The essential difference between promissory notes and bills of exchange is that the creator of the note promises to pay whereas drawer of the bill directs another to pay.

II. Issues of taxation

1. *Introduction*

The SME is often confronted with the difficulty of attracting finance from third parties.

In Ireland the banks constitute a major source of finance for SMEs. It is the general practice of the banks in granting loans to SMEs to demand personal guarantees from the principal shareholders in the SME, and in some cases charges over the personal assets of the shareholders, in addition to charges over the assets of the SME. The shareholders in an SME very often do not have effective protection from claims by the banks should the SME run into financial difficulties. The 'limited liability' status of the SME may be illusory.

Most SMEs in Ireland are unquoted private companies. It is difficult for a minority shareholder in such a company to dispose of his investment and accordingly there is some reluctance to become minority shareholders in Irish private companies.

This difficulty in raising share capital finance (by reason of the subsequent non-marketability of the share capital) tends to make the SME dependent upon bank finance or upon leasing finance.

There are a limited number of venture capital companies (VCCs) operating in Ireland. These tend to invest in the larger SMEs, i.e. those which it is anticipated will be large enough to be floated on the Stock Exchange in a 5- to 10-year period subsequent to the investment.

The VCC and the target company (SME) will have to determine how the capital is to be injected. It may very well be that there is a conflict of interest between both parties in determining how the injection will be executed.

In general, the (tax) differences between debt financing and equity financing can be established as follows:

In case of debt financing by the VCC, the interest payments are for the SME in principle tax-deductible expenses, which have a negative impact on the results (possibly into a loss position) and on the cash flow of the SME. The VCC will be fully taxable on the interest income.

It may very well be so that this situation is not at all desirable. Indeed, the SME will probably be in need of extra means at a time when heavy investments are planned which will already have a negative impact on the results (depreciation of the investment).

From a tax point of view such a situation may also prove to be unwise. The interest deduction cannot be properly used because of insufficient profits (creation of losses) whereas the interest income with the VCC is immediately taxed.

To meet both economic and tax demands, two main options are available:

- either the loan agreement is concluded under circumstances where the interest rate is in the beginning rather low (e.g. profit-sharing loan or convertible loan); or
- the VCC decides to participate in the capital of the SME.

In case of equity finance, the following problems arise:

Dividend income: if the VCC is in need of a more or less regular income to finance its own investment, this will have to be done by way of dividend distribution. This may present a great deal of problems.

Dividends are not tax-deductible, so that the dividend capacity will normally be lower than the interest payment capacity.

In case of dividend distribution both the VCC and the individual shareholder will receive a dividend. The dividend taxation of individuals is often very disadvantageous, since it will be regarded as normal taxable income.

To avoid this problem, the VCC might opt for preference shares, so that dividends can be distributed to the VCC and not to the individual shareholder.

Dividends received by the VCC from Irish resident companies are not regarded as taxable income of the VCC for the purposes of corporation tax. However, where the VCC is a closely owned company it may be liable to a surcharge on undistributed investment income at the rate of 20%. Preference share dividends received by an Irish resident company from another Irish resident company are liable to corporation tax in Ireland.

Capital gains income: this way could be interesting since, by doing so, the SME retains all profits.

Problems are:

- If the value of the SME decreases, the capital loss realized on the sale of the shares is only deductible from capital gains; furthermore, anti-avoidance rules have been made.
- If the value of the SME increases, the capital gain on the realization of the shares held by the VCC in the SME will be liable to corporation tax on companies' capital gains in most instances, or to corporation tax on profits if the VCC is regarded as dealing in shares, which is unlikely.

In the next section (Equity/Debt finance), a summary is given of all important items that could influence the decision-making of the VCC and the SME.

In the last section (Practical taxation guidance), we give practical guidance, resulting from the information in the Equity/Debt finance sections.

2. *Equity finance*

2.1. Introduction

Registration or other duties

In general any contribution to the share capital of an Irish limited company is subject to a stamp duty at the rate of 1%. The stamp duty is payable on the greater of the cash contribution or on the nominal value of the shares. Certain designated investment companies do not attract this stamp duty.

If shares have been issued in exchange for contribution in kind, a stamp duty of 1 to 6%, depending on the nature of the asset transferred, is levied and is payable on the value of the assets of any kind contributed, after deduction of liabilities, if any, attached to such assets and assumed by the capital company, and of expenses incurred by a company in connection with such contribution. The minimum amount on which duty is payable is, however, the nominal value of the shares in the capital company issued in exchange.

There are no other taxable events connected with the formation of capital. No stamp duty is payable when the issued capital of the capital company is increased through capitalization of profits or reserves.

Additional costs of creating a company are:

- A fee of IRL 166 is payable on the incorporation of a company. The fee is payable to the Registrar of Companies and must be paid on the formation of both a corporation and a private limited company.
- Chamber of Commerce fees: membership is purely voluntary.
- Charges for listing on the stock exchange; the initial fee for admission to listing ranges from IRL 140 where the value of the shares does not exceed IRL 100 000, to a maximum of IRL 89 960 where the value of the shares exceeds IRL 2 000 000 000. Annual listing fees range from IRL 1 300 where the nominal value of the listed security does not exceed IRL 1 000 000 to IRL 22 720 where the nominal value of the security exceeds IRL 2 000 000 000.
- Other: there are legal fees and printing costs in respect of the memorandum and the articles of association of the company in addition to the cost of the

statutory books and the corporate seal. Also, there is a general duty and filing fee of IRL 25 payable to the Registrar of Companies.

Are there conditions to be met in respect of the legal forms of the VCC?

Are there any specific forms available?

Irish company law provides no special legislation for VCCs. Irish law recognizes a variety of incorporated and unincorporated forms of business.

The two most important types of incorporated business enterprises are: the public limited company (plc) and the private limited company (ltd).

Other legal forms of doing business other than public and private limited companies are: the partnership, the limited partnership and the sole proprietorship (see above under legal matters).

A VCC can operate in Ireland either under the form of a public limited company or a private limited company. They are subject to the same laws and regulations.

Are there limits as to the degree of participation of the VCC in the SME?

There are no limits as to the degree of participation of a VCC in an SME. An SME can be a 100% subsidiary of a VCC.

2.2. Tax situation of the SME

Creation of the SME

Are there registration or other duties?

The same duties as outlined under Section 2.1 are applicable.

Are there exemptions for certain zones, projects, activities?

For indirect tax purposes (registration duties, etc.) no special regimes are provided for certain zones, projects, activities.

Is the indirect tax treatment different for the following types of shares: ordinary shares; preference shares; redeemable and other shares?

For indirect tax purposes no difference is made between these different types of shares.

Corporate tax

Are the costs related to the creation or increase deductible?

The cost of forming a company or of raising capital is considered a non-deductible item.

Rates

The present corporation tax amounts to 40% from 1 April 1991. A higher rate of corporation tax applies to certain income of close companies and service companies.

Several companies are subject to a higher rate. These rates are applicable to 'close companies'. A 'close company' is a company which is controlled by 5 or fewer persons or by its directors. Certain companies are not 'close' companies if the public has a 35% shareholding and the shares are quoted on a recognized stock exchange. The most important provision for close companies is that all or part of their undistributed after-tax non-trading income is subject to a special surcharge of 20%. If this income is distributed within 18 months of the end of the accounting period, the surtax will not apply. Should the surplus be distributed later on there will not be a credit. In principle only non-trading profits are liable to a surtax. A special corporation rate

amounting to 10% is applicable to new businesses established in the Custom House Docks area of Dublin and Shannon.

Certain inner city designated areas in several towns and cities attract special tax incentives trying to aid the redevelopment of the areas. These tax incentives include favourable capital allowance regimes and a 200% deduction in respect of rental payments by certain tenants.

Also, how does a redemption of shares affect the tax position of the SME?

Where shares are redeemed by a company for an amount in excess of the sum originally subscribed to the company in respect of its shares, the surplus is treated as a distribution of profits akin to a dividend.

Dividend distribution

Does a different tax regime apply to dividend distribution to X (private shareholder of the SME) on the one hand and to the VCC on the other?

Generally an Irish resident company must account for ACT (advanced corporation tax) on the payment of a distribution (e.g. a dividend). That ACT is a sum equal to the tax credit attaching to the dividend or distribution. Where the dividend or distribution is paid to a 51% parent, or where it is paid to members of a consortium (5 of fewer companies who are the sole shareholders in the SME) ACT need not be accounted for if both parties so elect.

The tax treatment of recipients of dividends varies depending on whether they are individuals or companies, individuals being taxable on distributions received but Irish resident companies being in general exempt from tax (other than surtax on undistributed income of close companies) on distributions received from other Irish resident companies. An individual who is liable to tax on a distribution from an Irish resident company may be exempt from tax on part of the dividend where it is paid out of profits taxed at the 10% rate or corporation tax. This latter relief is subject to a limit which is generally IRL 14 000 per annum per shareholder.

Does a different tax regime apply according to the different types of shares?

In general there are no differences in the tax regime applicable according to the different types of shares save that preference shares paid by one Irish resident company to another Irish resident company are not eligible for the normal inter-company exemption from tax.

Is the tax base affected by the distribution of dividends (deductible dividend)?

No, since the dividends are never a deductible item for distributing companies.

Is the tax rate affected by the distribution of dividends?

There is in principle only one tax rate applicable in Ireland for companies which can not benefit from the 10% corporation tax. The tax rate will not be affected by the distribution of dividends. However, the payment of a distribution or of dividends may enable a close company which has been in receipt of investment income or certain types of service income to avoid a surcharge of 20% which would otherwise arise on the undistributed investment or service income.

Is a withholding tax withheld? Rate? Exemptions?

There are no withholding taxes withheld on the distribution of dividends. However, an advanced corporation tax (ACT) is applicable. When an Irish resident company makes a distribution it must make a payment of ACT for the accounting period in which the distribution is made, equal to the tax credit attaching to the distribution. The tax credit normally amounts to 25/75 of the distribution paid. If the company is a company liable to the rate of 10% of CT the tax credit amounts to 1/18

and the ACT payable is 1/18 of the distribution. ACT does not arise on dividends paid within a group of Irish resident companies, provided there is at least a 51% relationship between the relevant companies (see further).

2.3. Taxation of the VCC

Corporate taxation

The tax treatment of a holding company is no different from that of any other company and the normal rules for calculating corporate tax apply. Dividends received by Irish resident companies from Irish resident companies are not subject to corporation tax save for a surcharge on the undistributed investment income of closely held companies and except in the case of preference share dividends.

Are the costs related to the creation of the VCC deductible?

The cost of forming a company or of raising capital is considered a non-deductible item.

Are management costs and interest deductible?

Audit and accountancy fees, secretarial fees, salaries, office overheads, and other such expenses are deductible items.

In principle interest which is a business expense is deductible in computing profits for CT. Interest on money borrowed for the purchase or improvement, or letting of premises is also allowable for CT. Interest on money borrowed to acquire shares in or lend to certain trading or rental companies may be allowed provided various conditions are fulfilled.

How are dividends taxed?

Dividends received by an Irish resident company from another resident company are exempt from corporation tax (other than the surcharge on the undistributed investment income of closely held companies). This exemption does not apply to preference share dividends. Dividends are not subject to a withholding tax.

What is the capital gains taxation if the shares of the SME are sold?

Resident companies which are not regarded as trading in shares are liable to corporation tax on companies' capital gains on any gains arising from the disposal of shares. A company which is regarded as trading in shares would be liable to corporation tax on any profits arising from the trade or dealing in shares. Generally a VCC would not be regarded as dealing in shares.

Gains on the sale of development land are liable to capital gains tax, whereas gains from other assets are liable to corporation tax.

Capital gains on the sale of development land [1] are taxed as follows:

Period of ownership	Taxe rate (%)
≤ 3 years	50 50
3 to 6 years	50 35
> 6 years	50 30

[1] Includes unquoted shares deriving the greater part of their value from Irish development land.

Deferral of capital gains tax is possible in case of transfer of assets within groups of companies. A group of companies means two or more Irish resident companies where the parent owns (in)directly at least 75% of the capital of the subsidiary company.

What about capital losses?

Capital losses of the current year and unused capital losses of prior years may be set against capital gains. Only the positive net gains are charged to tax. However, an anti-avoidance measure has been taken regarding tax losses rising on shares. The effect of the anti-avoidance legislation is to disallow the capital loss arising to the extent the value of the shares has been materially reduced by the payment of a dividend from a company to a corporate shareholder having a holding of 10% or more in that company.

What is the tax position of the VCC in case of redemption of shares by the SME?

Where an SME redeems shares held by a VCC the proceeds of redemption are treated as if they were a dividend to the extent that the proceeds exceed the original sum subscribed to the SME for the shares. To the extent that the proceeds are equal to or less than the sum originally subscribed for the shares the redemption is subject to corporation tax on companies' capital gains (assuming the company is not dealing in shares).

Rates

See the above rates under 'corporate taxation'.

Is there recoverability of the tax withheld by the SME?

There is no withholding tax. The benefit of a tax credit (equal to the ACT) is passed to the shareholders.

Distribution of dividends by the VCC

Does a different tax regime apply according to the different types of shares?

No different tax regimes are applicable according to the different types of shares.

Is the tax base affected by the distribution of dividends?

Since the dividends are not considered a deductible item, the tax base will not be affected by the distribution of dividends.

Is the tax rate affected by the distribution of dividends?

The tax rate is not affected by the distribution of dividends. The payment of a dividend by a closely held VCC may help avoid a surcharge on undistributed investment income of a closely held company.

Is a withholding tax withheld?

No withholding taxes are withheld, but the distribution of dividends is subject to an advanced corporation tax (ACT). When the recipient of the dividend is an individual, the net dividend plus the ACT does constitute a fully taxable income, taxed at the normal rates. The ACT paid is creditable against the final tax charge and repayable. If the dividends are received by resident companies the ACT is passed on to the shareholders (under the form of a tax credit). ACT is payable by a company in respect of dividends paid to the European Community, as it is payable on all other dividends.

Are there specific tax regimes available?

To encourage the creation of new businesses in economically declining areas there are tax incentives (e.g. a corporation tax of 10%) in a number of particular regions and for particular businesses. These regions are:

- The Custom House Docks Area of Dublin;
- Shannon.

Certain inner city designated areas in several towns and cities attract special tax incentives trying to aid the redevelopment of the areas. These tax incentives include favourable capital allowance regimes and a 200% deduction in respect of rental payments by certain tenants.

Transfer of shares

In case of transfer of the shares of the SME, do special taxes apply to these transfers?

The transfer of the shares of a company may give rise to a capital gain, which will be subject to a capital gains tax. However, that capital gains tax can be deferred in case of (i) the transfer of assets within groups of companies (above); (ii) the replacement of business assets; and (iii) capital reconstructions and company amalgations (in case of 'bona fide' reorganizations).

Furthermore the transfer of shares is subject to a stamp duty of 1%.

Tax situation of the individual shareholder

Is the interest paid on the loans granted in view of the purchase of the shares of the SME deductible?

Interest paid on loans applied to the purchase of an SME may be deductible for tax purposes for both individuals and companies provided certain conditions are met.

How are dividends taxed?

Resident individuals are subject to income tax on the net dividend and the tax credit (equal to the ACT). The tax credit will be credited against income tax.

Excess of tax credit will be refunded.

A special tax incentive exists in respect of dividends paid out of profits taxed at the 10% rate of corporation tax. Half of such dividends (to a maximum of IRL 14 000 per annum of dividends per shareholder) may be exempt from tax.

Interest payable to directors and their associates who have significant shareholdings in close companies is restricted. If interest paid exceeds the prescribed amount, the excess is treated as a distribution.

In case the SME is not a company but an unincorporated enterprise

If the VCC participates in such an enterprise, how does this affect the position of the enterprise?

The tax position of a VCC which is acting as a partner in an unincorporated enterprise carrying on a trade would be the same as that of any other person carrying on a trade, i.e. it is liable to tax on its share of the profits of the trade as they arise. Where the partnership is a limited partnership the entitlement of the limited partners to offset losses arising against other income is restricted to the extent of their investment in the partnership.

Is a transparent company (partnership) created? If so, what are the tax implications?

Where the VCC is a partner in a partnership, it will have unlimited liability for the liabilities of the partnership in a limited partnership. If it is a limited partnership, and the VCC is a limited partner in it the liability of the VCC is limited to the amount of capital it has agreed to subscribe to the partnership. However, a limited partner cannot take part in the management of the limited partnership.

Partnerships are not themselves liable to tax but rather the individual partners in them are liable to tax on their share of the income and gains of the partnership.
They may be liable to corporation tax if the partner is a company, or income tax and capital gains tax if the partner is an individual.

3. *Debt finance*

Preliminary question: is there a debt/equity ratio to be respected?

There are no rules in the company law regarding the debt/equity ratio in any company.

What if the ratio is not respected?

Since there is no debt/equity ratio to be respected, there are no consequences.

3.1. Tax situation of the SME

Does the difference between the following types of loans have implications for the tax situation of the SME:

- *ordinary loans;*
- *convertible loans;*
- *profit-sharing loans;*
- *other types (perpetual debts, index linked debts, Section 84 loans, etc.)?*

Yes, since the tax treatment of the interest payment may be different. Certain interest is treated as being a distribution of profit for tax purposes. The rules which determine whether a particular interest payment is to be treated as being interest or as a distribution for tax purposes are extremely complex. Furthermore, they are likely to be significantly amended in the forthcoming 1992 finance act and for that reason a detailed description has not been given here.

Interest on convertible notes, profit participation loans, and other 'Section 84 loans' may be treated as a distribution in certain circumstances. It is likely that on loans issued by Irish banking and financial institutions after 31 December 1991, such interest will not be treated as a distribution.

In general, interest on indexed linked loans and on perpetual loans is treated as interest and not as a distribution.

Where the payments of interest are considered to be a distribution the SME paying the interest will not obtain a tax deduction in respect of it, and becomes liable to account for the ACT in respect of it, but it may be in a position to obtain finance at favourable rates on such a loan. As mentioned above this position may soon be of historic interest only.

What is the deduction regime for the different types of loans?

In principle interest which is a business expense is deductible in computing profits for CT. Interest on money borrowed for the purchase, improvement, or letting of premises is also allowable for CT. Interest on money borrowed to acquire shares in or lent to certain trading or rental companies may be allowed provided various conditions are fulfilled. In general, interest relief is not allowed where money is borrowed for purposes other than above.

However, interest payments on certain types of securities are not considered a deductible item, e.g. on certain securities convertible into shares in the company; interest on securities where the return to the lender is dependent on the results of the company paying the interest; interest in excess of a normal commercial return and interest paid to non-resident associated companies in certain circumstances. The rules which determine whether a particular interest payment is to be treated as being interest or as a distribution for tax purposes are extremely complex. Furthermore they are likely to be significantly amended in the forthcoming 1992 finance act and for that reason a detailed description has not been given here.

The rules relating to determining whether a particular interest payment is to be treated for tax purposes as interest or as a distribution are complex and are in the process of change. The rules are not likely to be relevant to the provision of finance by Irish financial institutions after 31 December 1991. They may have a theoretical relevance to the provision of finance by individuals but this is not likely to be significant as individuals do not normally charge interest on finance, or provide finance other than to their own companies.

The company may also be liable to pay ACT in respect of the distribution.

Are there specific regimes available?

There are no special regimes available to promote debt finance.

What is the situation if the VCC also participates in the SME?

Interest paid to a shareholder is not explicitly seen as (hidden) profit distribution provided the loan is not connected with the shares.

What is the withholding tax in each case of the different types of loans?

An annual interest payment by a company (except for interest falling under the definition of distribution and for interest payable to banks carrying on a bona fide banking business in Ireland) is normally subject to a withholding tax at the standard rate of income tax (commonly 29%). The payer is obliged to account to the revenue authorities for the tax withheld. Resident recipients may credit the withholding tax against their tax assessment. If a company is making a qualifying profit distribution the ACT must be paid by the company.

3.2. Tax situation of the company that grants a loan to the SME

What is the situation concerning the different types of loans:

- *ordinary loans;*
- *convertible loans;*
- *profit-sharing loans;*
- *other types?*

As outlined above interest payments on certain securities may be considered qualified profit distributions.

In respect of the taxability of the interests, are there exemptions or reductions for certain zones or activities?

There are no tax exemptions or relief available in respect of interest on loans to an Irish resident SME.

How are the capital gains on receivables taxable?

Loans which carry a rate of interest and which are capable of being transferred or sold are considered to be chargeable assets for the purposes of taxes on capital gains.

Where a loan is made otherwise than in the course of carrying on a trade of making loans, and the loan has the characteristics described, a gain on its disposal is likely to be liable to corporation tax on companies' capital gains. A gain on the disposal of a loan made in the course of a trade of granting loans would be liable to corporation tax on trading profits.

What if the loan is converted into capital with capital gains or losses?

The conversion of loan capital into share capital, where the loan has not been granted in the course of a trade of granting loans, does not give rise to a tax charge on companies' capital gains. The shares acquired are treated as the same asset as the loan, for the purposes of that tax. Where the loan was made in the course of a trade of making loans, the conversion into capital would be treated as a disposal in the course of a trade for the purposes of corporation tax on income.

Are capital losses on receivables realized by the VCC deductible?

Since receivables will be considered an asset, capital gains or losses will follow the same regime on capital gains and losses as outlined above.

Are interest payments deductible (for the acquisition of the funds)?

Interest payments arising on the acquisition of funds to finance a loan to an SME will be tax-deductible where the loan is made in the course of a trade of making loans. It will also be tax-deductible where certain other conditions are met, i.e. broadly where the SME is a trading company or rental income company, and a person advancing the loan has a 5% interest in the SME or a connected company, and has a common director.

Is there a withholding tax on interest paid by the VCC?

The rules relating to withholding taxes on interest have been described earlier. Where VCC is paying the interest to an Irish bank generally withholding tax will not arise.

3.3. Tax situation of the fund

Can the fund recover the withholding tax on interest withheld by the VCC?

The tax situation of the fund with regard to the interest received from an Irish VCC, and its ability to recover withholding tax on such interest where relevant, would depend on the exact legal status of the fund and on its place of residence.

The rate of withholding tax on payment to Belgian residents is limited by the double tax agreement between Belgium and Ireland to 15%.

If the fund is an Irish resident corporate entity it would be liable to corporation tax in Ireland on the interest but would receive a credit for the tax withheld.

If the fund were an unincorporated arrangement between the European Community and regional authorities, it is likely to be exempt from tax in Ireland and to be able to recover tax withheld.

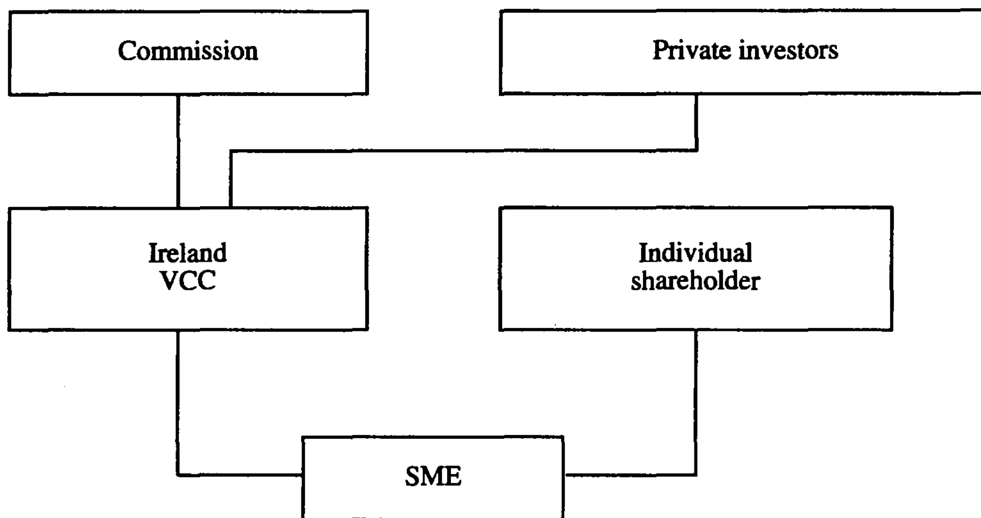
Is the interest taxable?

See the reply above.

Practical guidance

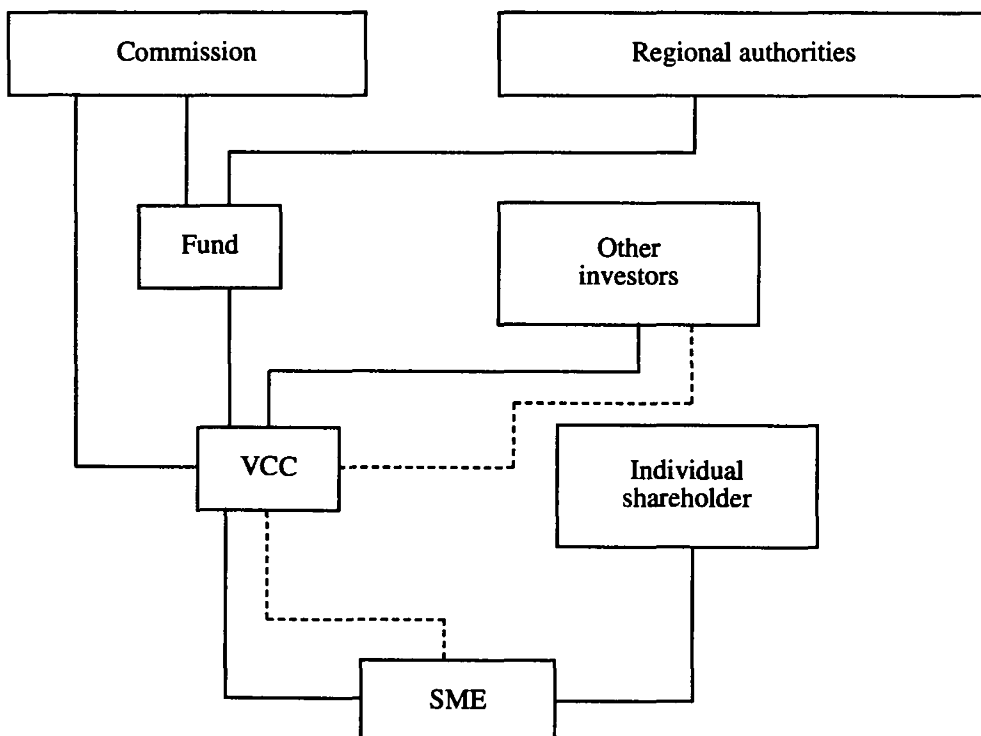
I. Equity finance

1. Scheme



II. Debt finance

1. Scheme



2. *Comments on structure*

2.1. *Position of the SME*

Costs of increasing capital:

Capital duty of 1% (depends amongst other things also on the form of the company); and additional costs.

These costs can, in absolute figures, be an obstacle, although they are rather limited. These costs are, however, not tax-deductible for the SME and have a negative impact on the results.

Taxable base:

The profits of the SME are positively influenced by the capital increase.

This means that if normally losses would have occurred, because of the capital increase a better result can be shown.

If the capital increase leads to a profit situation, this profit is normally taxed at 40%.

Special tax rates (10%) exist for income generated by companies located in several zones.

'Close' companies may be subject to a surcharge.

Tax rate:

The profits are taxed at 40%.

Redemption of shares:

2.1. *Position of the SME*

Costs of granting loan:

There are no capital duties levied at the granting of a loan. However, it may be possible that there are other costs related to the granting of the loan (e.g. bank fees, etc.). Those fees are normally deductible on short-term loans only.

Taxable base:

The interest payments are normally deductible expenses that have a negative impact on the results and on the cash flow.

This situation may prove unwise because a loss position may be created (no immediate use of interest deduction).
This disadvantage may partially disappear if it is a profit-sharing loan.

Tax rate:

The deductible interest payments save a taxation at the corporate tax rate.

Reimbursement of the loan:

Where a premium is paid on redemption over the price subcribed for the shares initially, the premium is treated as if it were a dividend.

Dividend distribution:

The dividends distributed are part of the taxable base.

ACT applies to dividends or other distributions paid by the SME. The rate is normally 25/75ths of the dividends but may be 1/18th where the dividend is paid out of profits taxed at the 10% rate. Where the dividend is paid to a 51% parent or to a corporate member of a consortium ACT may be avoided.

2.2. *Position of the VCC*

Taxable base:

(a) Dividend income

Dividends received (other than on preference shares) are exempt from corporation tax but may be subjected to a surcharge if the VCC is a closely held company and does not pay equivalent dividends.

(b) Capital gains taxation

In principle taxed. Deferral is possible if certain conditions are fulfilled (e.g. in case of transfer of assets within a bona fide reorganization of companies).

(c) Capital loss on shares

May be set off only against other capital gains. Several restrictions exist.

(d) Interests payments are deductible

Dividend distribution:

The normal rules apply.

Has normally no impact on the taxable result.

Interest payment:

The deductible interest paid to the VCC is normally subject to a withholding tax of 29%.

However, interest from several qualifying loans are subject to ACT.

2.2. *Position of the VCC*

Taxable base:

(a) Interest income

This income is fully taxable at 40%; several companies located in economically undeveloped zones are subject to a corporate tax of 10% but cannot provide finance to an Irish SME.

(b) Capital gains taxation

A conversion of a loan into capital will not normally give rise to capital gains at the point of conversion.

(c) Capital loss on loans

Capital losses on loans which were transferable and carried interest are deductible from capital gains.

Interest payment to fund:

Tax-deductible.

Transfer of shares:

Stamp duty of 1% applies.

2.3. *Position of the individual shareholder*

Dividend income:

Dividends received are included in his taxable income. If ACT is withheld, this tax may be credited against the final tax; any excess is refundable.

Purchase of the shares:

Interest relief is available to individuals who borrow money in order to invest in the share capital of a trading company or rental income companies provided certain conditions are met. These conditions are reasonably restrictive and detailed.

2.4. *Position of the fund*

If the fund is a corporate body resident in Ireland it would not be liable to tax on dividends received from the SME other than preference share dividends. Preference share dividends would be liable to corporation tax at 40%.

If the fund were not resident in Ireland there would be a theoretical liability to Irish income tax in respect of the dividend from the SME but it is not the normal practice of the Irish Revenue Commissioners to pursue such a liability in most cases.

Transfer of loans:

No taxation.

2.3. *Position of the individual creditor*

Interest income:

Interest income is considered a taxable income for the individual creditor. The withholding tax is credited against the final tax; any excess is refundable.

2.4. *Position of the fund*

The tax situation of the fund with regard to the interest received from an Irish VCC, and its ability to recover withholding tax on such interest where relevant, would depend on the exact legal status of the fund and on its place of residence.

The rate of withholding tax on payment to Belgian residents is limited by the double tax agreement between Belgium and Ireland to 15%.

If the fund is an Irish resident corporate entity it would be liable to corporation tax in Ireland on the interest but would receive a credit for the tax withheld.

If the fund were an unincorporated arrangement.

3. *Unincorporeted SME*

If the VCC participates in the SME (sharing of profits and losses), an equivalent part of the profits/losses is as such attributed to the VCC, which is normally taxed on this income.

3. *Unincorporated SME*

If the VCC grants a loan to an unincorporated SME, the interest will be deductible by the SME and fully taxable in the hands of the VCC provided the VCC is not a partner in the unincorporated business. If the VCC is a partner in addition to making a loan, interest will be treated as a share of the profits of the partnership.

Conclusion

Equity finance

1. *Major disadvantages*

Costs related to increase of capital; furthermore, they are not tax-deductible;

The capital increase will normally lead to a higher taxable base and thus a higher tax burden with the SME; this both for corporate income tax purposes;

Share capital in Irish private companies is not readily marketable so that an investor may find it difficult to liquidate his investment.

2. *Major advantages*

Dividends received are in principle tax exempt;

The provision of share capital relieves the SME of the burden of interest costs and can also increase its capacity to borrow money from other sources.

Debt finance

1. *Major disadvantages*

The deductible interest payments may lead to a loss position of the SME, whereas the interest income with the VCC is immediately taxable;

Some interest payments (e.g. profit-sharing loans) are treated as qualifying profit distribution;

In principle capital gains on some loans are taxable;

Interest on loans in order to finance the acquisition of a participation is deductible subject to conditions.

2. *Major advantages*

No costs are related to the granting of the loan;

The taxable base of the SME will normally be reduced, which may save corporate income tax;

The capital losses are deductible to the extent there are capital gains;

The private shareholder is not confronted with a purchase of shares.

Ireland	Equity	Debt	
SME profit before tax	100	Interest payment deductible with SME	Yes (– 100)
Corporation tax 40%[1]	– 40		
ACT 25/75[2]	– 33	Witholding tax 27%[4]	– 27
Dividend at recipient's level	60	ACT	Not applicable
Taxable base	0	Interest income before tax at recipient's level	73
CIT at recipient's level[3]	0	Taxable base	100
Dividend after tax at recipient's level	60[4]	CIT 40%	40
		Tax borne at source	27[5]
		Tax *still* due/restitution	13
		Interest income after tax	60

[1] If CIT tax rate = 10%, the ACT will be 1/18 of the dividend.
[2] ACT paid by the SME is creditable against its liability to CIT.
[3] Preference share dividends are liable to CIT (40%) at the VCC level; previously paid ACT cannot be set off against CIT liability, unless within the same company or group.
[4] If the VCC is a 'closely owned' company, a 20% surcharge on undistributed investment income applies.
[5] Creditable against the VCC's CIT-liability and refundable. Withholding tax does not apply in all cases.

III. Other issues

1. *Local and regional authority issues*

As seen above, regional authorities can participate in the provision of venture capital. This is already the case in the Shannon and Gaeltachta areas (see Section I. 3).

2. *Impact assessment*

The Irish venture capital market is relatively sophisticated, with an availability of a wide range of vehicles and methods.

The situation whereby duty of 1% is payable on the issue or transfer of equity capital as against duty of 0.1% up to a limit of IRL 500 on the issue or transfer of debt capital is anomalous. This is particularly so when one considers the higher risk factor associated with equity investment. There is a case for modification or reversal of this anomalous situation.

The level of compliance work required because of recent company legislation will increase costs for corporate SMEs. Capital maintenance rules are designed to protect shareholders and creditors (which include holders of debt capital). If shareholder approval of a transaction were required and if the company was to be declared solvent notwithstanding the particular transaction, it would seem difficult to justify a situation where a company might be inhibited from entering into that transaction.

IV. Comparative legal and regulatory issues

1. *Absent positive features*

- Silent partnerships

In Germany, companies engage in silent partnerships (Germany, Section I.3.1). The management of the enterprise is left in the hands of the operator and the stake taken is always a minority of the equity. The operator is often given first option to buy back the silent partner's shares if it wishes to sell.

(a) In practice, although there are no statutory restraints on such an arrangement, the technique is not used in Ireland.

(b) If more finance was available to local authorities then the silent partnership might be used to invest in small, family-run local businesses. It appears that in Germany the silent partnership has been most effective in this context because of the lack of intrusion felt by operators of family businesses.

- One-member company

In Denmark, the one-member company is possible (Denmark, Section I.3). In the ApS, the equivalent of the Irish private limited company, only one founder is needed and only one specified manager is required. In the A/S, the equivalent of the Irish public limited company, only three founders are required.

(a) In Ireland, all companies must have two directors. Private limited companies must have two members. Public limited companies must have seven members. Although the 12th EC Directive (not yet implemented in Ireland) provides for one-member (i.e. shareholder) companies, there is no requirement that such a company may have one director only.

(b) Allowing one-member and one manager/director private limited companies would have three advantages. It would reflect the commercial reality of one-person businesses who incorporate to gain limited liability. It would prevent the situation arising where the second director (often the spouse or close relative of the business person) is fixed with liability where fraudulent trading was found on insolvency even though the second director had no real say in the operation of the company. In the context of the public limited company, it would allow the real owner who wishes to carry out an activity necessitating incorporation as a public limited company (such as the operation of a UCITS) to do so without having to put six nominees in place.

- Participating loans

In France (France, Section I.4.1) and in Germany (Germany, Section I.3.1) participating loans exist whereby the interest payable is linked to profits made.

(a) In Ireland, any such arrangement would constitute the lender as a partner of the business and the loan would be subordinated in right of repayment to all other lenders.

(b) Participating loans appear to be useful because the SME in difficult and unprofitable times will not have a heavy interest burden. At the same time, as a lender the provider of the venture capital obtains priority over all equity holders. By taking a fixed charge it obtains priority over subsequent lenders as well. Because the return is based on profits, only established SMEs will be in a position to attract finance through participating loans. If the feature is to be introduced the Partnership Act will require amendment.

- Self-financing

In Belgium, the restriction on an SME providing financial assistance to the purchaser of its own shares does not apply to MBOs (Belgium, Section I.4.1).

(a) In Ireland, financial assistance is possible only when shareholder approval has been obtained and a declaration of solvency after the granting of the assistance is given by the directors.

(b) The rationale of the Irish legislation is that once the shareholders know and approve and once creditors are protected by the solvency of the company (as evidenced by the declaration) adequate protection is in place for those likely to be affected by a depletion in the company's capital. We would not recommend a completely unrestricted right for MBOs to have access to company assets to finance the buyout. However, if the Belgian legislation has any restrictions on the use of this method it would be useful to compare them with the Irish limitations and then decide whether any changes might usefully be made to Irish law.

- Bearer bonds

In Belgium, bearer bonds transferable by delivery are used by NVs/SAs, the equivalent of the Irish public limited companies (Belgium, Section I.4.1).

(a) In Ireland, bearer bonds do not constitute a noticeable element in venture capital. The Exchange Control Acts require Central Bank consent before an Irish company may issue bearer instruments. Consent would probably be given only if the company restricted the instrument so that it could not be held by an Irish resident.

b) If bearer bonds were to be made freely available, then the Exchange Control Acts would have to be amended.

- Enhancements to the risk capital market

In Italy three measures have been adopted by regional organizations, following contributions from EC funds, with the aim of 'enriching' the risk capital market:

(i) the creation of venture capital companies investing solely in SMEs;

(ii) the creation of guarantee funds covering a share of losses which may be suffered by venture capital investors;

(iii) 'accomplishing funds' acquiring participation in funds or investment companies specializing in acquiring participation in SMEs.

(a) While State agencies (such as the IDA) can acquire equity stakes in companies, a venture capital company would not qualify to receive funding. The present grants and support are provided to the SME and not to venture capitalists. The bodies administering existing EC funds (EDFO, BABEL, Esprit, etc.) seek to provide funding directly rather than through venture capital specialists.

(b) It would promote the provision of private venture capital if funding was provided to specialist venture capital companies investing in SMEs who may have expertise and considerable experience in all aspects of business development. Public funds could be used in conjunction with private funds to positive effect.

2. *Absent positive techniques*

- Jointly owned shipping firms

In Denmark, jointly owned shipping firms exist (Denmark, Section I.4). The owners are only severally liable for the firm's debts.

(a) In Ireland, liability is both joint and several.

(b) The feature would be of benefit to the shipping and fishing industries. The change could be implemented by amending the Partnership Acts or the Merchant Shipping Acts.

Italy

Introduction

The Italian institutional venture capital market is young in comparison with that of other industrialized countries, notably the United Kingdom. The main reasons for the delayed growth of merchant banking and venture capital activities are the lack of legal and fiscal rules to support venture capital providers, notably rules facilitating disinvestment.

As far as tax matters are concerned, the following negative aspects should be taken into consideration:

- Although exemption from corporate tax is granted to SMEs and VCCs situated in underdeveloped areas such as the Mezzogiorno, an equalization tax is levied in case such a company distributes dividends, which neutralizes the effect of the tax exemption. In some cases, partial double taxation may arise due to the non-refundability of the tax credit.
- Capital gains on shares are in principle fully taxable.
- The technique of redemption of shares is unknown in Italian law.

On the other hand, several incentives have been created:

- Specific forms for VCCs (SIF, SFI, etc.) with tax benefits;
- Exemptions from local or corporate income tax for companies in certain regions (Mezzogiorno area, new offshore centre of Trieste).

As far as debt finance is concerned, interest payments are only deductible to a proportion equal to the ratio of gross taxable income to total gross income. This implies that the total amount remains undeductible if the SME is exempt from corporate income tax.

I. Legal and regulatory issues

1. *Typical investment vehicle used*

The following entities are typically used in Italy as vehicles for the provision of venture capital:

- joint-stock companies;
- limited partnerships;
- limited liability companies.

The Associazioni Italiana delle Finanziare di Investimento nel capitale di rischio (AIFI) defines investment holding companies as follows:

(a) Their main activity consists of investing in unquoted companies (equity financing) through the acquisition of minority shares and unquoted shares.

(b) They are actively involved in the development of the companies in which they invest.

2. *Applicable legal measures*

- Comitato Interministeriale per il Credito ed il Risparmio (CICR) Resolution dated 6 February 1987.
- Circolare Applicativa della Banca d'Italia No 15948 dated 11 March 1987.

This resolution and Circolare Applicativa of the Banca d'Italia govern the participation of banks and central credit institutions in Societa d'intermediazone finanziaria (SIF) (this is the equivalent of a merchant bank) engaged in the following activities:

(a) advising and assisting a firm in connection with economic and financial resources, in particular how to cover investments and development costs;

(b) organizing funding by means of venture capital and borrowed capital; and

(c) temporary acquisition of company debentures and shares, or similar instruments, and also participating in an underwriting syndicate in order to place them on the market.

- Italian Republic Law No 317 of 5 October 1991

This applies to intervention in innovation and development in connection with SMEs and covers 'participating loans' and innovation and development finance companies (SFIs).

- Bill on 'closed-ended mutual investment funds'

This is currently under discussion by the Commissione Finanze e Tersoro della Camera.

- Law No 197 dated 5 July 1991

In order to avoid money laundering, this law submits the activities of qualified financial intermediaries to certain rules. Other unqualified intermediaries (e.g. holding companies, SIF) can be authorized, on request, by the Ministry of the Treasury. These intermediaries are registered in a special record kept by Banco d'Italia.

3. *The investment vehicle*

The CICR Resolution and the Circolare Applicativa (see Section 2) contain the rules which regulate the activity of merchant banks (SIFs). Venture capital companies in which banks do not participate are only subject to the provisions of the Italian Civil Code which regulate joint-stock companies.

The CICR Resolution fixed the essential parameters within which the SFIs have to be established and must operate. The Circolare of the Bank of Italy has carried into effect some of the rules in the Resolution.

For instance, the Resolution states that the SFI must have a minimum share capital determined by a further Banca d'Italia provision. The Circolare has stated that

the capital cannot be lower than LIT 50 billion. For another example, compare item (f) of the Resolution with item (c) of the Circolare.

The rules are summarized below.

The SIF must have a minimum share capital of LIT 50 billion. Majority shareholdings can only be acquired by the major credit institutions. The activity of the SIF in purchasing debentures, shares or similar bonds is designed to secure profits. It cannot manage the company in which it participates. The total participations must not exceed the amount of the net assets and of the subsequently issued convertible bonds of the SIF.

The latter cannot finance the companies in which it holds a share. Each investment of the SIF in the share capital of a company must not exceed 20% of the net assets of the SIF. The indebtedness of the SIF cannot be higher than twice the amount of its share capital.

Innovation and development

Under Italian Republic Law No 317 of 5 October 1991, two interesting beneficial developments have occurred. A new category of company, the innovation and development finance company (the SFI) has been created. A new financial tool, the participating loan, has also been initiated.

The companies which can benefit from the provisions of Law N 317 and qualify as SFIs must have the following characteristics:

- they must be companies the exclusive object of which is the acquisition of temporary shareholdings in SMEs;
- they must be established as joint-stock companies;
- they must have a minimum capital as specified by a decree issued by the Ministry of Industry;
- they are subject to investment limits specified in a Ministry of Industry decree.

The types of investment typically made by SFIs are as follows:

- the purchase of shares in joint-stock companies, limited liability companies and in limited partnerships;
- the purchase of stock options on shares in joint-stock companies, limited liability companies and limited partnerships;
- subscribing for convertible bonds;

The following are prohibited:

- investment in:

(i) other SFIs;

(ii) companies controlling and controlled by SFIs;

Closed-ended investment funds

Where the vehicle used to provide venture capital is a closed-ended mutual investment fund, it will be subject to new legislation currently under discussion. The new bill is under discussion by the Commission Finanze e Tesoro della Camera.

Closed-ended funds will have to meet the following requirements:

- they would need a management company with a minimum capital of LIT 50 billion;
- a charge of 5% will be levied on any increase in the share capital of the fund;
- the minimum subscription for investors participating in the fund is LIT 50 million;
- the fund is limited in duration to a maximum of 10 years. A further three years is allowed for disinvestment;
- the distribution of the fund's profits will be controlled. A minimum of 80% must be distributed to the participants and a maximum of 20% can be distributed to the management company;

- the management company must have a minimum holding in the closed-ended mutual investment fund of 5% of the fund's issued share capital;
- the investment fund must invest a minimum of 40% and a maximum of 70% of the invested amount in unquoted companies;
- of the amount invested a minimum of 20% must be invested in quoted companies;
- a maximum of 5% of the shares in any single quoted company which carry voting rights can be acquired by the investment fund. In the case of an unquoted company the limit is raised to 30% of the voting shares (or to such other amount as will ensure that the investment fund has control over the company);
- the investment fund's shares must be valued quarterly;
- after one year, the investment fund can be admitted to the list of the Italian Stock Exchange secondary market.

Various tax considerations affect the viability of the closed-ended mutual investment funds. Investors into the fund, which are not individuals, will be penalized from a tax point of view. This may make it difficult for these funds to raise capital.

Decree Law No 72 dated 6 March 1991 forms part of the rules designed to suppress criminal activities. It deals with money laundering and with certain operational formalities to be observed by specified financial operators.

Regulation

In particular, the rules contained in the order affect brokers whose main activity is to participate in other companies. On receipt of a request from an interested party, the Ministero del Tesoro can recommend the brokers qualified to carry out the specified activity (including the taking of participations).

4. *The recipients of venture capital*

No significant legal obstacles prevent SMEs in Italy from obtaining venture capital finance.

Law No 317 (referred to above) also instituted the system of participating loans. These can be made by special credit institutions which grant medium and long-term loans to industrial firms, and also by SFIs to certain categories of SME which meet the following requirements:

- their staff has to consist of a maximum of 200 employees and their invested net assets must be less than LIT 20 billion;
- the SMEs must not belong to a group of companies the size of which exceeds that specified in the first item;
- the SMEs have to be joint-stock companies;
- their capital stock must be no less than LIT 200 million;
- they are required to publish their own financial statements in the Busarl (joint-stock companies and limited liability companies gazette) and to file balance sheets at the Companies Registry Office, together with the profit and loss statement, directors' and auditors' reports and the minutes of the shareholders' resolution approving all of the above documents.

The aim of participating loans is to realize innovation and development projects. The loans will be granted for a duration of not less than four years.

The interest rates applicable to participating loans can be either fixed or variable. Fixed rates will be set at an annual amount not exceeding the official discount rate in force during the period to which the loan redemption

rates referred. The payment of an additional amount at an interest rate previously agreed between the company and the borrower will be in proportion to the operating profits of the borrower.

The borrower can give only personal securities and not real securities.

Participating loans can benefit from a special security issued by the Mediocredito Centrale up to an amount of 80% of the loan.

II. Issues of taxation

1. *Introduction*

The SME is often confronted with the difficulty of attracting financial means from third parties.

Indeed, on the one hand, to contract a loan with a bank, the SME has most of the time to low an equity, so that the financial institutions feel rather reticent to grant a loan.

On the other hand, because of the high risk of the investment, only very few persons will be willing to increase the capital (and therewith the loan capacity) of the SME.

The VCC can therefore play an important role in the expansion of the SME.

The VCC and the target company (SME) will have to determine how the capital is to be injected. It may very well be that there is a conflict of interest between both parties in determining how the injection will be executed.

In case of debt financing by the VCC, the interest payments are for the SME in principle tax-deductible expenses which have a negative impact on the results (possibly into a loss position) and the cash flow of the SME.

Under certain circumstances the interest burden is even not deductible.

The VCC is in principle fully taxable on the interest income, although, here too, some exceptions exist.

From a tax point of view, debt financing may prove to be unwise. The interest payments, even if they are deductible, may not be properly used because of insufficient profits (e.g. because of the interest burden and the depreciation of the investment, losses are created) whereas the interest income with the VCC is, in principle, immediately taxed.

Two main options are available to solve this problem:

- either the loan agreement is concluded under circumstances where the interest payment is in the beginning rather modest (e.g. profit-sharing loan or convertible loan),
- or the VCC can decide to take an interest in the capital of the SME.

In case of equity finance, the following problems arise:

If the VCC is in need of a more or less regular income to finance its own investment, this will normally have to be done by way of dividend distribution.

This may present a great deal of problems:

Dividends are, for corporate tax purposes, not deductible so that the dividend capacity will normally be lower than the interest capacity. If certain SMEs are exempted from corporate taxation, this effect seems to be neutralized by a kind of tax equalization (56.25 %) which can only partially be recovered by the VCC.

In case of dividend distribution, both the VCC and the individual shareholder will receive dividends. Since the individual shareholder is taxed at the progressive rates, his position is not very favourable. To avoid this problem, the VCC might opt for preferential shares, so that dividends can be distributed to the VCC and not to the private shareholder.

Apparently, the Italian tax system does not have a system of dividend exemption, but a tax credit system. In principle, the tax credit amounts to 9/16 of the dividend, (i.e. the withholding tax included) which implies that the corporate tax paid by the SME is totally recovered by the VCC. There are, however, situations that lead to double taxation, e.g. due to the non-refundability of the tax credit. In this context a combination of dividend and interest income could, in some circumstances, be of help.

Instead of receiving dividends, the VCC might aim at the realization of capital gains on shares.

This option could be interesting since, by doing so, the SME retains all profits which may be useful in view of the investments planned.

The following problems exist:

The capital gains realized are fully taxable, although the taxpayer can opt for a taxation over four years. Do the gains underly the local taxes? If so, this is less interesting than in case of dividend income.

The individual shareholder is not in a good position to finance the purchase of the shares, since the interest burden is not deductible. Therefore, one could consider the possibility of a repurchase of shares by the SME. Apparently, this technique is unknown in Italian company law.

In the next section (Equity finance/Debt finance), a summary is given of all important items that could influence the decision-making of the VCC and the SME.

In the last section (Practical taxation guidance), we give practical guidance, resulting from the information in the sections Equity Finance/Debt finance.

Creation of the VCC

Are there registration or other duties?

A registration tax of 1% is due on contributions in cash to a company in exchange for stock or shares. The tax is levied on the par value of the shares issued or on the amount actually paid up.

A corporate licence tax is payable when a company is recorded in the Register of Enterprises, and then annually to maintain the registration. The licence and annual duties are as follows:

- LIT 12 million for an SpA;
- LIT 3.5 million LIT for an Srl.

For transformations of companies in the Register of Enterprises, the duty is LIT 81 000.

On 5 July 1991, the European Commission brought an action against Italy before the European Court of Justice because of this corporate licence tax. The European Commission argues that these registration fees are prohibited in Article 10(c) of EEC Directive 69/335/EEC concerning indirect taxation on the raising of capital. The amount of the fees is disproportionate to the service rendered to the individual enterprises.

In addition to the taxes referred to above, there are Chamber of Commerce fees and costs for publication in the Official Gazette. The Chamber of Commerce fees are very small (around LIT 50 000 plus an annual fee of around LIT 300 000).

Are there conditions to be met in respect of the legal forms of the VCC? Are there any specific forms available?

Italian company law does not provide for any special condition or restriction as regards the legal form or the minimum share capital of VCC companies.

However, some limits are set forth by special laws or resolutions:

(a) Resolution issued by Credit and Savings Interdepartmental Committee (CICR) on 2 February 1987. Prior to the issue of such a resolution, which provides for the creation of financial intermediation companies, substantially held by credit institutions, venture capital activity was precluded to banks and credit institutions. At present, the possibility of participating in companies' risk capital is extended to credit institutions, which can perform venture capital activity through the intervention of the abovementioned financial intermediation companies, obviously subject to some restriction as regards the legal form and the participation degree in the participated companies' capital;

(b) Law No 317 of 5 October 1991, providing for financial and tax facilities to small enterprises and to VCCs which participate in small enterprises' risk

capital and introducing a new system for granting tax facilities, substantially based on the tax credit method.

A VCC will most likely operate in Italy under the form of an SpA (Società per azioni or corporation). Such a company needs at least two shareholders and a minimum capital of LIT 200 million.

In particular, according to both the abovementioned law and resolution a VCC must operate as an SpA.

The minimum share capital of a VCC created by the abovementioned resolution dated 6 February 1987 must be of at least LIT 50 billion.

Other legal forms which are often used are the Srl (società a responsabilité limitata or limited liability company) with a minimum capital of LIT 20 million. An Srl must have one or more directors who must also be members, unless the articles of incorporation stipulate otherwise.

Only an SpA can issue bonds, not an Srl. Bonds issued as a result of a resolution of a shareholder's meeting are subject to a registration tax of 1% of the amount to be issued.

Are there limits as to the degree of participation of the VCC in the SME?

As far as the limits to the degree of participation of the VCC in the SME are concerned, it must be pointed out that, as a general principle, the participation must be limited to a degree such as not to allow the VCC to achieve control of the SME.

With respect to Law No 317 of 5 October 1991, such a law specifies that the participation of the VCC in the SME must be a minority participation. In addition, the possibility of benefiting from the facilities provided by Law No 317 is restricted to the VCC participating in an SpA or Srl (not in partnerships).

2. *Equity finance*

2.1. Tax situation of the SME

Creation and increase of capital

(a) *Are there registration or other duties?*

See 'Creation of the VCC'

(b) *Are there exemptions for certain zones, projects, activities?*

See 'Creation of the VCC'

(c) *Is the indirect tax treatment different for the following types of shares:*

ordinary shares;

preference shares;

redeemable shares;

other?

The tax treatment of these shares is not different as far as registration duties are concerned.

Corporate taxation

A — Taxable base

Are the costs related to the creation or increase of capital deductible?

These costs are deductible. Generally they are depreciated in equal instalments over five years.

Are there specific regimes for certain SMEs?

The Mezzogiorno plan:
This programme aims at transforming the dual character of the Italian economy and reducing the gap between the economic status of the industrialized North and underdeveloped South. The Mezzogiorno consists of the following areas: Sicily, Sardinia, Abruzzi, Molise, Campania, Apulia, Basilicata, Calabria, West-Lazio, The islands of Elba, Giglio and Capraia.

The principal benefits for companies established in the region comprise tax concessions, grants and low interest financing.

- Tax concessions

(i) Ten-year exemption from local income tax (ILOR)

This exemption starts as from, and includes, the taxable year in which the enterprise becomes profitable. Partial exemption exists in case of reconstruction, conversion, expansion and modernization of existing plants to the extent that income is attributable to the additional investment.

(ii) Ten-year exemption from corporation tax (IRPEG)

This exemption starts as from the date of incorporation.
Companies incorporated before the entry into force of Law No 64 of 1 March 1986 are 50% exempt from IREG.
Registration tax reduction: from 1% to 0.50%.
Exemption from equalization tax (the so-called 'IRPEG di conguaglio').
The payment of the equalization tax on profits distributed, when due, is not required for companies which perform their activities in the Mezzogiorno area and which are 100% exempt from IRPEG. Companies 50% exempt from IRPEG pay an equalization tax of 9/32 (equal to 50% of 9/16).

- *Financial incentives*

These incentives are subject to constant changes and vary from case to case.

(i) Outright cash grants

The cash grants available for development programmes in the Mezzogiorno vary in accordance with:

the type of manufacturing activity (building construction, machinery and equipment, motor vehicles, intangible assets, stocks, operating costs);

the location of the plant;

the size of the investment.

The maximum amount of the incentives is limited to 75% of the investment raised to 80% for scientific and technological research centres.

(ii) Low interest-rate loans

These loans at low interest rates (usually ranking from 5 to 7.5%) are granted by certain authorized credit institutions for a period of 15 years and are repayable together with interest, in general, from the third year of the loan.

- Other incentives

Social security charges are usually reduced by 8.5% for employers and 1.5% for employees. Normal charges for electric power are reduced by 50% for power used by industrial facilities in the Mezzogiorno.

- Incentives in rental accounts

These incentives are available for payment of lease rentals. The incentive can be granted on the total investment up to an amount of LIT 30 million for each productive unit. In case of leasing of machinery, the investment can amount to LIT 700 million. The maximum duration is 15 years.

All the abovementioned incentives are available until 31 December 1993. However, as far as the 10-year exemptions are concerned, in case a company has applied for such exemptions before 31 December 1991 and, at that date, the 10-year term has not expired yet, such exemptions will be available until the expiration of the 10-year period. In 1993, the Italian Parliament should issue a new law, in order to extend the duration of the abovementioned facilities and to regulate the entire system of tax concessions in the Mezzogiorno on a new base. According to the new regulation, the total or partial tax exemptions will probably be substituted with a tax credit proportionate to the cost of the new investment.

Central and Northern Italy:

Incentives related to the underdeveloped areas of Central and Northern Italy have not expired. However, due to their geographical locations, the provinces of Trieste and Gorizia (on the boundary with Yugoslavia) are considered assisted territories until 31 December 1995.

Incentives applicable are similar to those granted in the Mezzogiorno. In fact, Law No 26, dated 1 January 1986, has extended to such provinces the 10-year 50% exemption from IRPEG which is granted to companies located in the Mezzogiorno area and which were incorporated before 1986. In addition companies located in the abovementioned provinces are entitled to a 10-year exemption from ILOR. Equalization tax is reduced by one half with respect to SME operation in the provinces of Trieste and Gorizia. The same tax reliefs are granted to new enterprises that are set up before 31 December 1994 in the Valtellina (area North of Milan damaged by floods).

The decree that the Italian Government was expected to issue before 31 December 1991 has not been issued yet.

Law No 317 of 5 October 1991 — Financial facilities and tax concessions to small enterprises:

Law No 317 grants financial incentives and tax reliefs to new initiatives which are aimed to develop small industrial or services enterprises and handicraft enterprises.

Facilities provided by the new law are related either to new investments, to the acquisition of services or to research and development expenditure. It is to be noted that, except in particular cases (such as in case of capital contributions to cooperatives and pools of small enterprises), each incentive or facility is an alternative to the others and, also, it cannot be cumulated to facilities granted by other regional or national laws. Therefore, if an enterprise applies for the tax relief in connection with the realization of a new investment, it isnotallowed anymore to ask for capital contributions or for the tax credit in relation to the acquisition of services.

For the purpose of the application of this law the following are considered as small enterprises:

small industrial enterprise: an enterprise with not more than 200 employees and an equity not exceeding LIT 20 billion, net of depreciations and monetary revaluations;

small trading and service enterprise: an enterprise with not more than 75 employees and an equity of LIT 7.5 billion, net of depreciations and monetary revaluations.

As for services enterprises, only those operating in the field of planning and design of manufacturing systems and EDP services are considered eligible for the incentives provided by the law.

- Tax concessions

Instead of a total or partial exemption from taxation, limited to the period 1991-93, the new law grants, to qualifying companies, a tax credit, proportionate to the cost sustained and creditable against corporate income tax (IRPEG), personal income tax (IRPEF) and local income tax (ILOR) relating to the tax period in which the tax relief is granted.

In case, in such a tax period, the tax credit exceeds the tax debit, the excess can be utilized to decrease the tax debit of the subsequent tax periods, not beyond the fourth or, alternatively, can be deducted from VAT payments relating to the tax periods subsequent to that in which the credit is granted, not beyond the fourth.

The amount of the tax credit varies depending on the different type of investments or expenditure and on the dimensions of the enterprise. However, it ranges from a minimum amount of 20% to a maximum of 50%.

• Capital contributions and loans at reduced rates

As an alternative to the tax credit, eligible new investments and expenditure for the acquisition of services aimed to increase the productivity and to facilitate the transfer of technology are entitled to capital contributions equal to the amount of the tax credit.

A capital contribution not exceeding 30% of the cost sustained in order to realize the development programme and soft loans are granted to cooperatives and pools of small enterprises set up for the purpose of rendering services finalized to the development and the rationalization of pools' production, marketing and management. However, such a capital contribution cannot exceed, for each enterprise, the amount of LIT 300 million per year or the amount of LIT 800 million in a three-year period. Higher contributions are granted to cooperatives and pools of small enterprises located in depressed areas (50% of the cost). Unlike the rest of facilities, contributions in discussion can be cumulated to those provided by other regional or national laws or regulations.

B — Rates

• Corporate income tax and local income tax

The rate of corporate income tax (IRPEG) is 36%. The rate of local income tax (ILOR) is 16.2%. Only 75% of the local income tax is deductible for purposes of determining the taxable base for corporate income tax purposes. There is no local income tax on dividend distributions.

The tax burden will depend on the region of Italy in which the company is situated, i.e. either:

(a) in an area where no tax benefits are available;

(b) in the Mezzogiorno where income is exempt from corporate income tax and local income tax for a period of 10 years;

(c) in depressed areas in Central and Northern Italy where income is exempt for a period of 10 years-from local income tax (No longer available. See the section on Central and Northern Italy.

	(a)	(b)	(c)
Profit	400 000	400 000	400 000
Disallowed items	22 000	22 000	22 000
Income subject to corporate income tax	422 000	422 000[2]	422 000
Income not subject to local income tax	4 000[1]		(422 000)
Income subject to local income tax	418 000		
ILOR (16.2%)	67 716		
IRPEG (36%)	133 637[3]		151 920
Tax payable	201 353		151 920

[1] 4000 = dividend distribution which is exempt from local income tax (ILOR).
[2] Profits are exempt from corporate income tax in the Mezzogiorno.
[3] IRPEG is levied on 422 000 less 75% of ILOR (75% of 67 716).

• Capital gains tax

A local tax on the increase in value of immovable property (INVIM) is imposed on gains realized on the disposal of immovable property. The tax is imposed at progressive rates, depending on the period of time between acquisition and disposal of the property and on the ratio between actual gain and original cost of acquisition. The municipality in which the immovable property is situated may determine the tax rates subject to certain limits. The minimum rates vary between 3 and 25%, the maximum rates between 5 and 30%. Companies are not only subject to this tax on the disposal of their immovable property, but also on the increase in value of immovable property they own for each period of 10 years, unless the property is used directly in the company's own business activities.

INVIM is deductible for the purposes of IRPEG and ILOR.

Are there specific regimes for certain SMEs?

See 'Corporate taxation'.

How does a redemption of shares affect the tax position of the SME?

The concept of redeemable shares does not exist in Italy.

Dividend distribution

Does a different tax regime apply to dividend distribution to X (shareholder of the SME) on the one hand and to the VCC on the other hand?

No. See Section 2.2.

Does a different tax regime apply according to the different types of shares (ordinary, preference, redeemable and other shares)?

Holders of saving shares can opt for a final 15% withholding tax, instead of the normal 10%.

Is the tax base affected by the distribution of dividends?

Dividends are not deductible when computing the taxable base of a company.

Is the tax rate affected by the distribution of dividends?

An equalization tax is levied if dividends are paid out of profits which have not been subject to tax or which are subject to tax at a rate lower than the present 36% rate. That means that if a company distributes to its shareholders more than 64% of the income declared for the purposes of corporate income tax an additional corporate income tax applies. The additional corporate income tax amounts to 56.26% of the excess.

The equalization tax is strictly connected with the tax credit to which the company or the individual may be entitled. In fact the purpose of this method is to prevent dividends distributed out of exempt profits benefiting from a tax credit for taxes which have never been paid by the distributing company.

Example:

Assume that the taxable income amounts to LIT 2 million and the distributed profit amounts to LIT 1.6 million.

Distributed profits		1 600
Declared taxable income	2 000	
Less: 36% of 2 000 (IRPEG)	(720)	
		(1 280)
Distributions exceeding 64% of taxable income		320
Equalization tax (56.25% of 320)		180

What about withholding tax?

A withholding tax of 10% is withheld on profits distributed to resident taxpayers. This withholding tax is considered as an advance payment of the shareholder's personal or corporate income tax. The recipient can credit the withholding tax against his tax liability. If the withholding tax exceeds the tax liability, the difference can be refunded or alternatively carried forward at the taxpayer's option.

In case of dividend distribution to companies exempted from corporate income tax, a withholding tax of 32.4% applies.

With reference to this point, it should be pointed out that, as far as VCCs operating in the Mezzogiorno are concerned, the exemption only concerns local income tax on profits reinvested in the Mezzogiorno. A VCC is not entitled to the 100% exemption from corporate income tax, which is granted only to 'productive enterprises'. Although the meaning of 'productive enterprise' is not completely clear, we believe that the exemption in argument is to be referred to companies which directly realize the 'productive investment'. As the 100% exemption is precluded to VCCs, dividends distributed to VCCs are regularly subject to 10% withholding tax. Such a withholding tax is refundable for the VCC.

As for the tax credit on dividends received by the VCC, even if the SME is exempt from corporate income tax and therefore dividends are distributed out of non-taxable profits, the recipient of dividends is still entitled to the 9/16 tax credit. One of the conditions to benefit from the tax credit is that dividends received are included in the recipient company's taxable base. Therefore such a benefit is precluded in case of savings shares for which the shareholder has opted for the 15% final withholding tax. As, apart from this specific case, dividends are included in the VCCs' taxable base, VCCs situated in the Mezzogiorno are entitled to the tax credit. In practice, however, it cannot be excluded that some problems with the tax authorities might arise with respect to this point.

As far as the equalization tax is concerned, no equalization tax is due if the SME is 100% exempt from corporate income tax.

2.2. Taxation of the VCC

Are the costs related to the creation of the VCC deductible?

These costs are deductible. Generally, they are depreciated in equal instalments over five years.

Are management costs and interests deductible?

Interest is deductible. However, if a company receives income which is exempt from tax, the amount of deductible interest is restricted to a proportion of the total amount of interest paid; this proportion is equal to the ratio of gross taxable income to total gross income. In order to determine this ratio no account may be taken of extraordinary items of income or interest for late payments for which a reserve is established.

Management costs are deductible provided the amounts are reasonable and computed at arm's length.

They are closely scrutinized by the tax authorities, particularly when paid to a related company.

How are dividends taxed?

Dividends received from the SME are considered as taxable income subject to corporate income tax. No local income tax is due. Italian companies and permanent establishments in Italy of foreign corporations (and resident individuals) which receive dividends from companies having their legal or administrative headquarters or principal business purpose within Italy are entitled to a tax credit of 9/16 (or 56.25%) of the dividend. The credit is also included in the taxable income and deducted from the tax due.

Example:

Other income (after local income tax)	100 000
Dividends from Italian companies	10 000
Tax credit (56.25% of dividend)	5 625
Taxable income	115 625
IRPEG tax (36%)	41 625
Tax credit (5 625)	
Corporate income tax	36 000

Example:

	SME and VCC normally taxable
Profit after local tax	100
Corporate income tax	36
Net profit	64
Equalization tax	0
Gross dividend	64
Withholding tax	6.4
Net dividend	57.6
VCC	
Other income	100
Dividends	57.6 + 6.4
Tax credit	36
Taxable	200
	Ordinary taxation

How are the capital gains taxed if the shares of the SME are sold?

Disposal of shares, bonds and similar securities (excluding quotas of limited liability companies) are always deemed to generate gross receipts rather than capital gains. Gross receipts are a part of the taxable income of the company.

The alienation of 'quotas' (membership rights) of limited liability companies generates capital gains because they are deemed to be 'assets' of the company. The capital gains may be included in the taxable base, at the VCC's option, in the year in which they are realized or may be spread over a maximum of four years in equal amounts in the current and following fiscal years. However, for finance investment companies, quotas of limited liability companies are not considered as assets and therefore the alienation of quotas in this case generates gross receipts. Therefore, as long as the VCC can be considered a finance company, it cannot benefit from the deferment of taxation even in the case of alienation of quotas of limited liability companies.

What about capital losses?

Capital losses are determined in the same way as capital gains.

What is the tax position of the VCC in case of redemption of the shares by the SME?

The concept of redeemable shares does not exist in Italy.

Are there specific regimes?

VCCs situated in the Mezzogiorno cannot obtain the same benefits as the SME situated in that area. As far as VCCs are concerned, the 100% exemption for profits reinvested in the Mezzogiorno concerns ILOR, but not IRPEG.

Exemption from local income tax (ILOR) on profits reinvested in the Mezzogiorno. An Italian company is entitled to exclude from its taxable base an amount up to 100% of its in principle taxable income, if this income is reinvested in the Mezzogiorno. This exemption may not be claimed on profits which already enjoy an exemption from local income tax.

The exemption is also available when the reinvested profits take the form of equity investments in corporations, located in the assisted territories for the purpose of the construction, expansion or reactivation of industrial plants in assisted areas in that region. In this case, the exemption can be invoked even if the SME is already exempted.

Companies operating in the new offshore financial centre of Trieste (branches and subsidiaries of credit institutions, brokerage companies, insurance companies, financial companies borrowing funds in international markets, foreign intermediary companies and foreign companies assisting international trade) are excluded from corporate income tax (IRPEG) and are subject to local income tax (ILOR) at half of the normal rate.

Until 31 December 1993 financial companies whose exclusive business purpose is the temporary participation in the risk capital of small enterprises (see above, Law No 317) are entitled, in each tax period, to a tax credit equal to 5% of the increase in value of the participations purchased in each tax period and still in portfolio at the end of the tax period (31 December). However, the tax credit cannot exceed LIT 200 million.

Rates

See Section 2.1.B.

Is there recoverability of the tax withheld by the SME?

Yes, see Section 2.1.

Distribution of dividends by the VCC

Does a different tax regime apply according to the different types of shares (ordinary, preference, redeemable, other shares)?

The tax treatment of the different types of shares is the same.

Is the tax base affected by the distribution of dividends?

See point 2.1.

Is the tax rate affected by the distribution of dividends?

See point 2.1.

Is a withholding tax withheld?

A withholding tax of 10% is withheld on profits distributed to resident taxpayers.

Transfer of shares

In case of transfer of the shares of the SME, do special taxes apply to these transfers?

The transfer of shares is subject to registration tax at the fixed amount of LIT 100 000.

2.3. Tax situation of X (individual shareholder)

Is the interest paid on the loans granted in view of the purchase of the shares of the SME deductible?

No, this interest is not deductible.

How are the dividends taxed?

See point 1.7.8. (1c).

2.4. In case the SME is not a company but an unincorporated enterprise

The following forms are available:

General partnerships:all partners are jointly and severally liable for all the firm's debts and obligations.

Limited partnerships: the liability of the silent partners is limited to their capital contributions while the general partners are jointly and severally liable for all debts and obligations of the partnership.

The partnership limited by shares: this legal form combines some of the features of both a limited partnership and a limited liability company. It is a company in which at least one member has unlimited liability while the liability of the remaining members is limited to their capital contributions.

These legal forms (except the partnership limited by shares) are not considered as separate entities for tax purposes. Their taxable income is allocated among the partners (VCCs) who pay tax on the amount allocated (corporate income tax).

3. *Debt finance*

Is there a debt/equity ratio to be respected?

According to Italian law a debt/equity ratio is only stated where the debt is represented by securities, in which case the ratio is 1:1, unless the debt is secured by mortgage on real property or by State bonds.

3.1. Tax situation of the SME

Does the distinction between the following types of loans have implications for the tax situation of the SME?

(a) *Ordinary loans*

Interest is in principle tax-deductible unless the SME receives interest income or other revenue which is tax-exempt. In that case the interest paid is deductible in an amount corresponding to the ratio of gross taxable income to total gross income.

From 1 January 1990 the part of the interest exceeding the 'official discount rate' is considered an excessive

interest charge, and therefore not deductible. Even though it is not stated in the law, this provision is generally deemed to be applicable only to loans denominated in lira extended by a resident lender company to a borrower company either resident or non-resident. This provision could apply to a loan between unrelated parties.

With regard to this point, it should be pointed out that such a provision directly concerns interest receivable and only indirectly debt interest, in the sense that Article 56 of the Italian Income Tax Law states that for income tax purposes if the amount of interest received is lower than the official discount rate or if it is undetermined, such an amount is deemed to be equal to the official discount rate.

However, the entry into force of such a provision is postponed to 1994.

(b) *Convertible loans*

Debt convertible into equity is recognized as debt for legal, accounting and taxation purposes. On conversion of debt into equity a registration tax of 1% would be due. The same tax treatment as for ordinary loans applies.

(c) *Profit-sharing loans*

A profit-participating loan is treated as debt for legal, accounting and taxation purposes, unless it is shown as equity in the statutory balance sheet of the SME.

What is the situation if the VCC also participates in the SME?

Money paid by the VCC (shareholder of the SME) to the SME shall be considered as a loan, unless it appears from the balance sheet of the SME that the payment was made for another reason (i.e. equity).

What is the withholding tax in each case of the different types of loans?

Intercompany loans: no withholding tax applies on interest payments between two Italian companies.

Loan granted by an individual shareholder of the SME: the withholding tax rate is 15% on interest of this kind of loan. This withholding tax is final only on interest paid to a non-resident.

3.2. Tax situation of the company that grants a loan to the SME

What is the situation concerning the different types of loans: ordinary loans, convertible loans and profit-sharing loans?

The interest income will constitute taxable profit for the VCC

In respect of the taxability of the interest, are there exemptions or reductions for certain zones or activities?

A VCC operating in the new offshore financial centre of Trieste will be excluded from corporate income tax (IRPEG) on the interest received. The local income tax will be reduced to 8.2%.

Finally, the VCC could in future take the form of a closed-ended investment fund. At present, closed-ended investment funds are not allowed to operate in Italy. In fact, the draft law concerning such funds, issued on 7 March 1991, is still pending.

According to the abovementioned draft law, the tax position of closed-ended funds should be similar to that of open-ended funds.

Closed-ended funds, when operating, should not be liable to corporate income tax, local income tax or personal income tax.

Withholding tax on profits received by such funds should be final.

Funds should be liable to a net worth tax at the rate of 0.25% per annum. Where more than 50% of the capital of the fund is invested in the shares or debentures of

SMEs, the rate is reduced to 0.1% p.a. of the net worth. Profits realized by individuals (private investors) participating in the fund should not form part of their taxable income.

Companies participating in a closed-ended fund are granted a tax credit on profits derived from their participation, equal to 10% of the same profits. The tax credit is included in the taxable base.

How are capital gains on receivables taxed?

According to the normal rules of corporate income tax and local income tax.

What if the loan is converted into capital with capital gains or losses?

If the loan is converted into capital for an equal amount, such an operation should not generate any capital gain.

Are capital losses on receivables realized by the VCC deductible?

Yes, they are treated as ordinary losses.

Are interest payments deductible?

Yes, they are deducted according to the normal rules.

Is there a withholding tax on interest paid by the VCC?

A withholding tax of 15% is withheld if interest is paid to an individual shareholder.

No withholding tax is applicable to interest payments between two resident companies.

3.3. Tax situation of the fund

Can the fund recover the withholding tax on interest, withheld by the VCC?

The taxes withheld from interest paid to the fund are final and cannot be refunded.

Is the interest taxable?

With reference to the above, it is to be noted that according to Italian legislation on investment funds, an investment fund is not allowed to grant loans.

However, as far as closed-ended investment funds are concerned, they are not operative yet, because the draft law concerning such funds is still pending.

As far as open investment funds are concerned, Law No 83 dated 25 January 1992 has implemented Directives (EEC) 85/611 and 88/220.

The abovementioned law has brought only slight changes to the previous tax treatment of open investment funds (Law No 77 of 23 March 1983). An investment fund is not subject to the corporate, individual or local income tax. Open-ended funds must annually pay an amount equal to 0.05% of the net value of the fund, computed on that portion of the fund which consists of treasury bonds, current accounts, deposits and debentures, excluding convertible debentures.

On the remaining portion of the net worth of the fund the annual tax is equal to 0.25%.

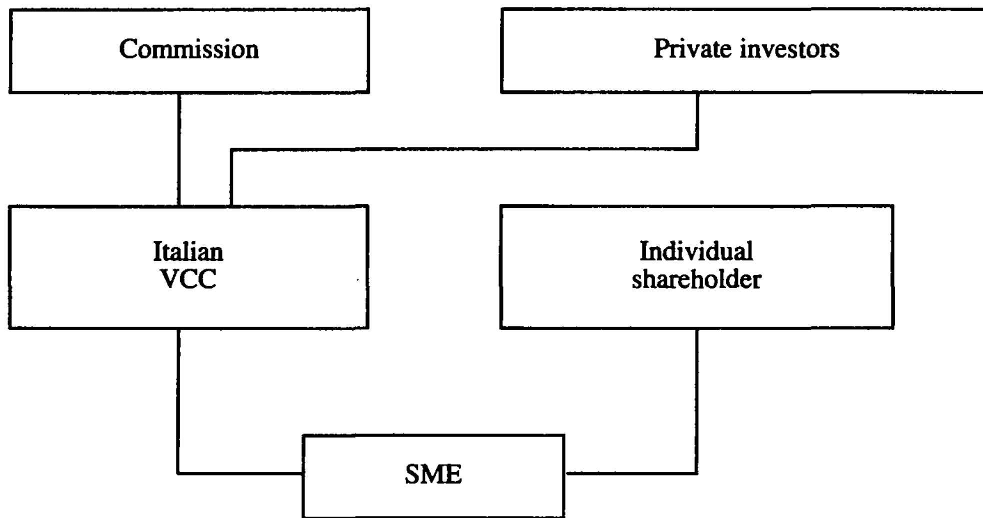
The rate of 0.25% is reduced to 0.10% on the net worth of the fund which consists of shares and convertible debentures of Italian companies, having as their exclusive or main purpose the performance of industrial activities.

The tax credit granted to unit holders of the fund on profits derived from the fund is raised from 10 to 15%.

Practical guidance

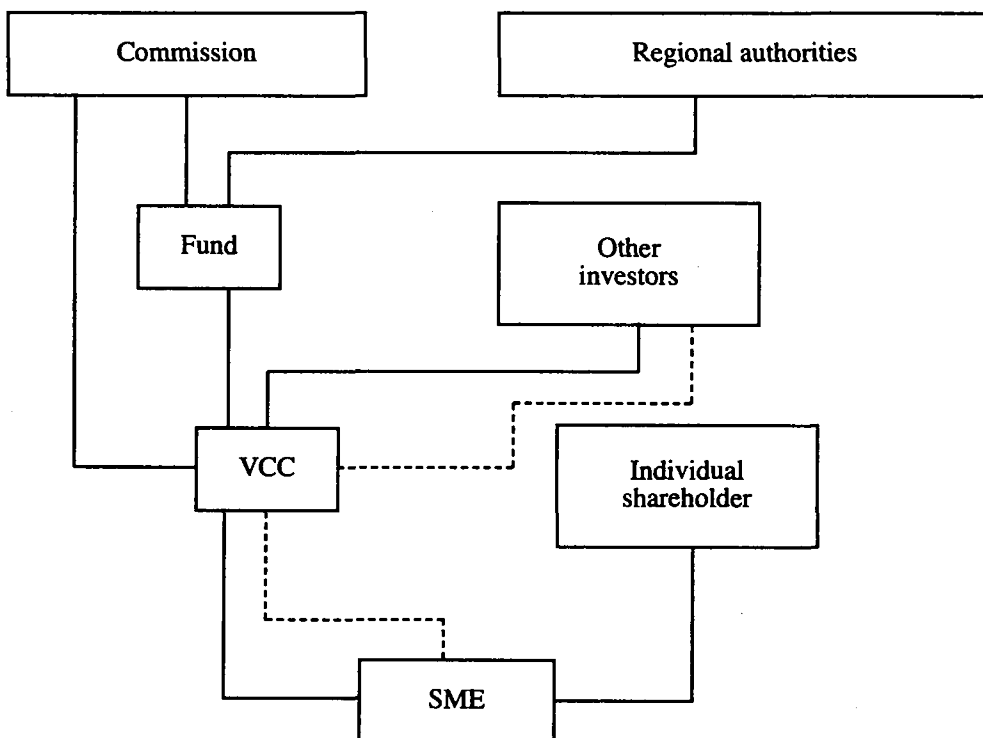
I. Equity finance

1. Scheme



II. Debt finance

1. Scheme



2. *Comments on structure*

2.1. *Position of the SME*

Costs of increasing capital:

Capital duty of 1%; notarial fees, etc. These costs can, in absolute figures, be an obstacle, although they are relatively seen, rather limited and tax-deductible. These costs, being tax-deductible for the SME, have a negative impact on the results.

No exemption from capital duty exists.

An annual licence tax of LIT 12 million is due for an SpA and of LIT 3.5 million for an SrL. This may be an obstacle for the constitution of a company.

Taxable base:

The profits of the SME are positively influenced by the capital increase.

This means that if normally losses would have occurred, because of the capital increase a better result can be shown.

If the capital increase leads to a profit situation, this profit is normally taxed at 36%.

Furthermore, a local tax of 16.2% is due. This tax is not calculated over the distributed dividends.

Special tax regimes exist (e.g. the Mezzogiorno). These companies are tax-exempt so that this disadvantage is offset.

2.1. *Position of the SME*

Costs of granting loan:

In principle no costs (except if secured by immovable property (2%) or if granted by a bank (0.25%)).

Taxable base:

The interest payments have a negative impact on the results and the cash flow of the SME. The interest payments are only deductible to a proportion equal to the ratio of gross taxable income to total gross income. This implies that the total amount remains non-deductible if the SME is exempted from corporate income tax.

Furthermore, this situation may prove unwise because a loss position may be created (no immediate use of interest deduction), whereas the interest income (with the VCC) is immediately taxable.

Tax rate:

A local tax of 16.2% is due on the profits (less dividend distribution), which is for 75% deductible for corporate income tax purposes.

The profits are taxed at 36%.

Certain regimes introduce an exemption system.

Redemption of shares:

Is not known in Italian law.

Dividend distribution:

The dividends are part of the taxable base (but not for local tax purposes).

To the extent the SME is not taxed on its profits and is not situated in the Mezzogiorno, an equalization tax of 56.25% applies to the amount of distributed dividends.

On the dividends distributed to the individual shareholder, a withholding tax of 10% applies. Should the VCC be exempt from CIT (e.g. in case it is situated in the financial centre of Trieste), a withholding tax of 32.4% applies.

2.2. *Position of the VCC*

Taxable base:

(a) Dividend income
The grossed-up dividend is fully taxable. This means that the net dividend plus the withholding tax plus the tax credit are added to the taxable base. Only the withholding tax is refundable. The non-refundability of the tax credit may lead to a double taxation. Indeed, the interest burden may lead to a negative result, in which case no corporate income tax applies.

Tax rate:

The deductible interest payments save a taxation of 36% (+ the local tax of 16.2%)

Reimbursement of the loan:

Has normally no impact on the taxable result.

Interest payment:

On the interest paid to the VCC, no withholding tax applies.

2.2. *Position of the VCC*

Taxable base:

(a) Interest income
This income is fully taxable, unless the VCC is tax exempt.

A VCC may be exempt from local income tax if it is situated in the Mezzogiorno area. However, the exemption does not apply unless the profits are reinvested as equity in SMEs located in these regions.

VCCs located in the new offshore financial centre of Trieste are subject to local income tax at half the normal rate. They may also be exempt from corporate income tax in this case.

Until December 1993, financial companies whose exclusive business purpose it is to temporarily participate in SMEs, benefit from a tax credit of 5% of the increase in value of the participations purchased in each tax period and still in portfolio at the end of the tax period.

(b) Capital gains taxation

In principle taxable, but for shares in limited liability companies, a taxation over four years exists.

(c) Capital loss on shares

In principle deductible.

(d) The interest payments are only deductible to a proportion equal to the ratio of gross taxable income to total gross income.

Dividend distribution:

The normal rules apply. However, an exemption of withholding tax applies to dividend distribution to the Commission.

Transfer of shares:

A registration tax of LIT 100 000 applies.

2.3. *Position of the individual shareholder*

Dividend income:

(b) Capital gains taxation

A registration tax of 1% applies at the moment of converting the loan into capital.

(c) Capital loss on loans

In principle deductible.

Interest payment to fund:

A withholding tax of 15% applies, which is final and cannot be refunded.

Transfer of loans:

No special tax applies.

2.3. *Position of the individual shareholder*

Dividend income:

The net dividend, with holding tax and the tax credit are taxable at progressive rates. The withholding tax can be refunded. The tax credit can be set off against the personal income tax.

See left side.

Purchase of the shares:

The financing of this operation may be difficult since the individual shareholder cannot normally deduct the interest burden.

There is no transfer of shares to the extent a loan is granted.
The interest burden remains thus with the SME.

2.4. *Position of the Fund*

No dividend income (see scheme).

2.4. *Position of the Fund*

The interest income is fully taxable.

3. *Unincorporated SMEs*

If the VCC participates in the SME (sharing of profits and losses), an equivalent part of the profits/losses is as such attributed to the VCC which is normally taxed on this income.

3. *Unincorporated SME*s

If the VCC grants a loan, the interest is deductible with the SME and fully taxable with the VCC.

Conclusion

Equity finance

1. *Major disadvantages*

Costs related to increase of capital;

The capital increase with the SME will normally lead to a higher profit and thus to a higher tax burden;

Because of the tax credit system, double taxation is to be expected;

The tax situation of the individual shareholder may be very disadvantageous as to the purchase of the shares;

Capital gains on shares are taxable;

The technique of repurchase of own shares is not known.

Debt finance

1. *Major disadvantages*

Interest is only partially deductible whereas it is totally taxable with the recipient;

Interest payments have a negative impact on the results and the cash flow of the SME. In case of a loss position, the interest deduction cannot be used, whereas the interest income with the recipient is immediately taxable;

Capital gains on loans are taxable.

2. *Major advantages*

Companies located in the Mezzogiorno and Trieste may be exempt from corporate income tax and/or local tax. For VCCs exempt from CIT, the advantage may be lost in case of dividend distribution, because of the equalization tax.

2. *Major advantages*

No costs are related to the granting of the loan;

The taxable base of the SME will normally be reduced;

Capital losses are deductible;

The problem of the imputation of the tax credit does not arise;

If the VCC is exempt from corporate income tax, the interest income is not taxed. However, this advantage may be neutralized when distributing dividends (equalization tax);

The private shareholder is not confronted with the purchase of the shares.

Italy	Equity		Debt		
	SME and VCC normally taxable	SME exempt from CIT[1]		Interest payments to VCC subject to CIT	Interest payments to exempt VCC[6]
SME profit before local tax	100	100	Interest payment deductible with SME	Yes[7] (–100)	Yes[7] (–100)
Corporation tax 36%	–36 64	0 100	With-holding tax	0	0
Equalization tax[2]	0	0			
			Interest income before tax at recipi ent's level	100	100
Gross dividend	64	100	Taxable base	100	0
Withholding tax	–6.4	–10[3]	CIT 36%	36	0
			Tax borne at source	0	0
Net dividend before tax at recipient's level	57.6	90	Interest income after tax	64	100
Taxable base	100	156.25			
CIT at recipient's level	–36	56.25			
Tax borne at source	42.4	66.25[4]			

Italy	Equity		Debt		
	SME and VCC normally taxable	SME exempt from CIT[1]		Interest payments to VCC subject to CIT	Interest payments to exempt VCC[6]
Restitution[5]	6.4	10			
Net dividend after tax	64	100			

[1] For instance an SME situated in the Mezzogiorno.
[2] Equalization tax is levied if dividends are paid out of profits which have not been subject to tax or only at a lower rate than the present 36% (normal CIT rate). So, in case a company distributes more than 64% of the income declared for CIT purposes, an additional CIT applies, amounting to 56.25% of the excess (over 64%). This equalization is connected with the tax credit of 9/16 or 56.25% of the dividend. However, exemption from equalization tax applies to SMEs situated in the Mezzogiorno.
[3] Withholding tax in case of dividend distribution to companies exempt from corporate income tax (e.g. VCCs situated in the offshore financial centre of Trieste) is 32.4% instead of 10%.
[4] Tax credit and withholding tax.
[5] Withholding tax is refundable; tax credit is lost.
[6] For VCCs operating in the new offshore financial centre of Trieste.
[7] Interest payments are only deductible to a proportion equal to the ratio gross taxable income to total gross income. This implies no deductibility if the SME is totally exempt from CIT.

III. Other issues

1. *Local and regional authority issues*

Several public corporations (GEPI, SPI, regional holdings) have been founded in order to provide venture capital to enterprises able to promote development in certain branches or areas, in particular from the employment point of view. Despite the fact that these companies provide venture capital, they have to be distinguished from the private and/or banking venture capitalists because of their different aims; they considerably affect the entrepreneurial projects to be carried on and the entrepreneur involvement level, whose role in the development cycle of the company is usually less active. In fact, except in a few cases (i.e. in situations such as Finanziaria Regionale Friulia and SPI), these companies, for many reasons, did not work as venture capital entities. In practice, such holding companies, by means of having acquired participations, aimed more at rescuing enterprises in a critical position than investing in enterprises showing good development potential from the income and managerial point of view.

The aim of these holding companies was, therefore, to promote employment. The intervention of the public corporations can be assimilated to a long-term loan granted to the enterprises rather than to participating in them by means of risk capital.

In fact, national and regional growth companies aim not to sell the participation whether in case of success (their main objective is not to realize capital gains) or of failure, in order not to compromise the level of employment or for more generically political reasons.

Moreover, there exists in Italy a series of provisions instituted following contributions from EEC funds and managed by some regional organizations, aiming to 'enrich' the risk capital market and to make it easier for SMEs to approach venture capital or merchant banking companies.

The first provision concerns the creation of venture capital companies destined to invest solely in SMEs. The beneficiaries of this provision have been the following regions:

Liguria (by means of the 'Ligur Capital SpA' foundation);

Sardinia (not yet established);

Marche (by means of the 'Marche Capital SpA' foundation);

Abruzzi (not yet established);

Molise (not yet established).

The second provision concerns the constitution of guarantee funds to acquire minority participations by venture capital or merchant banking companies in SMEs. Such guarantee funds cover a share of the probable losses which may eventually be suffered by the investment holding company on its participation. The beneficiaries of this second provision have been the following regions:

Liguria (by means of the 'Venture Fidi' foundation);

Umbria ('GPII' SpA);

Tuscany ('Fidi Toscana');

Apulia (not yet established);

Emilia-Romagna ('FIT' SpA);

Molise (not yet established).

The third and last provision is represented by the so-called 'accomplishing funds' acquiring participations in funds or investment private holding companies specialized in acquiring participations in SMEs. The beneficiaries of this last provision are the following regions:

Apulia (not yet established);

Lazio (not yet established).

2. *Impact assessment*

The venture capital market based on institutional investors in Italy can be considered young in comparison with the other industrialized countries, especially the United Kingdom. With the exception of a few cases, most operators now in the market began to operate during the 1980s (particularly in the second half). Because of its own recent origin, too, this market during recent years has been experiencing high growth rates and still shows a great vitality with reference both to the number of operators and to the capital invested in it.

On the basis of AIFI data, the number of holding companies grew from 7 in May 1986 to 37 at the end of 1990. Almost all these companies were newly founded. Partners' net assets nearly tripled in 1986–88 changing from 1 170 to 3 104 billion, the growth rate remaining high also during the following two years.

The number of actual participations remained low by comparison to the growth in the amount of capital on offer (both in terms of the number of operators and the availability of funds); on the basis of EVCA data (1988), only half of the funds issued by holding companies was invested in participative stakes in companies. It seems that this situation remained nearly unchanged during the following two years.

The main reasons for the delayed growth of the activities of merchant banking and venture capital are:

- a lack of a set of rules (especially from the tax point of view) supporting venture capital operations by institutional investors; lack or delay in passing several provisions allowing a real-estate market renewal (closed-ended, Righi-Battaglia and SIM's laws) in order to allow for disinvestment;
- a small enterprises network continuing mainly to conform to property closed models.

Tax regulations and difficulties in effecting a disinvestment by the investors make the participation by means of venture capital less inviting for the company.

It should be noted that recently, in absolute terms, interventions promoting new enterprises (venture capital), as well as those typical of merchant banking ('bridge-investments' with a view to obtaining a quotation, share reorganization, etc.) mainly applied to medium or medium/large sized companies, have been progressively growing.

A considerable investment rate is involved in growth operations, where consolidated enterprises are preferred.

On the basis of information concerning 356 operations carried on by Italian investment holding companies, the participating enterprises' average proceeds of sales are about 40 billion. The average share capital (possible surcharge included) is just lower than 2.5 billion. The average size of shareholding is equal to 20%.

The growth in management and family buy-out operations is noticeable. As far as the available funds are concerned, it is assumed that the increase in operators and available resources will continue in the future, allowing a higher number of companies to enjoy these resources.

The passing of several provisions (in particular the law concerning small enterprises and innovation holding companies and the law governing closed-ended funds) could lead to further development in the market as far as venture capital operations are concerned.

No doubt more and more companies will have growth and reorganization requirements, especially due to the European market's new dimensions. The requirements that SMEs will have to fulfil in the future can be summarized as follows:

- necessity of a quick growth and of a more effective presence in foreign markets;
- ability in managing purchasing operations and in agreeing also at an international level;
- operating on the basis of managerial methods and with greater attention to strategic and financial aspects;
- greater distinction between personal and company property.

IV. Comparative legal and regulatory issues

Recommendations

In Italy there are no specifically regulated venture capital companies (like, for example, the French Société de capital risque), except in the banking area.

It would be desirable to introduce specific rules governing non-banking venture capital companies. This would encourage the development of venture capital techniques.

To promote venture capital operations it is recommended to provide some fiscal incentives (such as the tax reduction for participating certificates in Luxembourg venture capital investment).

Luxembourg

Introduction

No major legal obstacles exist to the provision of venture capital in Luxembourg except that the government scheme of issuing venture capital investment certificates and the consequent tax advantages are limited to Luxembourg residents. The holder of a certificate is free to sell the certificate to a third party provided he is a Luxembourg resident.

From a tax point of view, no major obstacles occur. It should, however, be noted that the dividend and capital gains exemption only applies under certain conditions, so that double taxation may result, not only for corporate income tax, but also for business tax and net worth tax purposes. As far as debt finance is concerned, interest on loans in order to finance the acquisition of a participation in the SME is not deductible to the extent it relates to exempt income.

Favourable regimes exist when the VCC takes the form of an investment fund (tax-exempt dividend income) or a 1929 holding company (tax-exempt interest and dividend income).

Furthermore, several laws (e.g. the Laws of 13 December 1988 and 3 April 1989) have been enacted in order to promote the provision of risk capital through tax reductions.

I. Legal and regulatory issues

1. *Typical investment vehicle used*

- Stock company;
- Limited company.

2. *Applicable legal measures*

- The Law of 27 April 1984 promoting productive investments by enterprises and stimulating job creation by promoting the retention of transferable securities.
- The Law of 7 June 1989 concerning the extension and the modification of the Law of 27 April 1984.
- The Law of 13 December 1988 creating a temporary specific tax regime for audiovisual investment certificates.
- The Law of 3 April 1989 creating a temporary tax system for venture capital investment certificates.
- The Law of 10 August 1915 concerning commercial companies.
- The Law of 13 March 1988 relating to undertakings for collective investments.

Luxembourg legislation on venture capital is very limited and only deals with some elements of this financial technique.

There is no specific legislation on SMEs and venture capital.

It has to be borne in mind that an SME in most European countries is of a similar size to big enterprises in Luxembourg. Therefore the legislation concerning venture capital can be used for all types of enterprises in Luxembourg.

The legislation referred to the above contains, on the one hand, the possibilities that exist for the provision of risk capital and, on the other, the tax reductions related to these techniques.

3. *The investment vehicle*

There do not appear to be any significant obstacles to the operation of investment vehicles. The laws set out above, provide, however, certain formalities and restrictions.

- The Law of 27 April 1984

This law and the Law of 7 June 1989 create a system which provide finance to SMEs. The SMEs receiving the finance are not subject to restrictions. There are, however, some restrictions on the providers of the finance.

The object of this law is to allow natural persons who are taxpayers in Luxembourg and who acquire ordinary shares or shares in a partnership representing cash investment in a finance company to benefit from tax advantages.

The companies which may issue those shares have to be either stock companies or limited companies.

Only the following are considered to be an acquisition of securities representing a cash investment:

(i) the subscription of shares on the occasion of the constitution of the company or when there is an increase of capital;

(ii) the acquisition of subscription rights;

(iii) the acquisition of shares in an undertaking for collective investment;

(iv) the conversion of convertible bonds in shares or capital shares.

The taxpayers may obtain an abatement of their taxable income.

The dividends and profits are free of all taxes if the shares and securities are in the possession of the taxpayer at the end of the year of their acquisition.

The invested venture capital benefits from property tax exemption.

- The Law of 7 June 1989

By virtue of this law enterprises in Luxembourg, in particular financial institutions, have not had any problems selling their shares. In this way the enterprises received a considerable amount of capital without being forced to take expensive credits or loans.

There are only three limitations:

(i) the owner of these shares has to be a natural person;

(ii) the tax advantage can only be accorded if the shares are paid up in full;

(iii) The only qualifying increase of capital is the one by assets brought in and not by incorporating the reserves.

- The Law of 13 December 1988

This law establishes a temporary tax system for audiovisual investment certificates which stimulate the investment of risk capital for the production of audiovisual works which will be directed in Luxembourg.

The government is authorized to issue, during the time-period from 1988 to 1992, audiovisual investment certificates for the shareholders and associates in proportion to their participation in the registered capital of the company located in Luxembourg.

In order to be granted an authorization from the government to issue investment certificates the matter must be approved by the Minister for Finance and the Minister for Cultural Affairs.

- Law of 3 April 1989

The venture capital certificates are destined to encourage the investment of risk capital in new enterprises or for new productions.

The government is authorized to issue, during the period 1988 to 1992, venture capital investment certificates for shareholders or associates in proportion to their participation in the registered capital of a finance company located in Luxembourg.

These finance companies must be approved by the government and their only activity must be financed by risk capital.

The decision to issue risk capital investment certificates is taken by the Minister for Finance and by the Minister for the Economy.

Participants will be able to benefit from a tax reduction. This reduction will not constitute more than 30% of the taxpayers' taxable income.

The reduction due to risk capital investment cannot be combined with the reduction for the audiovisual investment.

Both the laws of 1988 and 1989 promote the financing of enterprises' activities by investment certificates.

In this case both legal and natural persons acquire these financial securities, whereby the company that gets the investment certificates plays the role of a financing 'middleman' for the SME.

At the outset the Law of 27 April 1984 was adopted to provide SMEs with the necessary structure for the provision of risk capital. The expected success did not occur. Therefore the new laws of 1988 and 1989 were adopted especially to improve the situation.

- The Law of 10 August 1915

This law deals with all types of companies and with all possible financial techniques related to these companies, in particular the stock company.

The law contains several financial techniques which allow the provision of risk capital to all types of companies.

These techniques may be considered as equity finance and debt finance.

They include: increase of capital; preference shares; redeemable shares; convertible bonds.

No particular obstacles arise under this law. It does, however, impose certain conditions and restrictions which must be respected.

- The Law of 13 March 1988

The first part of the law deals with undertakings for collective investment in transferable securities (UCITS) situated in the Grand Duchy of Luxembourg.

For the purpose of this law UCITS are undertakings whose:

(i) sole object is the collective investment in transferable securities of capital raised from the public and which operate on the principle of risk spreading;

(ii) units are repurchased directly or indirectly, out of those undertakings' assets.

The law also relates to investment companies with variable capital in transferable securities (SICAV).

These investment companies shall be taken to mean those which have adopted the form of a public limited company governed by Luxembourg law and whose:

(i) exclusive object is to invest their funds in transferable securities in order to spread the investment risks and to insure for their shareholders the benefit of the result of the management of their assets;

(ii) shares are intended to be placed with the public by means of a public or private offer;

(iii) articles of incorporation provide that the amount of the capital shall at all times be equal to the net asset value of the company.

The SICAV shall be subject to the provisions applicable to public limited companies.

It may also invest in securities such as commodities or in real estate.

All the information that a SICAV publishes, all legal obstacles and all limits of permissible investments can be found in the Luxembourg Monetary Institute Circular 91/75 concerning the revision and the remodelling of the rules applicable to Luxembourg organisms covered by the Law of 13 March 1988 relating to UCITS.

Apart from the capital duty levied on the contribution of capital to civil and commercial companies and the subscription tax, no other tax shall be payable by the undertakings for collective investment referred to in this law.

4. *The recipient of venture capital*

As under the previous section there appear to be no significant restrictions which affect the recipients of venture capital finance. A few points must, however, be made.

- Law of 13 December 1988

As the title of the law suggests, the recipients of venture capital under this law must be engaged in the audiovisual sector. Furthermore, the works must be produced and directed in Luxembourg. The recipients must be approved by the government and their only activity must consist of the financing of audiovisual work. It is not possible to combine the advantages derived from this law with those of the Law of 27 April 1984.

- Law of 3 April 1989

This tax advantage cannot be combined with the benefit of another special tax system conferred by another law.

The registered capital of the Luxembourg enterprise that can benefit from risk capital must not be superior to LFR 500 000 000.

This financing will be accomplished exclusively for investments in the registered capital of new enterprises or of enterprises attempting an increase of capital.

- Law of 10 August 1915

As has been seen in Section 3, this law, which is of a general application to all commercial companies, allows the provision of venture capital to all types of companies. There are, therefore, no restrictions on recipients.

5. *The provision of venture capital*

With the exception of the comment made below, there appear to be no legal obstacles to the provision of venture capital in Luxembourg.

- Law of 3 April 1989

The originality of the Luxembourg system regarding venture capital investment certificates consists in the fact that the owner of the certificate may negotiate the certificate and sell it to a third person who must be a Luxembourg resident. They are the only persons who can benefit from the tax advantages.

II. Issues of taxation

1. *Introduction*

The SME is often confronted with the difficulty of attracting financial means from third parties.

Indeed, on the one hand, to contract a loan with a bank, the SME has most of the time too low an equity, so that the financial institutions feel rather reticent to grant any loan.

On the other hand, because of the high risk of the investment, only very few people are willing to increase the capital (and therewith the loan capacity) of the SME.

The VCC can therefore play an important role in the expansion of the SME.

The VCC and the target company (SME) will have to determine how the capital is to be injected. It may very well be that there is a conflict of interest between both parties in determining how the injection will be executed.

In general, the (tax) differences between debt financing and equity financing can be established as follows:

In case of debt financing by the VCC, the interest payments are for the SME in principle tax deductible expenses, which have a negative impact on the results (possibly into a loss position) and on the cash flow of the SME. The VCC will be fully taxable on the interest income.

It may very well be that this situation is not at all desirable. Indeed, the SME will probably be in need of extra means at a time when heavy investments are planned which will already have a negative impact on the results (depreciation of the investment). From a tax point of view such a situation may also prove to be unwise. The interest deduction cannot be properly used because of insufficient profits (creation of losses) whereas the interest income with the VCC is immediately taxed.

To meet both economic and tax demands, two main options are available:

- either the loan agreement is concluded under circumstances where the interest rate is in the beginning rather low (e.g. profit-sharing loan or convertible loan); or
- the VCC decides to participate in the capital of the SME.

In case of equity finance, the following problems arise:

Dividend income: if the VCC is in need of a more or less regular income to finance its own investment, this will have to be done by way of dividend distribution. This may present a great deal of problems.

Dividends are normally not tax-deductible, so that the dividend capacity will normally be lower than the interest payment capacity.

In case of dividend distribution both the VCC and the individual shareholder will receive a dividend. The dividend taxation of individuals is often very disadvantageous. To avoid this problem, the VCC might opt for preference shares, so that dividends can be distributed to the VCC and not to the individual shareholder.

Dividends received constitute taxable income for the VCC. However, when the VCC has a 'substantial holding' during a certain period in the SME, dividends received are completely exempt from corporate income tax. The interest due to the VCC for the financing of such a substantial holding is not deductible to the extent that the interest payments do not exceed the amount of dividends received.

1929 holdings and investment funds are not taxable on their income. Dividends remain untaxed. The interest is not deductible.

Capital gains income: this way could be interesting since, by doing so, the SME retains all profits and if the

value of the SME decreases, the capital loss realized on the sale of the shares is tax-deductible.

If the value of the SME increases, the capital gain will be tax exempted, if the affiliation privilege is met or when the VCC operates under the form of a 1929 holding. The problem is that the individual shareholders will normally not have enough means to purchase the shares. Moreover, tax-wise, their position is rather uninteresting because they cannot claim an interest deduction, which has of course a very negative impact on the financing of this purchase. Therefore, one could consider a redemption of shares. This means that the SME purchases its own shares. Only to the extent a hidden capital gain is expressed, taxation takes place with the SME. For the VCC, the capital gain will be taxed as mentioned above.

In the next section (Equity/Debt finance), a summary is given of all the important items that could influence the decision-making of the VCC and the SME.

In the last section (Practical taxation guidance), practical guidance is given resulting from the information in the sections Equity/Debt finance.

2. *Equity finance*

2.1. Introduction

Are there registration or other duties?

In general, any contribution of cash to the capital of a company in exchange for shares is subject to a capital duty at the rate of 1% in the case of an SA, and 0.5% in the case of an SARL, if at least 90% of its share capital belongs to family members. The taxable base is the amount of cash contributed.

The contribution in kind to the capital of a company in exchange for shares is subject to a capital duty at the rate of 1% for an SA and 0.5% for an SARL. The taxable base will be either the par value of the shares received or the value of the contribution, whichever is greater. The contribution will be valued at fair market value, i.e. the price which could be obtained for the asset at public sale under normal circumstances from independent buyers, less any obligation assumed by the company which is attached to the asset.

Additional costs of creating a company are:

- notarial fees;
- Chamber of Commerce fees;
- costs for publication in the Official Gazette.

Also, other taxes are related to the capital: e.g. the net worth tax, the business tax on capital and the subscription tax for 1929 holding companies and investment funds.

Are there conditions to be met in respect of the legal form of the VCC? Are there any specific forms available?

Luxembourg legislation provides no special legislation concerning VCCs.

A VCC will most likely operate in Luxembourg under the form of a corporation (SA); such a corporation needs at least two shareholders and a completely subscribed share capital of at least LFR 1 250 000 with a minimum of 25% paid up on each share (with the exception of 1929 holding companies in which case LFR 1 million has to be paid in).

A VCC can also operate under the form of a limited liability company (SARL); such a company requires at least two shareholders and a completely suscribed capital of FLR 500 000 fully paid in.

A VCC can also operate as an investment fund.

Are there limits as to the degree of participation of the VCC in the SME?

No. However, the degree of participation will have its consequences on the tax treatment of dividend income

and capital gains on shares. Moreover, capital duty of 0.5 % may be increased to 1% if the VCC takes a participation of more than 10%.

2.2. Tax situation of the SME

Creation of the SME

Are there registration or other duties?

See Section 2.1

Are there exemptions for certain zones, projects, activities?

No.

Is the indirect tax treatment different for the following types of shares:

- *ordinary shares;*
- *preference shares;*
- *redeemable shares;*
- *others (if regularly used)?*

No.

Corporate taxation

Are the costs related to the creation or increase of the capital deductible?

Yes.

Are there specific regimes for certain SMEs (certain zones, activities, projects)?

No.

Rates

Luxembourg resident companies are subject to Luxembourg corporation tax on their worldwide income earned during a fiscal year. Corporation tax comprises an income tax of 33% increased by an unemployment surtax of 1%. Also, other taxes normally become due, e.g.:

- municipal business tax on income;
- municipal business tax on capital;
- net worth tax;
- subscription tax.

Reduced rates apply to income up to LFR 1 312 000.

Income level (in LFR)	Corporate income tax (in LFR)
LFR 1 – 400 000	20%
LFR 400 001 – 600 000	LFR 80 000 on the first LFR 400 000 + 50% on the excess
LFR 600 001 – 1 000 000	LFR 180 000 on the first LFR 600 000 + 30% on the excess
LFR 1 000 001 – 1 312 000	LFR 300 000 on the first LFR 1 000 000 + 46.8% on the excess.
1 312 000 and over	33%

The only condition which must be met in order for the reduced income tax rate to apply is that the annual amount of taxable income should fall within the relevant band.

Are there specific regimes for certain SMEs (certain zones, activities, projects)?

No.

How does a redemption of shares affect the tax position of the SME?

The redemption of shares is considered as taxable profit for the SME for the amount exceeding the capital and the taxed reserves.

Dividend distribution

Does a different tax regime apply to dividend distribution to X (shareholder of the SME) on the one hand and to the VCC on the other hand?

No, with the exception of withholding tax.

Does a different tax regime apply according to the different types of shares: ordinary, preference, redeemable, other shares?

No.

Is the tax base affected by the distribution of dividends (deductible dividend)?

No.

Is the tax rate affected by the distribution of dividends?

No.

Is a withholding tax withheld? Rate? Exemptions?

Yes, at a rate of 15%.

An exemption from withholding tax exists if the following conditions are met:

- the distributing company is a 'société de capitaux', resident in Luxembourg and fully taxable;
- the parent company is a 'société de capitaux', resident of an EEC Member State and fully subject to tax;
- a direct participation of at least 25% exists during a non-interrupted period of at least two years at the moment of dividend distribution.

Business tax

Business tax on income

This is a municipal tax to which all Luxembourg companies are subject, with exception of the holding company of 1929.

The taxable base is the profit as computed according to the corporate income tax, with some differences.

The following items must be added (in so far as they were deducted during computation of the corporate income tax): 50% of rents and royalty payments if paid to persons who are not subject to the business tax; 40% of interest on long-term loans and on other loans which are an extension of capital were not deductible in the past. However, with the Act of 6 December 1990, this rule is abolished as from 1 January 1991.

The following items must be deducted from income:

- 10% of the assessed value of the company's real property; and
- income received from a permanent establishment abroad.

A basic exemption of LFR 700 000 of profits is available. The tax rate is usually 9.09%.

Business tax on capital

The taxable base is the net worth of the company, with some corrections.

To be added to the taxable base is the value of business assets (including patents) hired from persons not subject to the business tax; 40% of the amount of longterm debts must not be added; a basic exemption of LFR 1.8 million is available; the effective rate ranges from 0.36% to 0.6%. The usual rate is 0.5%. The 1929 holding company of 1929 is exempted.

Net worth tax ('impôt sur la fortune')

This is a State tax to which resident companies are subject with the exception of holding companies.

The taxable base is the value of worldwide net worth at 1 January of each year, which is defined as assets minus liabilities. Liabilities relating to assets that do not belong to the company's gross worth may not be taken into account (i.e. deducted) in computing net worth.

The minimum taxable net worth for resident companies is:

- in the case of a resident SA: LFR 500 000.
- in the case of a resident SARL LFR 200 000.

A tax of 0.5 % applies with a minimum of LFR 2 500 for an SA and LFR 1 000 for an SARL.

Excluded from the tax base are:

(i) Substantial holdings in another Luxembourg company, provided that the general definition of the affiliation privilege applies, i.e. provided that the parent company holds at least 10% of the issued capital of the subsidiary (or for a value of at least LFR 50 million) and has maintained this investment continuously for at least 12 months preceding 1 January of the respective year. This delay is not requested for qualifying participations acquired or contributed in the first year of constitution.

(ii) Foreign-sites immovable property which is exempted under a tax treaty;

(iii) Artistic and literary copyrights and unpatented inventions belonging to the originator or inventor;

(iv) The total net worth of a Luxembourg 1929 holding company;

(v) Debts related to exempted net worth;

(vi) Long-term debts.

Subscription tax

A tax is levied on the market value of shares.

For a 1929 holding company: 0.2%.

For investment funds: 0.06% (of the net assets).

Subscription tax has been abolished for all other companies.

2.3. Taxation of the VCC

Corporate taxation

Are the costs related to the creation of the VCC deductible?

Yes.

Are management costs and interest deductible?

Yes. However, interest paid to acquire participations that qualify for the participation exemption are not deductible to the extent that they do not exceed the dividend income.

How are dividends taxed?

Dividends received constitute taxable income in the hands of the VCC. The withholding tax (15%) is credited against the VCC's income tax.

However, two important exemptions exist:

If the VCC is a 'société de capitaux' (joint stock companies, limited liability companies and partnerships limited by shares), resident in Luxembourg and fully taxable, and holds a participation of at least 10% of the distributing company's share capital or a participation having a cost price of at least LFR 50 million, the dividends received are completely exempt from income tax.

The participation exemption will, however, only be applicable provided the recipient company has held the investment from the beginning of its financial year and at least during the 12 months preceding the end of the financial year during which the dividends are received. When the VCC is a 'société de participation financière' the same principles are applicable.

When the VCC is a 1929 holding company, dividends paid will not be taxed as such due to the fact that holding companies are only subject to a 0.2% 'taxe d'abonnement'.

What is the capital gains tax if the shares of the SME are sold?

Basically, all gains arising from the sale of capital assets are treated as ordinary income and taxed at normal rates.

Deferred taxation of capital gains, however, is possible. When, in the case of a going concern, a non-depreciable asset is sold voluntarily, the gain realized at the time of alienation may be postponed by allocating that gain to a reserve, and by applying it to the cost of acquisition or production of the new asset (shares emitted at the moment of capital increase or constitution of a company), which is purchased or produced to replace the alienated one, provided that:

(a) the alienated asset was a company asset for at least five years prior to sale;

(b) if the gain is realized on shares, it may be rolled over into the acquisition of another shareholding if consent is obtained from the Treasury Minister and the realization and reinvestment are considered to be in the interests of the national economy.

N.B.: An amendment to the law has been drafted which, if voted, would mean that the reinvestment would only have to be for valid economic reasons, rather than in the interests of the national economy.

Capital gains arising in the hands of a holding company (1929) are not taxed.

Capital gains realized by a 'Sopafi' (i.e. an ordinary Luxembourg company) are fully tax-exempt, if:

- there is an active participation. This condition is fulfilled to the extent that the Luxembourg company holds at least 25% of the share capital of the subsidiary or the purchase price amounts to at least LFR 250 000 000;
- the shares have been held for a minimum period of 12 months preceding the beginning of the year in which the shares were sold;
- the subsidiary is a resident taxpayer subject to income tax or a non-resident taxpayer subject to a tax corresponding to the Luxembourg corporate income tax (i.e. minimum 15% on the taxable base).

What about capital losses?

A capital loss from the sale or other disposition of business property is treated as any other loss. It may be set off against positive income. These losses may be carried forward for five years. Carry-back is not allowed.

What is the tax position of the VCC in case of redemption of the shares of the SME?

As mentioned before, the redemption of shares is considered as taxable profit for the SME. The tax position of the VCC will be similar to the one where a dividend is distributed. Moreover, no withholding tax applies in case of redemption of shares.

Are there specific regimes?

Yes, the abovementioned holding company of 1929.

Rates

See above. As to the business tax on income, the same treatment applies as for corporate income tax. This means that if the dividends are not taxed under the corporate tax regime, no business tax on income applies. As to the business tax on capital, participations (in fully taxable companies) of at least 10% or LFR 50 million are excluded from the taxable base. The same rules apply for net worth tax purposes, if additionally the participation is held for an uninterrupted period of 12 months preceding 1 January of the respective year (with the exception of the first year of constitution).

Is there recoverability of the tax withheld by the SME?

If withholding tax is withheld (which will not always be the case) this tax will be credited against the recipient's company income tax. In case of excess, the withholding

tax is refundable. This is not the case for 1929 holding companies.

Distribution of dividends by the VCC

Does a different tax regime apply according to the different types of shares: ordinary, preference, redeemable, other shares?

No.

Is the tax base affected by the distribution of dividends (deductible dividend)?

No.

Is the tax rate affected by the distribution of dividends?

No.

Is a withholding tax withheld? Rate? Exemptions?

Yes, at a rate of 15%

No withholding tax applies to dividends distributed by a 1929 holding company.

Are specific regimes available?

The VCC could operate as a 1929 holding company provided the requirements are met. In most cases of passive venture capital investment this should be the case. Care would have to be taken, however, to ensure that the company observed the conditions, particularly with regard to its own funding, and its involvement with its subsidiaries, in order to obtain its status.

An investment fund (whether a corporate entity, i.e. a SICAV or SICAF or an unincorporated collection of assets, an FCP) can operate as a VCC. There are particular conditions attached to venture capital funds, e.g.:

- the directors of the management bodies and the investment advisers must be suitably qualified;
- the prospectus must contain a detailed description of the risk inherent in the investment policy.

The tax regime applicable to venture capital funds is the same as applied to any other Luxembourg fund, i.e. they are exempt from all tax in Luxembourg apart from an annual subscription tax of 0.06% of the net assets (Law of 13 March 1988).

No withholding tax is levied on distributions made by a Luxembourg investment fund.

Dividend income received from the fund by the shareholder is taxable unless the shareholder has a special tax status (e.g. the Commission), or the investment qualifies under the 'Loi Rau' (Law of 27 April 1984). Under this law, individual resident taxpayers who subscribe to shares on the formation or increase or capital of a qualifying company benefit from an exemption of LFR 60 000 per year of dividend income (since the Law of 7 June 1989) in addition to an allowance in respect of the investment in the year the investment is made. Shares in investment funds only qualify if at least 75% of the investment portfolio of the fund is invested in shares of qualifying resident share capital companies.

Transfer of shares

In case of transfer of the shares of the SME, do special taxes apply these transfers?

No.

2.4. Tax situation of X (individual shareholder)

Is the interest paid on the loans granted in view of the purchase of the shares of the SME deductible?

No, since the dividend income does not constitute business income.

How are the dividends taxed?

Dividends are included in taxable income for individual income tax purposes. However, when withholding tax is

withheld this tax may be credited against the individual income tax due, any excess being refundable. For specific regimes see previous page.

2.5. In case the SME is not a company but an unincorporated enterprise

If the VCC participates in such an enterprise, how does this affect the position of the enterprise?

It does not affect the position of the enterprise itself.

Is a transparent company (partnership) created?

Yes.

If so, what are the tax implications (both for the enterprise and the VCC)?

Or is a new tax subject created? What are then the tax implications?

A general partnership (Société en nom collectif) will be created under a business name by those two persons who are personally, jointly and severally, and indefinitely liable for the company's debts.

It is performed by deed under private seal published by extract. Shares are not normally transferable. However, the articles of incorporation may provide for departures from this rule.

A partnership's day-to-day management is entrusted to a manager. The law does not prescribe any governing body.

The company is not as such subject to tax but personal or corporate income tax is levied on the partners to the extent of their share in the company's income.

This type of company has a legal personality separate from that of its members.

Another possibility is one where a limited partnership is created (Société en commandité simple).

It is formed under a business name by one or more partners ('general partners') who are jointly and severally and indefinitely liable and one or more 'limited partners' who merely contribute capital and are liable only to the extent of their contribution.

It is formed by deed under private seal published by extract. Shares are not normally transferable. The articles of association may provide for departures from this rule.

Day-to-day management is carried out by a manager. A limited partner is prohibited from taking any part in management. No governing body is prescribed.

The company is not as such subject to corporation tax but its members are taxed on the corresponding personal or corporate income.

For corporate income tax the profits of the partnership which is transparent for tax purposes are taxed at the level of the partners. Thus, any profits received by the Commission will be covered by the Commission's special tax status.

Withholding tax is levied on the dividends from the SME to the shareholder (corporate entities, partner in the VCC) unless the affiliation privilege applies.

If the affiliation privilege provisions do not apply, taxes are due twice.

3. *Debt finance*

Preliminary question: is there a debt/equity ratio to be respected?

The debt/equity ratio which should be respected by ordinary companies is based on an arm's length principle. Tax inspectors tend to accept a ratio from 3:1 to 6:1 as a safe harbour rule, unless it can be proved that there are good reasons for a higher ratio. If the tax authorities do not accept a higher ratio, they may reclassify part of the debt as a hidden capital contribution.

1929 holding companies are limited to a debt/equity ratio of 3:1 (subscribed capital). In addition they are allowed to issue bonds up to a maximum amount of 10:1 (paid-up capital). If the holding company is in serious breach of this provision, it may ultimately lose its exempt tax status.

3.1. Tax situation of the SME

Does the distinction between the following types of loans have implications for the tax situation of the SME:

- *ordinary loans,*
- *convertible loans,*
- *profit-sharing loans,*
- *other types (if regularly used)?*

No. However, profit-sharing loans granted by the shareholder are more often reclassified as equity. Even if this is not so, no exemption of withholding tax applies. Indeed, 15% is levied.

What is the deduction regime in the different types of loans? Are there specific regimes available? What is the situation if the VCC also participates in the SME?

Interest payments on the different types of loans are tax-deductible.

There are no specific regimes available.

Interest on loans granted by the VCC, as a shareholder, at excessively high rates may be deemed to constitute a hidden profit distribution and are taxed as such.

What is the withholding tax in each case of the different types of loans?

Interest from profit-sharing loans is subject to a withholding tax of 15%. There is no withholding tax on interest paid on the other types of loans.

Remark:

No taxes are due on debt issues.

3.2. Tax situation of the company that grants a loan to the SME

What is the situation concerning the different types of loans: ordinary loans, convertible loans, profit-sharing loans, other types?

The interest is fully taxable. However, in case of profit-sharing loans granted by the shareholder, the interest payment will be reclassified as dividend and consequently treated as such.

In respect of the taxability of the interest, are there exemptions or reductions for certain zones or activities?

Yes, the 1929 holding company is not taxed on interest income.

How are the capital gains on receivables taxable? What if the loans are converted into capital with capital gains or losses?

Capital gains on loans (e.g. at the moment of conversion into capital) are fully taxable. No deferred taxation is available. Capital losses are tax-deductible.

Are capital losses on receivables realized by the VCC deductible?

Yes (see above).

Are interest payments deductible (for the acquisition of the funds)?

Yes. However, interest paid to acquire participations that qualify for the participation exemption is not deductible provided it does not exceed the dividend income.

Is there a withholding tax on interest paid by the VCC? Are exemptions available (e.g. in case of payments to the European Commission)?

Normally, there is no withholding tax withheld. However, interest from profit-sharing loans is subject to a withholding tax of 15%. This income forms part of the recipient's taxable income, with a credit being given for the tax already withheld.

3.3 Tax situation of the Fund

Luxembourg law does not have special 'funds' with the exception of SICAVs and SIVAFs, which are irrelevant to this study. What about the mutual funds (FCP)? Could you give additional information?

Can the fund recover the withholding tax on interest withheld by the VCC

If withholding tax is withheld the withholding tax will probably be recoverable.

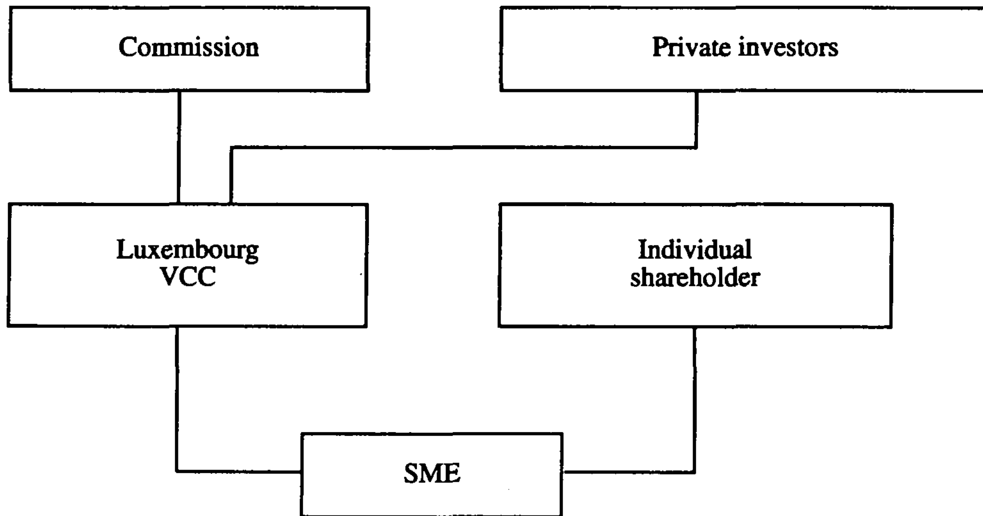
Is the interest taxable?

The fund is transparent for tax purposes, consequently, income is taxed directly in the hands of its participants.

Practical taxation guidance

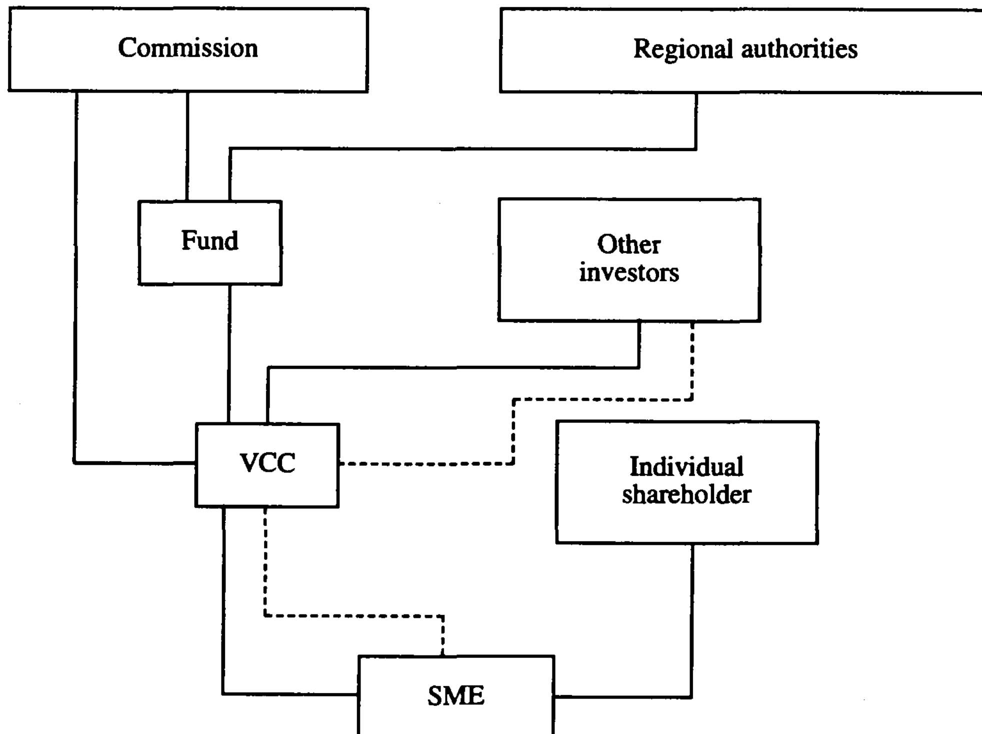
I. Equity finance

1. Scheme



II. Debt finance

1. Scheme



2. *Comments on structure*

2.1. *Position of the SME*

Costs of increasing capital:

Capital duty of 0.5 or 1% (depends also on the form of the company); notarial fees, etc.
These costs can in absolute figures be an obstacle, although they are, relatively seen, rather limited and tax-deductible. These costs, being tax-deductible for the SME, have a negative impact on the results.
The participation taken by the VCC could have as a consequence that on future increases by the individual shareholder, a capital duty of 1% instead of 0.5% becomes due.

Taxable base:

The profits of the SME are positively influenced by the capital increase.
This means that if normally losses would have occurred, because of the capital increase a better result can be shown.

If the capital increase leads to a profit situation, this profit is normally taxed at 39.39%. This implies not only corporate income tax, but also taxes that are related to profits (business tax on income) and to capital (subscription tax, business tax on capital, net worth tax).

Special tax rates exist for income up to LFR 1 312 000.

Tax rate:

2.1. *Position of the SME*

Costs of granting loan:

No costs.

Taxable base:

The interest payments are normally deductible expenses that have a negative impact on the results and on the cash flow.

This situation may prove unwise because a loss position may be created (no immediate use of interest deduction) and other advantages related to profit are lost (e.g. reconversion status).
This disadvantage may partially disappear if it is a profit-sharing loan. In this case, the deductibility of the interest may be a problem in case the loan is granted by the shareholder.

In case the VCC participates in the SME to which the VCC also grants a loan, the interest payments are not deductible when interest rates are excessively high. Such interest constitutes a hidden profit distribution.

Tax rate:

The profits are taxed at 39.39%.

1929 holding companies are taxed at a 0.2% subscription tax.

Redemption of shares:

Only if hidden gains are expressed, the redemption leads to taxation. Provided no hidden gains are expressed, the redemption decreases the equity of the SME and therewith the taxes related to the equity (net worth tax, business tax on capital).

Dividend distribution:

The dividends are part of the taxable base.

On the dividends distributed to the individual shareholder, a withholding tax of 15% applies; on the dividends distributed to the VCC, the same withholding tax applies. However, provided all conditions are met (substantial holding, etc.), no withholding tax applies. Dividends distributed to a 1929 holding company always underly a withholding tax of 15%.

2.2. *Position of the VCC*

Taxable base:

(a) Dividend income

This income is in principle taxed as ordinary income. This can lead to a double taxation (39.39% with the SME and 39.39% with the VCC).
However, when the affiliation privilege is met, dividends received are completely tax-exempt. Dividends received as a 1929 holding company are also tax-exempt. However, the 15% withholding tax cannot be recovered.

(b) Capital gains taxation

The deductible interest payments save a taxation at the corporate tax rate and other taxes, such as business tax and, indirectly, net worth tax and subscription tax.

Reimbursement of the loan:

Has normally no impact on the taxable result.

Interest payment:

The deductible interest paid to the VCC is normally exempt from withholding tax;
However, interest from profit-sharing loans is subject to a 15% withholding tax.

2.2. *Position of the VCC*

Taxable base:

(a) Interest income:

This income is fully taxable at 39.39%, except if the VCC is a 1929 holding company.

(b) Capital gains taxation

In principle taxed. Exemption is possible if certain conditions are fulfilled (e.g. direct participation of minimum 25%, minimal duration of detention, etc.). In case of redemption of shares, taxation as dividend income takes place.	The capital gain realized at the moment of converting the loan into capital is in principle fully taxable, with the exception for the 1929 holding company.
(c) Capital loss on shares	(c) Capital loss on loans
Is tax deductible.	In principle deductible.
(d) Interest paid for the financing of a qualifying substantial holding is not deductible provided it does not exceed the dividends received.	
Dividend distribution:	Interest payment to the fund:
The normal rules apply. However, an exemption applies to dividend distribution to the Commission.	Tax deductible to the extent no exempted dividend income exists.
Transfer of shares:	Transfer of loans:
No special tax applies.	No special tax applies.
2.3. *Position of the individual shareholder*	2.3. *Position of the individual shareholder*
Dividend income:	Dividend income:
Dividends received are included in his taxable income. If withholding tax is withheld, this tax may be credited against income; any excess is refundable.	See left side.
Purchase of the shares:	There is no transfer of shares if a loan is granted.
The financing of this operation may be difficult since the individual shareholder cannot normally deduct the interest burden.	The interest burden remains thus with the SME.
2.4. *Position of the fund*	2.4. *Position of the fund*
No dividend income (see scheme).	The interest income is taxable in the hands of its participants.
3. *Unincorporated SME*	3. *Unincorporated SME*

If the VCC participates in the SME (sharing of profits and losses), an equivalent part of the profits/losses is as such attributed to the VCC which is normally taxed on this income.

If the VCC grants a loan, the interest is deductible with the SME and fully taxable with the VCC.

Conclusion

Equity finance

1. *Major disadvantages*

Costs related to increase of capital; moreover, an annual subscription tax applies;

The capital increase will normally lead to a higher taxable base and thus a higher tax burden with the SME; this both for corporate income tax purposes as for net worth tax and business tax;

The dividend and capital gains exemption does not always apply, which results in a double taxation, not only for corporate income tax purposes, but also for business tax and net worth tax;

The tax situation of the individual shareholder may be very disadvantageous as to the purchase of shares;

Interest payments by the VCC to acquire exempt dividend income are not deductible to the extent of dividends received;

interest payments are not at all deductible for 1929 holding companies;

The 1929 holding company cannot recover the 15% withholding tax on dividends.

2. *Major advantages*

Dividends received are tax-exempt when the application privilege is met (e.g. 10% participation) or when the recipient is a 1929 holding;

Debt finance

1. *Major disadvantages*

The deductible interest payments may lead to a loss position of the SME, whereas the interest income with the VCC is immediately taxable;

Some interest payments are treated as hidden profit distribution;

In principle capital gains on loans are taxable;

Interest from profit-sharing loans is subject to a withholding tax of 15%;

Interest on loans in order to finance the acquisition of a substantial participation is not deductible if it relates to exempt the expense income;

Interest on profit-sharing loans granted by the shareholder may not be deductible.

2. *Major advantages*

Capital gains on shares can be tax-exempt under certain conditions. One of the conditions is a participation of a minimum of 25%.

No costs are related to the granting of the loan;

The taxable base of the SME will normally be reduced, which saves corporate income tax, business tax, net worth tax and subscription tax;

The risk of double taxation (with SME/VCC) does normally not exist;

The capital losses are deductible;

The priviate shareholder is not confronted with a purchase of shares;

Interest income is not taxable for 1929 holding companies.

Luxembourg	Equity				Debt		
	VCC with qualifying participation[1]	VCC without qualifying participation	VCC 1929 holding company[2]		Interest payments on ordinary loans	Interest on convertible or profit-sharing loans[5]	VCC 1929 holding company
SME profit before tax	100	100	100	Interest payment on ordinary loans	Yes (–100)	Yes (–100)	Yes (–100)
Corporation tax 39.39%	–39.39	–39.39	–39.39	Witholding tax 15%	0	15	0
Gross dividend	60.61	60.61	60.61	Interest income before tax at recipient's level	100	85	100
Withholding tax 15%[3]	–0	–9.09	–9.09[4]	CIT 39.39%	–39.39	–33.48	0
Net dividend before tax at recipient's level	60.61	51.52	51.52	Interest income after tax	60.61	51.52	100
Taxable base (participation exemption 100%)	0	60.61	0				
CIT 39.39%	0	–23.87	0				
Tax withheld at source	0	9.09	0				
Tax still due	0	14.87	0				
Net dividend after tax	60.61	36.74	51.52				

[1] Ten per cent shareholding or minmum LFR 50 million during at least 12 months.

[2] 1929 holding companies are not subject to CIT; only a 'taxe d'abonnement' of 0.2% is due.

[3] No withholding tax of a participation of minimum 10%/ min. LUF 50 million during at least 12 months; if withheld, withholding tax is creditable against CIT, but excess is never refundable.

[4] In case the VCC is a 1929 holding company, the withholding tax cannot be recovered.

[5] Profit-sharing loans granted by a shareholder are often reclassified as equity. Even if this is not so, no exemption of withholding tax applies.

III. Other issues

1. *Local and regional authority issues*

There are no provisions that allow an authority to invest in a venture capital company, but there are no provisions preventing it from doing so either.

In two cases the government may participate in the provision of venture capital to SMEs:

- In the Law of 13 December 1988 the government will issue investment certificates to the shareholders of the concerned company located in Luxembourg.
- The Law of 3 April 1989 authorizes the government to issue venture capital investment certificates to the shareholders of the finance company located in Luxembourg.

In these two laws the provision of certificates is the result of the intervention of the Luxembourg government in issuing certificates in order to develop a certain sector of the Luxembourg economy.

2. *Impact assessment*

The Law of 27 April 1988 and the Law of 7 June 1989 did not meet with the success expected. But the Law of 13 December 1988 and the Law of 3 April 1989 had a big impact on SMEs.

Especially in the audiovisual sector, these laws caused huge amounts to be invested in Luxembourg.

IV. Comparative legal and regulatory issues

1. *Absent positive features*

In Luxembourg as in the other Member States, positive measures and features can be classified in three categories:

- the regulation of the providing or receiving of venture capital;
- laws stimulating investment vehicles in order to provide venture capital; and
- publicly owned investment vehicles set up by national, regional or local authorities.

Each of these three headings is discussed below.

2. *Measures pertaining to the regulation of venture capital*

In some EC Member States bonds may be issued whereby repayment of interest or the reimbursement of capital is linked to the borrower attaining a certain turnover or profit (France Section I.4.1, Germany, Section I.3.1).

- According to the Law of 10 August 1915, participating bonds may be issued by SMEs. Belgian legislation prohibits the issue of such bonds.
- Though participating bonds could form an incentive for venture capital companies to invest in the early days of the development of the recipient company, they do not seem to have been successful in France. As the Law of 27 April 1984 was not successful, it is doubtful that this system would operate with efficiency in Luxembourg.
- The Law of 10 August 1915 would have to be modified in order to regulate precisely the issuing of participating bonds.

In Greece, a grant is given whenever a venture capital company takes an equity stake in an SME which invests in high technology or innovation (Greece, Section I.5).

- In Luxembourg, no direct cash grants are available for venture capital companies investing in high technology undertakings.
- As there are more and more foreign companies established in Luxembourg which want to invest in high technology, a direct cash grant would stimulate the venture capital company to invest in certain high risk technologies.
- As in Luxembourg special laws are adopted for certain sectors of the economy, a special law would have to be voted, as the Law of 13 December 1988.

The loan compensation scheme reduces the losses sustained by venture capital companies (Netherlands, Section I.3).

- An equivalent to the Dutch system does not exist in Luxembourg.
- A similar scheme would reduce the use of venture capital companies.
- To create a similar scheme, the national authorities would have to amend legislation on economic expansion.

3. *Publicly owned venture capital companies*

Local authorities are empowered to provide venture capital (Greece, Section II.1, Ireland, Section I.3, United Kingdom, Section I.5).

In some of the EC Member States, express approval to this purpose is necessary (France, Section I, Netherlands, Section II.1).

- In Luxembourg, due to enterprises' small size, there is no possibility for the local authority to provide venture capital to SMEs. It would be a great help for

SMEs if local authorities, the communes, could participate in providing venture capital to SMEs located in their territory.

- But due to the small size of the territory of Luxembourg, and regarding the fact that there are two vehicles in which the Luxembourg government is involved, it would not change very much if local authorities could create public venture capital companies.
- The best solution would be, as in Belgium, to adopt a national investment agency by a new law which encourages the creation of new companies by means of taking an equity stake or by subscribing to convertible debentures.

The existence of non-profit capital holding companies (Germany, Section III).

- These holding companies do not exist in Luxembourg. The only holding companies that exist in Luxembourg are those interested in companies which make profits.
- As the public sector is not established very much in the venture capital sector, the creation of non-profit capital holding companies could make a contribution to the financing of SMEs.
- To set up such a company, legislative modifications would be required.

4. *General recommendations*

It appears that during the last 10 years some efforts have been made in Luxembourg to stimulate venture capital techniques, but the expected success was not achieved.

The reason seems to be that Luxembourg legislation is not adapted to the needs of the Luxembourg economy in this area.

Even if the listed features could be of some help in Luxembourg, the Luxembourg economy has to be considered, and it is not clear that the features adopted in other countries would be effective in Luxembourg.

Nevertheless, some techniques existing in other countries should be reconsidered for Luxembourg.

The Netherlands

Introduction

Like the United Kingdom, the Netherlands is a relatively unregulated successful market for venture capitalists. There are no significant legal or regulatory obstacles to the provision of equity or debt finance.

No major drawbacks occur, as far as tax matters are concerned.

Double taxation is avoided in the case of interest as well as dividend income, since the latter is tax exempt if it results from a qualifying participation (5%). Capital gains also remain tax free if they are realized on qualifying participations.

Finally, the fact that no special tax benefits have been granted to companies situated in less developed areas may be considered a negative point.

I. Legal and regulatory issues

1. *Typical investment vehicle used*

The following types of venture capitalists operate in the Netherlands.

- 'Participatie maatschappijen' (participation companies). One has to distinguish between:

  ordinary venture funds ('normale participatie maatschappijen'), hereinafter referred to as 'PMs';

  private venture funds ('particuliere participatie maatschappijen'), hereinafter referred to as 'PPMs'.

- 'Regionale ontwikkelingsmaatschappijen' (regional development organizations), the so-called 'ROMs'.
- Local and regional authorities.
- The 'borgstellingskredieten voor het midden- en kleinbedrijf' (see Guarantee funds section of this report).
- The 'aangepast achtergesteld krediet' ('AA-Krediet') (see 'Guarantee funds' section of this report).
- The 'technische ontwikkelingskrediet' (technical development loan).

2. *Applicable legal measures*

- Gemeentewet
  Law on municipalities which govern their powers.
- Provinciewet
  Law on provinces which govern their powers.
- Regeling van de Staatssecretaris van Economische Zaken van 25 november 1988 nr. 688/2263, Stcrt. 232, Directie Wetgeving en andere juridische aangelegenheden, zoals laatstelijk gewijzigd bij Besluit van 20 december 1989, nr. WJA/JZ 89112158, Stcrt. 250, on the Borgstellingskredieten voor het Midden- en Kleinbedrijf.
- Regeling van de Minister van Economische Zaken van 11 december 1986, nr. 6861415, Directie Wetgeving en andere Juridische aangelegenheden, JZ (Stcrt. 241), Besluit van 18 juni 1990, nr. WJA/JZ 90017847, Stcrt. 116, on the Technische Ontwikkelingskrediet.
- Regeling Bijzonder Financiering 1971, brief van de Ministers van Financiën en Economische Zaken aan de Nationale Investeringsbank NV van 27 November 1981, nr. 381 13 252 (Directive Financieringen) Stcrt. 1982, 81.

3. *The investment vehicle*

PMs

The abbreviation 'PM' is not commonly used. For the purpose of this study 'PM' is used as opposed to 'PPM'.

Any legal private entity (legal or natural person) can operate as a venture capitalist.

No specific obstacles exist regarding PMs. PMs operate within the framework of the relevant body of law which applies to them by virtue of the legal form under which they are constituted. However, detailed provisions exist for banks under the 'Wet toezichtkredietwezen'. Pursuant to Art. 25 of this law, participation in enterprises is subject to prior approval ('verklaring van geen bezwaar') of the Minister van Financiën or the Nederlandsche Bank NV.

PPMs

(The abbreviation 'PPMs' is commonly used. The 'garantieregeling' also refers to PPMs).

PPMs are venture capitalists operating under the 'garantieregeling particuliere participatie maatschappijen 1981', hereinafter, 'the garantieregeling'.

The purpose of the garantieregeling is to stimulate the establishment and growth of SMEs in the Netherlands, by helping PPMs provide venture capital to SMEs.

The means for achieving this purpose is compensation by the Nederlandsche Bank NV (the Dutch Central Bank) to the PPM of a maximum of 50% of the investment where the investment is lost. The garantieregeling lays down strict conditions which have to be complied with. The maximum compensation is HFL 1 250 000.

ROMs

The ROMs are public corporations in which the shares are held by the Dutch State and/or provinces. The following ROMs exist:

the NV Brabantse Ontwikkelingsmaatschappij (BOM);

the NV Gelderse Ontwikkelingsmaatschappij (GOM);

the NV Industriebank LIOF shareholders: the Dutch State (97%) and the Province of Limburg (3%);

the NV NOM Investerings- en Ontwikkelingsmaatschappij voor Noord-Nederland (NOM); shareholder: the Dutch State (100%);

the Overijsselse Ontwikkelingsmaatschappij NV (OOM); shareholder: the Province of Overijssel.

The main ROMs are the LIOF (Limburg), NOM (Drenthe, Friesland and Groningen) and OOM (Overijssel including Twente).

The manner in which ROMs operate is largely regulated in their articles of association. In any case, since the financial reorganization of November 1990 they must operate as revolving funds.

Local and regional authorities

(See below.)

Borgstellingskredieten voor het midden- en kleinbedrijf

The purpose of the arrangement is to stimulate the provision of bank loans to SMEs with a good performance record, but which lack sufficient securities to attract normal bank loans.

The arrangement mainly regulates the relationship between the participating banks and the Dutch State. Under certain conditions the Dutch State enters into a 'borgstellingsovereenkomst'. By this agreement the State guarantees the bank repayment of the 'borgstellingskredieten' (loans) to be granted by the bank to an SME.

Aangepast achtergesteld krediet ('AA-Krediet')

The Nationale Investerings Bank NV (NIB) under certain conditions can provide subordinated loan agreements which are 100% guaranteed by the Dutch State. The purpose of the arrangement is the creation of new forms of venture capital.

Technische ontwikkelingskrediet

The arrangement aims at stimulation of innovative projects by co-financing such projects. Loans can be provided for up to a maximum of 40% of the costs of development during the development phase of an innovative project.

Repayment of the loan and interest takes place by annual payment of:

- a fixed amount;
- a percentage of the turnover that is to be realized if the project is successful.

The Minister van Economische Zaken fixes repayment of the loan plus accrued interest in such a way that the loan will be paid back within the duration of the developed product. Where, after expiry of the duration of the

developed project, the loan has not been paid back fully, the amount still due shall be remitted.

4. *The recipient of venture capital*

There are some restrictions on the categories of SME that can benefit from finance provided by the various entities referred to above.

PPM

Art. 1 of the garantieregeling defines an SME as a public corporation (NV) or private limited company (BV), established in the Netherlands, having less than 100 employees, and not belonging to a group of companies with a total of more than 200 employees.

The recipients of venture capital from PPMs are the following:

- NV (a public company);
- BV (a limited liability company);
- General partnerships (vennootschap onder firma — VOF);
- Limited partnerships (commanditaire vennootschap — CV) under certain conditions.

In order to have any rights under the garantieregeling, an NV, BV, VOF or CV has to be recognized by the Nederlandsche Bank NV (Arts. 3, 4, 5 and 6). The petitioner has to be a private participation enterprise. None of the shareholders may be a public legal entity. The petitioners' expertise, intentions and prior record are investigated. The Nederlandsche Bank NV shall take a decision within 60 days of receipt of the petition.

A system has been adopted whereby global control is exercised without prior consent of the Nederlandsche Bank for each individual participation. In order to avoid withdrawal of the recognition, the already recognized PPM has to comply with the demands of Arts 7 to 10. Any participation should be reported to the Nederlandsche Bank NV. The obligation to report is not designed as a control on the participation, but rather in order to gather information on the functioning of the garantieregeling.

The enterprise in which participation takes place must be either an NV or a BV.

Participations can take place in different forms:

- acquisitions of shares (primary);
- convertible subordinated loans.

ROM

The ROMs only provide venture capital to SMEs which already have established or are planning to establish a business on the territory of their respective provinces.

Although their utility has diminished ROMs still play an important role regarding the provision of venture capital to SMEs in the regions where they operate. ROMs aim at risky, innovative, expanding and starting SMEs. The highest possible return is not the ROM's first priority although, as seen above, since the financial reorganization of November 1990, they must operate as revolving funds. Regional development is seen as a public task of the ROMs.

Borgstellingskredieten voor het midden- en kleinbedrijf

Recipients must be SMEs with less than 100 employees (including all employees of the group). The maximum amount of the 'borgstellingskrediet' is HFL 1 million.

- **Aangepast achtergesteld krediet**

The purpose of the arrangement is the creation of new forms of venture capital finance to be provided to enterprises with a good performance record and with a lasting potential for returns (usually a minimum equity of 20% is demanded). The enterprise must have a real need for venture capital in order to continue or expand business. Furthermore, it must be assessed whether or not the enterprise is able to satisfy its needs by other means, on acceptable terms.

Technisch ontwikkelingskrediet

This arrangement is not usually applicable to SMEs but could nevertheless be relevant in certain cases. This is because it usually relates to large projects but nevertheless can be used, for instance, in connection with computers.

5. *The provision of venture capital*

Equity finance

There are no significant legal obstacles to the provision of equity finance in the Netherlands. The following types of shares, all of which are regulated under company law, can be issued:

- ordinary shares;
- preferred shares;
- cumulative preferred shares;
- priority shares.

Debt finance

There are no significant legal obstacles to the provision of debt finance in the Netherlands. The most common methods involve unsecured loans, secured loans and convertible debt securities.

II. Issues of taxation

1. *Introduction*

The SME is often confronted with the difficulty of attracting financial means from third parties. Indeed, on the one hand, to contract a loan with a bank, the SME has most of the time too low an equity, so that the financial institutions feel rather reticent to grant an loan.

On the other hand, because of the high risk of the investment, only very few persons are willing to increase the capital (and therewith the loan capacity) of the SME.

The VCC can therefore play an important role in the expansion of the SME.

The VCC and the target company (SME) will have to determine how the capital is to be injected. It may very well be that there is a conflict of interest between both parties in determining how the injection will be executed.

In general, the (tax) differences between debt financing and equity financing can be established as follows:

In case of debt financing by the VCC, the interest payments are for the SME in principle tax-deductible expenses, unless the proceeds are used to finance the acquisition of the shares in a foreign subsidiary qualifying for the participation exemption. Interest expenses will have a negative impact on the results (possibly into a loss position) and on the cash flow of the SME. The VCC will be fully taxable on the interest income.

It may very well be that this situation is not at all desirable. Indeed, the SME will probably be in need of extra means at a moment when substantial investments are planned which will already have a negative impact on the results, e.g. depreciation of the investment. From a tax point of view such a situation may also prove to be unwise. In practice, the SME cannot benefit from the interest deduction because of insufficient profits (or even losses) whereas the interest income received by the VCC is immediately taxed.

To meet both economic and tax demands, two main options are available.

- either the loan agreement is concluded under circumstances where the interest rate is in the beginning rather low (e.g. profit-sharing loan or convertible loan). The 'arm's length' requirements must be met,
- or the VCC decides to participate in the capital of the SME.

In case of equity finance, the following problems arise:

If the VCC is in need of a more or less regular income to finance its own investment, this will have to be done by way of dividend distributions.

This may present a great deal of problems.

Dividends are normally not tax-deductible so that the dividend capacity of the SME will be lower than the interest payment capacity.

In case of dividend distribution the VCC and the individual shareholder will receive a dividend. The dividend taxation of individuals is often very disadvantageous. To avoid this problem, the VCC might opt for preference shares, so that dividends can be distributed to the VCC and not to the individual shareholder owning ordinary shares.

The VCC receiving the dividends can only claim the participation exemption if the VCC holds at least 5% of the SME. It should be noted that in certain cases a lower percentage than 5% may not be an obstacle to claim the participation exemption, since also in that case a qualifying participation can be deemed to exist. If the participation exemption is not applicable, the dividend income is taxed as ordinary income at the full rate (which is a very disadvantageous situation since this implies a double taxation, firstly with the SME, secondly with the VCC).

If the VCC holds a qualifying participation the deductible costs (fees, interest burden, etc.) cannot be properly used since they cannot be set off against taxable profits.

Therefore, two options could be considered:

(a) a combination of interest income and dividends;

(b) instead of distributing dividends, the VCC might aim at the realization of a capital gain on shares.

This option could be interesting since, by doing so, the SME will be in the position to retain all profits.

Problems could arise:
If the value of the SME decreases, the capital loss realized on the sale of the shares by the VCC is not tax-deductible if the VCC holds a qualifying participation. Otherwise the losses are tax-deductible.

If the value of the SME increases, the capital gain will in principle be tax-exempt if it relates to a qualifying participation (otherwise the capital gain is fully taxable). A problem is that the individual shareholders will normally not have enough means to purchase the shares. Therefore, one could consider a redemption of shares. This means that the SME purchases its own shares. For personal income tax purposes, the proceeds are treated similarly as in the case of liquidation, i.e. the amount exceeding the average paid-up capital will be considered taxable income for the shareholder. There are some exceptions to this general rule. If for instance a quoted company purchases its own shares merely as a temporary portfolio investment with the intention of selling them at a later stage rather than actually decreasing the company's capital, the sale to the company will not result in taxable income. For the VCC, the distributed amount above the average paid-up capital is treated as dividend income which can benefit from the participation exemption if the VCC holds a qualifying participation.

In the next section (Equity/Debt finance), a summary is given of all important items that could influence the decision-making of the VCC and the SME.

In the sections ('Equity/Debt finance') practical guidelines are given, resulting from the information in the section 'Practical taxation guidance'.

2. *Equity finance*

2.1. Creation of the VCC

Are there registration or other duties?

Any contribution in cash or in kind to the risk-bearing capital of a resident company is subject to a capital duty of 1%. Any entity which has its capital divided into shares is subject to this duty.

If shares have been issued in exchange for contributions in kind, the taxable base will equal either the value of the contribution after deduction of obligations against the contribution assumed by the company, or the par value of the stocks issued, whichever is greater. Contributions of immovable property are, in principle, subject to both a 6% transfer tax and the 1% capital duty. Capital duty is then creditable against the transfer tax.

Additional costs of creating a company are:

- Chamber of Commerce fees;
- charges for listing on the Stock Exchange;
- notarial and legal fees.

Are there conditions to be met in respect of the legal forms of the VCC? Are there any specific forms available?

Dutch company law provides no special legislation concerning the VCCs.

A VCC will most likely operate in The Netherlands under the form of an NV (naamloze vennootschap) or a BV (besloten vennootschap met beperkte aansprakelijkheid). Another legal form in which the VCC can operate is the partnership (VOF or commanditaire vennootschap).

Are there limits as to the degree of participation of the VCC in the SME?

No. However, a recognized private participation company (PPM) is restricted to a maximum individual investment of HFL 2 500 000.

2.2. Tax situation of the SME

Creation and increase of capital

Are there registration or other duties?

See under 2.1.

Are there exemptions for certain zones, projects, activities?

Yes. The internal reorganization facility. This facility is only applicable if a company of the group established in one of the EC countries incorporates a Dutch company and contributes to that company or contributes to an existing Netherlands company its entire enterprise or a substantive part thereof (e.g. 100% shareholdings in subsidiaries may qualify as such; a case is pending before the European Court of Justice regarding this matter) in exchange for newly issued shares of that (Netherlands) company. The share merger facility is only applicable if a Dutch (holding) company would acquire at least 75% of the share capital in another company established within the EC in exchange for newly issued own shares.

Is the indirect tax treatment different for the following types of shares:

- *ordinary shares;*
- *preference shares;*
- *redeemable shares and others?*

No.

Corporate taxation

Are the costs related to the creation or increase deductible?

Yes.

Two options are possible:

- the costs are deductible in the year of creation or increase of the capital;
- the costs can be activated and depreciated over a few years.

Rates

Normal tax rate:

- on the first HFL 250 000: 40%.
- on the excess: 35%.

How does a redemption of shares affect the tax position of the SME?

The redemption of shares by the SME does not constitute taxable income for corporate income tax purposes at the level of the SME.

Dividend distribution

Does a different tax regime apply to dividend distribution to X (private shareholders of the SME) on the one hand and to the VCC on the other?

No. The dividends paid constitute taxable income for the SME.

Does a different tax regime apply according to the different types of shares?

No.

Is the tax base affected by the distribution of dividends (deductible dividend)?

No, because the dividends do not constitute deductible expenses for the SME.

Is the tax rate affected by the distribution of dividends?

No.

Is a withholding tax withheld? Rate? Exemptions?

A withholding tax of 25% is withheld when the recipient is a private shareholder.

If the recipient of the dividend is a resident Dutch company which has a qualifying participation (usually 5% or more) in the distributing company, the participation exemption applies. In such a case no dividend tax is withheld. If no qualifying participation exists, a withholding tax of 25% applies.

2.3. Taxation of the VCC

Corporate taxation

Are the costs related to the creation of the VCC deductible?

Yes, see above.

Are management costs and interest deductible?

Yes, irrespective of whether a substantial participation exists or not.

How are dividends taxed?

When the VCC has an interest of at least 5% (in certain cases a lower percentage may qualify) in the capital of the SME, the VCC will benefit from the participation exemption. If not, the dividends will constitute taxable income for the VCC.

What is the capital gains tax if the shares of the SME are sold?

Gains accruing to a company from the disposal of shares are considered as ordinary income, taxable at normal rates if no substantial participation exists. Otherwise, the capital gains are tax-exempt.

What about capital losses?

In case the participation exemption is not applicable, losses are considered as ordinary losses and therefore tax-deductible. Losses incurred after the six first years following the creation of a company may be set off against the income of the preceding three taxable years (carry-back) and the income of the following taxable eight years (carry-forward).

Losses incurred during the first six years following the creation of a company may be set off against income of subsequent taxable years without limitation in time.

Capital losses on participations, qualifying for the participation exemption, are not tax-deductible.

What is the tax position of the VCC in case of redemption of the shares by the SME?

The difference between the redemption price and the average paid-up capital constitutes normal taxable income for the VCC if the participation exemption does not apply. Otherwise, the gain is tax exempt.

Rates

See previous page; tax exemption for dividends and capital gains out of a qualifying participation.

Is there recoverability of the tax withheld by the SME?

There is no withholding tax withheld in case of a qualifying participation provided an application therefor is made in advance. Otherwise, the withholding tax is creditable against the corporate income tax liability. In case of losses a refund of dividend tax withheld can be claimed.

Distribution of dividends by the VCC

Does a different tax regime apply according to the different types of shares?

No.

Is the tax base affected by the distribution of dividends?

No.

Is the tax rate affected by the distribution of dividends?

No.

Is a withholding tax withheld?

In respect of private shareholders, see Section 2.2.

If the European Commission is the shareholder, dividend tax must be withheld at 25%. Depending on the participating vehicle of the Commission, the nature of the activities of the VCC and the SME respectively, a partial or full refund of the tax withheld can be claimed. It may be possible to obtain an exemption from withholding the dividend tax, provided the Dutch Ministry of Finance grants this exemption. It is necessary that this is discussed in advance with the Ministry of Finance.

Are specific regimes available?

No. There is a dividend exemption of HFL 2 000 p.a. (HFL 4 000 for a married couple) available for dividends received from certain VCCs by an individual shareholder.

Transfer of shares

In case of transfer of the shares of the SME, do special taxes apply on these transfers?

No, provided the SME is not a qualifying real estate company.

The VCC as partnership (VOF).

What is the tax treatment if the VCC is constituted in the form of a 'vennootschap onder firma'?

A partnership can be described as a legal form through which the various partners carry on a business under a common name. The most common form is the general partnership (VOF) with each partner being separately liable for the partnership's debts. A less usual form is the limited partnership (commanditaire vennootschap, CV), where the general or managing director is fully responsible for its debts but the limited partner is merely liable up to the amount of his capital contribution.

For tax purposes, a partnership is not treated as a separate legal entity but is considered transparent, i.e. for tax purposes each of the partners is considered to carry on a business for his share in the partnership. Consequently, each partner may use his own system of profit calculation (within, of course, the scope of the sound business practice rules). A limited partner will only be considered to carry on a business if he is entitled to the hidden reserves of the company. If not, he will be considered as a private investor. His profit share in the latter case will be considered as investment income. The rules for the calculation of business profits do not apply then.

Certain anti-abuse rules have been published by the Ministry of Finance to limit the use of limited partnerships as tax shelters.

What would the tax position of the Commission participating in the VOF be?

In principle, similar to the position of a corporate partner. There may be a possibility to claim an exemption depending on the nature of the activities of the VCC. It is necessary that this is discussed in advance with the Dutch Ministry of Finance.

Tax situation of X (individual shareholder)

Is the interest paid on the loans granted in view of the purchase of the shares of the SME deductible?

Yes.

How are the dividends taxed?

Dividends are included in the taxable income for individual tax purposes. However, the first HFL 1 000 (HFL 2 000 for married couples) of dividends from domestic companies are excluded from taxable income. The dividend exemption for dividends from certain VCCs is HFL 2 000 (HFL 4 000 for married couples).

A withholding tax of 25% is withheld, which is credited against the final income tax assessment. Excess of withholding tax over the income tax assessed will be refunded.

In case the SME is not a company but an unincorporated enterprise

If the VCC participates in such an enterprise, how does this affect the position of the enterprise?

The position of the enterprise will probably not be affected.

Is a transparent company (partnership) created? If so, what are the tax implications?

When a partnership is created, all the profits (and losses) derived from carrying on the business of the partnership are attributable to the partners and, provided the partners are corporate entities, taxable as corporate income with the respective partners (transparency principle). If an association or foundation has been created, it could still be subject to corporation tax if and to the extent that an enterprise is carried on. This will automatically be assumed if the purpose of the entity is to make profit but also if it competes with enterprises carried on by individuals or other entities, like corporations.

Example:

	VCC with substantial participation	VCC without participation	Individual shareholders
SME profit before tax	100	100	100
Corporation tax 35%	– 35	– 35	– 35
Gross dividend	65	65	65
Withholding tax		16.25	– 16.25
Net dividend before tax	65	48.75	48.75
Taxable base	0	65	65
Taxation (individual income tax rate e.g. 50%)	0	– 22.75	– 32.5
Net dividend after tax	65	42.25	32.5

3. *Debt finance*

Preliminary question: is there a debt/equity ratio to be respected?

There are no formal rules under Dutch law which prescribe in certain circumstances a fixed debt to equity ratio, other than the legal requirement for the minimum share capital of a BV (HFL 40 000) and an NV (HFL 100 000). In practice, however, the 'arm's length' principle must be applied to recharacterize a part or all of intercompany debt as equity. Usually a recharacterization will not take place if both the parent and the subsidiary are Dutch residents for tax purposes. The amount of the recharacterization is subject to 1% capital tax.

What if the ratio is not respected?

The interest payment is considered to be a dividend distribution.

3.1 Tax situation of the SME

Does the distinction between the following types of loans have implications for the tax situation of the SME:

- *ordinary loans;*
- *convertible loans;*
- *profit-sharing loans;*
- *other types (if regularly used)?*

No.

What is the deduction regime for the different types of loans?

In principle, all interest payments (including interest on profit-sharing bonds provided it is not granted by the shareholder in its capacity as shareholder) are considered to be business expenses and therefore tax-deductible. In some cases, however, a deduction for interest will not be allowed because it may hide a distribution of profits to a shareholder (for instance when an interest rate higher than the market rate is given or in case of thin capitalization or because the debt has been used to finance a foreign qualifying participation).

Are there specific regimes available?

No.

What is the situation if the VCC also participates in the SME?

The position of the SME is not affected by the mere fact that the VCC, grantor of a loan, also takes a participation.

What is the withholding tax in each case of the different types of loans?

There is no withholding tax. However, a withholding tax of 25% will be imposed on interest from profit-sharing loans or in case hidden dividend distributions are assumed.

3.2. Tax situation of the VCC granting a loan to the SME

What is the situation concerning the different types of loans:

- *ordinary loans;*
- *convertible loans;*
- *profit-sharing loans;*
- *other types?*

In respect of the taxability of the interest are there exemptions or reductions for certain zones or activities?

No, all interest income is fully taxable.

How are the capital gains on receivables taxable?

Capital gains are considered as ordinary income, taxable at the normal rates.

What if the loan is converted into capital with capital gains?

Gains are taxable as ordinary income. The issued capital is subject to a 1% capital tax.

Are capital losses on receivables realized by the VCC deductible?

Yes.

Are interest payments deductible (for the acquisition of the financial means)?

Yes.

Is there a withholding tax on interest paid by the VCC?

No, unless the interest is paid to a shareholder who is deemed to have a substantial interest in the VCC. A substantial interest in a company exists if the taxpayer owns/or owned (during the last five years), either directly or indirectly, alone or together with his family members in the first and second degree, at least one third of the shares of a company and, in addition, together with his spouse more than 7% of the nominal paid-in share capital. It follows from this definition that indirect ownership may also qualify.

3.3. Tax situation of the fund

Can the fund recover the withholding tax on interest, withheld by the VCC?

There is no withholding tax.

Is the interest taxable?

If the fund is not transparent the interest will be taxed at the level of the fund. If the fund is transparent the interest received will be subject to tax at the level of the beneficiaries, provided they are subject to Dutch tax.

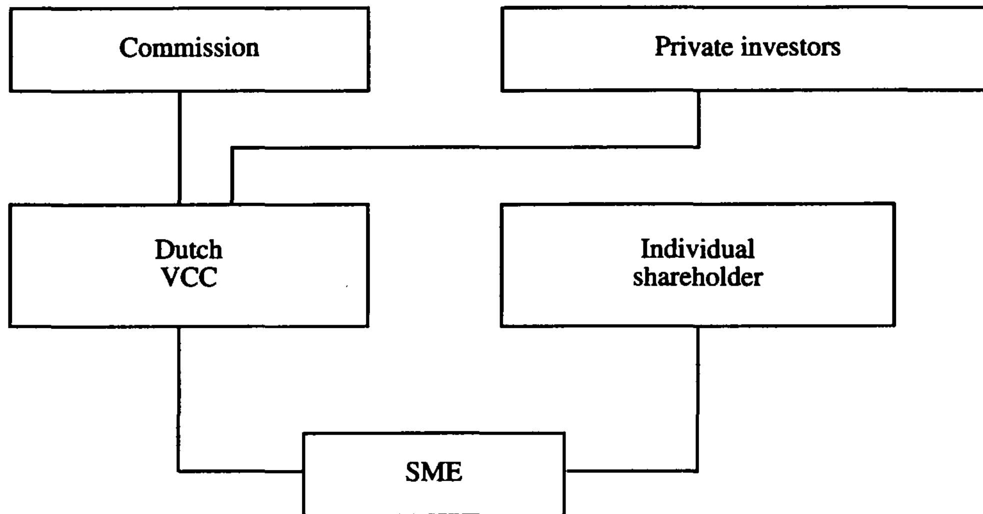
Would it be possible that the European Commission constitutes a 'stichting' that grants loans? What would then be the tax treatment?

The 'stichting' will most probably earn business income and be subject to corporate tax. An exemption could apply depending on the nature of the activities of the fund. This has to be discussed in advance with the Dutch Ministry of Finance.

Practical taxation guidance

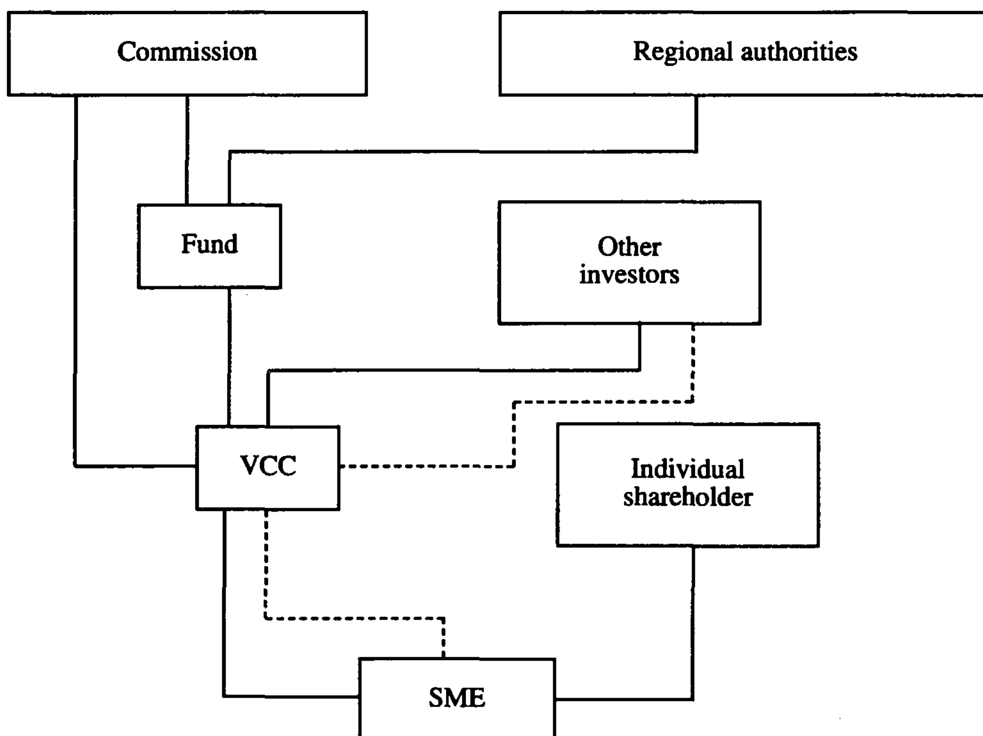
I. Equity finance

1. Scheme



II. Debt finance

1. Scheme



2. *Comments on structure*

2.1. *Position of the SME*

Costs of increasing capital:

Capital duty of 1%; notarial fees, etc.

These costs can in absolute figures be an obstacle, although they are, relatively seen, rather limited and tax-deductible provided they do not relate to a foreign participation for which the participation exemption applies.
These costs, being tax-deductible for the SME, have a negative impact on the results.

Taxable base:

The profits of the SME are positively influenced by the capital increase.
This means that if normally losses would have occurred, because of the capital increase a better result can be shown.
If the capital increase leads to profit situation, this profit is normally taxed at 35% or 40%.

Tax rate:

The profits are taxed at 35% or 40%.

Redemption of shares:

In principle, only to the extent the repayment is higher than the average paid-up capital of the SME, the redemption leads to the withholding of dividend tax.

2.1. *Position of the SME*

Costs of granting loan:

No costs (other than legal and placement fees, if any).

Taxable base:

The interest payments are normally deductible expenses provided the loan is entered into under 'at arm's length' circumstances and the proceeds of the loan have not been used to finance foreign qualifying participations. The interest expenses will, being deductible, have a negative impact on the (taxable) results and the cash flow.
This situation may prove unwise because a loss position may be created (no immediate use of interest deduction).
This disadvantage may partially disappear if the loan is a profit-sharing loan.

Tax rate:

The deductible interest payments save a taxation of 35% or 40%.

Reimbursement of the loan:

Has normally no impact on the taxable result.

Dividend distribution:

The dividends are part of the taxable base. On the dividends distributed to the individual shareholder, a withholding tax of 25% applies; on the dividends distributed to the VCC, the same withholding tax applies, but an exemption exists for VCCs which can claim the participation exemption. Usually a participation of a least 5% is necessary for claiming that exemption.

Interest payment:

The deductible interest paid to the VCC is normally exempt from withholding tax.

2.2. *Position of the VCC*

Taxable base:

(a) Dividend income

This income is tax-exempt under the condition that the VCC has a qualifying participation. If the VCC has no qualifying participation the dividend is taxed as ordinary income which is a very important obstacle.
In case of a qualifying participation the VCC will normally only have an interest burden and tax-exempted income.

(b) Capital gains taxation

In principle tax exempt if a qualifying participation exists; otherwise the capital gain is taxable at the full rate. In case of redemption of shares by the SME, taxation could take place as dividend income which again is free of corporation tax if the participation exemption is applicable.

(c) Capital loss on shares

In principle not deductible, except if the participation exemption does not apply.

Dividend distribution:

Usually, a dividend tax must be withheld on any distribution. The rate is 25%.

2.2. *Position of the VCC*

Taxable base:

(a) Interest income

This income is fully taxable at 35% or 40%.

(b) Capital gains taxation

The capital gain realized when the loan is converted into capital is fully taxable.

(c) Capital loss on loans

In principle deductible.

Interest payment to fund:

If this fund is a normal taxable company, the ordinary rules apply.

If the fund is not subject to corporate tax itself because it is transparent, then the partners themselves are subject to tax.

Transfer of shares:

No special tax applies, unless the SME is a qualifying real estate company.

Transfer of loans:

No special tax applies.

2.3. *Position of the individual shareholder*

Dividend income:

The corporate tax, contrary to the withholding tax, cannot be credited against individual income tax. The dividend is subject to the normal progressive tax rates.

Purchase of the shares:

2.3. *Position of the individual shareholder*

Dividend income:

See left side.

There is no transfer of shares if a loan is granted. The interest burden remains thus with the SME

2.4. *Position of the fund*

No dividend income (see scheme).

2.4. *Position of the fund*

The interest income is fully taxable. Only when the fund is transparent, the partners themselves will be subject to tax and not the fund itself.

3. *Unincorporated SME*

If the VCC participates in the SME, which is a (transparent) partnership (sharing of profits and losses), an equivalent part of the profits/losses is as such attributed to the VCC which is normally taxed on this income. This may be a way to benefit from the interest deduction.

3. *Unincorporated SME*

If the VCC grants a loan, the interest is deductible with the SME and fully taxable with the VCC, provided the SME is not transparent.

4. *The VCC is a VOF or CV*

Transparently taxed; if the Commission is a shareholder, no taxation takes place (Will the SME have to withhold 25% on the dividends distributed?).

Conclusion

Equity finance

1. Major disadvantages

Costs related to increase of capital;

The capital increase will normally lead to a higher taxable base and thus to a higher tax burden with the SME;

The participation exemption does not apply if the VCC does not have a qualifying participation, which may lead to double taxation;

The capital losses on a qualifying participation are not tax deductible.

2. *Major advantages*

Capital gains on qualifying participations are tax-exempt.

Dividend income from a qualifying participation is tax-exempt.

Debt finance

1. *Major disadvantages*

The deductible interest payments may lead to a loss position of the SME, whereas the interest income with the VCC is immediately taxable.

Capital gains are taxable.

2. *Major advantages*

No costs are related to the granting of the loan;

The taxable base of the SME will normally be reduced;

The risk of double taxation (with SME/VCC) does normally not exist;

The capital losses are deductible;

The private shareholder is not confronted with a purchase of shares.

Netherlands	Equity		Debt	
	VCC with qualifying participation[1]	VCC without qualifying participation		
SME profit before tax	100	100	Interest payments deductible with SME	Yes (–100)
Corporation tax 40%[2]	–40	–40	Withholding tax	0
Gross dividend	60	60		
			Interest income before tax at recipient's level	100
Withholding tax[3]	0	–15	CIT 40%	–40
Net dividend before tax at recipient's level	60	45		
			Net income after tax	60
Taxable base	0	60		
CIT 40% at VCC's level	0	–24		
Tax borne at source		15		
Tax still due		9		
Net dividend after tax	60	36		

[1] 5%; in this case no withholding tax is withheld.
[2] 35% for profits exceeding HFL 250 000.
[3] Withholding tax, if withheld, is refundable.

III. Other issues

1. *Local and regional authority issues*

In the Netherlands there are no differences between the legal considerations which apply in the Member State as a whole and those applying in particular assisted regions, namely Groningen, Drenthe, Friesland, Twente and Limburg. However, the situation regarding the regionale ontwikkelingsmaatschappijen (ROMs) differs in the various regions. In addition, the policy of venture capitalists (local and regional authorities) may differ from region to region.

- Communities (gemeenten)

Pursuant to Art. 228 of the Gemeentewet, community decisions regarding establishment and/or participation in legal entities and the provision of loans or guarantees to third parties are subject to the approval of the 'Gedeputeerde Staten' (GS), a provincial body.

According to Art. 234 of the Gemeentewet, permission shall not be granted for participation unless participation is seen to be in the public interest.

In practice, the financial risk of the participation and the public interest as seen by the authority involved play a decisive role.

It appears that communities have become more active in this field over the last five years.

- Provinces (provincies)

Legal provisions similar to those of the Gemeentewet are laid down in the Provinciewet (Art. 91). The province's decisions regarding participation are subject to approval by the Crown.

2. *Impact assessment*

- PMs and PPMs

The garantieregeling has been successful. The budget of the garantieregeling has been cut in 1990. The Ministers van Financiën and Economische Zaken have manifested an intention not to accept any new participations under the garantieregeling after 1995. In 1990 the total investments of PPMs under the garantieregeling amounted to HFL 445 800 000. The total investments of all PMs and PPMs amounted to HFL 2 385 000 000.

- ROMs

The ROMs dominated the venture capital market in the Netherlands during the early 1980s. Due to the rise of the PMs and the PPMs their market share has gradually diminished (12% in 1990). Today, they fill in the gaps left over by the PMs and PPMs. For example, PMs and PPMs are generally located in regions with the highest economic activity (mainly the western and central parts of the Netherlands). In the province of Limburg, however, where no PM or PPM has been established, the ROM retains a dominant position.

IV. Comparative legal and regulatory issues

1. *Preliminary remarks*

Three preliminary remarks should be made:

First, many of the positive features mentioned in the reports of other Member States have to do with tax incentives. Since this part is not concerned with issues of taxation, these positive features are disregarded hereinafter.

A second remark concerns the different opinions apparently existing in the various Member States to assess whether a certain feature has to be regarded as positive or negative. For example, the Greek report states that 'the most important deficiency of the legal framework is the absence of any provisions limiting venture capital companies' power to liquidate their portfolio'. From a Dutch point of view, it is not the absence, but on the contrary the existence of said provisions which should be regarded as an obstacle to venture capital, since this would limit the venture capitalists' possibilities of disinvestment.

A third remark, in connection with the second remark, concerns the fact that the absence of a regulatory framework, i.e. deregulation, in certain cases can be regarded as a positive feature. Both the United Kingdom and the Netherlands show fairly unregulated, but successful venture capital industries.

2. *Absent positive features*

- Société de capital risque (SCR); and
- Fonds communs de placements à risque (France, Section).

No such SCRs and FCPRs exist in the Netherlands. Apparently, the success of the SCR and FCPR has largely to do with tax incentives and therefore will not be commented on.

- Industrial Development Authority (IDA) (Ireland, Section I.3).

No such State agency exists in the Netherlands, although the ROMs may play a similar role. Establishment of such an agency or strengthening of ROMs could promote venture capital in problem regions. A private legal entity could be established or the existing ROMs could be strengthened.

- Grants provided to venture capital companies with respect to their participation in the equity of enterprises investing in high technology (Greece Section).

No such provision exists in the Netherlands. However, under certain conditions the SME itself can obtain a so-called 'technical development credit'. The purpose of the provision seems to be the stimulation of high technology industries instead of the development of venture capital. The latter may occur as a spin-off. Grants could be based on laws to be introduced. Establishment of a private legal entity could be an alternative.

Portugal

Introduction

Portuguese venture capital has not been a notable success and proposals are under consideration for reform of the financial system, including the institutions relevant to venture capital. Of all the Member States, Portugal perhaps provides the most stimulating challenge for creative borrowing of concepts from other Member States.

From a tax point of view, no major obstacles occur. On the contrary, tax incentive schemes have been introduced for companies (SMEs or VCCs) situated in the Madeira/Azores free zones (temporary exemption from corporate tax).

Also, in case the VCC takes the specific form of a 'Sociedade de capital de risco' (SCR) or a 'Sociedade de fomento empresarial' (SFE), it benefits from a temporary exemption from corporation tax.

I. Legal and regulatory issues

1. *Typical investment vehicle used*

Four types of venture capital company are provided for under Portuguese law. The designations used represent translations from the Portuguese language and may not, therefore, correspond to Anglo-Saxon entities bearing a similar name. The four types of vehicle are described below.

The investment company ('Sociedades de investimento — SI')

This is a sort of merchant bank which centres its activities on capital market deals.

Medium-and long-term loans may be offered by SIs as a first stage in securitization and/or flotation.

Given that Portuguese investors are risk averse and also that the capital markets do not offer hedging instruments, it has been concluded that SMEs are, generally, outside the scope of SIs' activities. No discussion of SIs is, therefore, included in this report.

Regional development companies ('Sociedades de desenvolvimento regional — SDR')

These are specialized credit institutions the main objects of which are to arrange financial operations, to promote productive investments and to render commercial services. They take the form of joint stock companies.

Risk capital companies ('Sociedades de capital de risico — SCR')

The 'White Book', which makes proposals for the reform of the Portuguese financial system, suggests that SCRs be replaced by a brand new type of non-banking institution specialized in venture capital. This suggestion may not be followed, however. Instead, the scope of activities of the RCCs will probably be expanded in order to absorb some of the RCCs' current attributes.

Seed capital companies ('Sociedades de fomento empresarial — SFE')

It has been suggested in the 'White Book' that SFEs too should be replaced by a new type of non-banking institution (see SCRs above).

Two further types of entity require a mention:

Venture capital trust funds

These have recently been referred to by government departments. No regulations or specifications have been published to date and it remains to be seen what the exact purpose of these funds would be. No further discussion of these funds has, therefore, been attempted in this report.

Entrusted funds

The regulations relating to these funds were published at the end of 1986.

Entrusted funds have been ignored by both entrepreneurs and investors alike. It appears that no more than six issues have been made since 1986. Existing uses seem to involve the use of entrusted funds as quick solutions to existing bad debt problems. No entrusted fund certificate has yet been listed, although they are eligible for listing.

2. *Applicable legal measures*

Regional development companies:

Specific laws:

- Decree Law No 449/80 of 20 October 1980;
- Decree-Law No 300/85 of 29 July 1985;

- Decree-Law No 49/86 of 14 March 1986;
- Decree-Law No 228/87 of 11 June 1987;
- Decree-Law No 97/88 of 22 March 1980;
- Decree-Law No 362/88 of 14 October 1988;
- Decree-Law No 28/89 of 23 January 1989;
- Decree-Law No 318/89 of 23 September 1989;
- Decree-Law No 25/91 of 11 January 1991.

Other laws:

- Decree Law No 215/89 of 1 July 1989 (Tax benefits code);
- 'Portaria' No 760/89 of 2 September 1989;
- Specialized credit institutions regulations;
- Banking regulations.

Risk capital companies

Specific laws:

- Decree Law No 17/86 of 5 February (30 April) 1986;
- Decree Law No 67/87 of 9 February 1987;
- Decree Law No 124/87 of 17 March 1987;
- Decree Law No 72/88 of 9 March 1988;
- Decree Law No 28/89 of 23 January 1989;
- Decree Law No 111/89 of 13 April 1989;

Other laws:

- Investment companies regulations;
- Banking regulations.

Seed capital companies

Specific laws:

- Decree Law No 248/88 of 15 July 1988;
- 'Portaria' No 522/88 of 4 August 1988;
- Decision of the (Portuguese) Council of Ministers No 35/89 of 3 October 1989;
- Decree Law No 289/89 of 2 September 1989;
- 'Portaria' No 760/89 of 2 September 1989;

Other laws:

- Decree Law No 17/86 of 5 February 1986 (SCR regulations);
- Other RCCs regulations;
- Investment companies regulations.

3. *The investment vehicle*

3.1 Regional development companies ('SDRs')

SDRs — An instrument of economic policy

The object of SDRs is to arrange financial deals which will ultimately promote, stimulate and make more attractive the productive enterprises situated in specific regions. The legislator apparently drew the inspiration for the idea from a centrally planned development principle popular during the 1960s and 1970s. The legislator recognized at the same time, however, the possibility of achieving enhanced efficiency through some decentralization.

In truth, however, economic planning in Portugal remains an idea on paper despite the fact that it has been under discussion since the last century.

At present, all of the benefits granted to SDRs are either guaranteed by or sourced by the government.

SDRs are specialized credit institutions and are regulated as such. By contrast, SIs are non-banking financial companies (para-banking companies). SDRs and SFEs are simply financial companies, with less power in monetary and financial fields.

The main objectives of the SDRs are referred to above (Section I.1). They have a similar scope to SIs. SCRs and SFEs have a narrower scope, as they are not allowed to borrow from banks.

Geographic limits

Although the SDRs are not subject to geographic restrictions, their activities are developed inside a well-defined territory (region).

Minimum share capital

ESC 600 million (approximately ECU 3.4 million).

(The 'White Book' does not refer to SDRs).

Equity representation

The following attributes are specific to SDRs. There are no equivalent rules as regards SIs, SCRs or SFEs.

Equity must be represented by nominative issues.

Investment policy

Limits are imposed on the activities which SDRs may engage in. The list of permitted activities describes the loans they are permitted to make and the portfolio of investments they are entitled to hold. The activities are as follows:

- to acquire shareholdings in other companies;
- to grant medium- and long-term loans to local enterprises and to acquire credits in relation thereto;
- to grant medium- and long-term loans to self-employed persons;
- to grant medium- and long-term loans to local authorities of the region in question. The loans made to local authorities must not exceed 20% of all outstanding loans;
- to subscribe, to underwrite and/or to purchase bonds (ordinary, etc.) and stocks;
- to subscribe, purchase and trade in securities. (It is assumed that SDRs can trade in commercial paper and notes);
- to issue guarantees (this activity is subject to constraints);
- to subscribe and to underwrite public debt certificates and bonds.

Certain lending and investment activities are prohibited. SDRs cannot:

- hold equity in other financial institutions or in real estate companies;
- acquire immovable assets, except those necessary for the carrying on of business;
- develop any agricultural, industrial or commercial activity;
- hold equity in foreign companies;
- grant loans to its managers or to related companies.

Permitted ancillary services

It is clear that SDRs can provide various services ancillary to the funding of SMEs. They can:

- promote new enterprises;
- prepare feasibility studies and arrange project financing;
- assist in financial engineering;
- offer technical, financial and management assistance;
- arrange personnel tuition and training seminars.

A range of general activities connected with regional development may also be engaged in by SDRs. They may:

- attempt to achieve local economic development;
- take part in the creation of local development poles, mainly industrial parks;
- cooperate in local economic planning;

- manage enterprises in the region (temporarily).

Supervision and prudential regulation

SDRs are subject to supervision by the Central Bank, which regulates, oversees and controls them. In doing so it applies the same rules as those applied to banks and other credit institutions.

Banking prudential rules on the following matters must be respected by SDRs:

- provisions against general credit risks;
- provisions against bad debts (non-performing loans);
- major risk ratios and rules;
- solvency ratios;
- obligatory reserves.

Privileges

SDRs enjoy a number of privileges:

They are exempt from stamp duty with regard to both their fund-raising and lending activities.

Bonds issued or guaranteed by SDRs are eligible to be counter-guaranteed by the State.

On the conclusion of a financial assistance programme, the liabilities of the SDRs are backed by a sovereign guarantee covering the following:

- they will be guaranteed to receive a minimum annual yield on preferred shares held by them for a period of five fiscal years;
- they will receive government subsidies in relation to interest paid on bonds issued by SDRs;
- the government will participate in personnel tuition and training costs;
- the government will share the cost of promoting regional development areas.

3.2. Risk capital companies ('SCRs')

SCRs are established in the form of joint stock companies. They are classified as financial institutions. There are no references to SCRs in the 'White Book' outlining reform proposals for the financial sector. The classification of SCRs will not, therefore, be altered to that of a banking institution in the near future.

Objectives

The objectives of SCRs are to participate temporarily in the equity of enterprises in order to promote productive investment and technological renewal. The participations could take the form of stock or capital shareholdings and convertible bond holdings.

Geographic limits

There are no regulations which impose territorial limits on the activities of SCRs, such as preventing them from holding foreign stock, for example. However, direct investments made outside Portugal by residents, including equity investments, require the Central Bank's permission. To date, we are not aware of any SCRs having requested the Central Bank's permission for direct investments abroad. It is thought possible that permission would be refused.

This restriction will not be considered as an obstacle in the context of the present study given that the EC Commission is concerned only with the internal situation in each Member State. Cross-border investment activity has been specifically excluded from the scope of this report.

Share capital requirements

The minimum share capital for SCRs is set at ESC 600 million (approximately ECU 3.4 million), although initially it is only necessary to subscribe 50%. The capital may be represented by any of the types of equity provided for in the 'Code for commercial companies' with regard to joint stock companies (i.e. ordinary stocks/ preferred stocks/registered stocks/registered bearer stocks/bearer stocks).

There is no requirement to register qualified shareholdings, i.e. those exceeding a certain percentage of the share capital, with the Central Bank.

Funding

SCRs are not allowed to have access to straight borrowing from Portuguese banks and other Portuguese financial institutions. They may raise funds from the following sources:

- borrowing from non-resident financial institutions where the loans mature in less than two years (these are subject to foreign exchange regulations);
- bond issues (i.e. involving ordinary bonds, convertible bonds, etc. but excluding treasury bills and bonds);
- raising funds on the Portuguese capital market or abroad (subject to foreign exchange regulations), through partnership agreements (giving them the right to share yields and windfall profits resulting from shareholding).

Permitted investment activities

SCRs are permitted to make the following investments:

- to purchase and to trade in equity capital (including the use of equity as collateral);
- to subscribe for and to underwrite convertible bonds (issued by resident companies);
- to act as agent in connection with medium- and long-term loans on behalf of foreign financial institutions;
- to place stocks, bonds and other securities (these probably include commercial paper and notes, although there are no known examples); and
- to subscribe for and to underwrite non-convertible bonds and other securities issued by listed residents, being either State-owned or private companies (once again these securities probably include commercial paper and notes).

There are some significant limitations on the SCRs' investment policy:

- they cannot invest more than 20% of their net worth in any one company;
- no more than 75% of the SCRs' portfolio can consist of shareholdings which have been in the portfolio for more than 12 years.

SCRs are not permitted to engage in the following activities:

- acting as a holding company;
- developing agricultural, commercial and industrial activities;
- having shareholdings in the equity of banks and para-banking institutions;
- lending funds of any nature (mortgage-backed loans included); and
- purchasing and trading tangible assets.

Permitted ancillary services

As in the case of SDRs, SCRs are entitled to provide a number of ancillary services. They can:

- elaborate economic feasibility studies;
- prepare project financing studies;
- finance restructuring schemes and marketing plans, mergers and acquisitions (provided they are intended to improve production or promote new technologies).

The rendering of other ancillary services is prohibited.

Supervision and prudential regulation

SCRs are directly controlled, regulated and overseen by the Central Bank. They are not, however, subject to close supervision. No prudential rules apply to SCRs.

Privileges

SCRs benefit from certain tax exemptions and other privileges. The tax aspect is covered below. They are exempt from stamp duty payable on incorporation (normally 3% of their capital).

3.3. Seed capital companies ('SFEs')

The third in the list of venture capital vehicles looked at is the seed capital company ('SFE'). As in the case of SCRs, the SFEs are established as joint stock companies and are also classified as financial institutions. Certain of their activities are subject to Central Bank regulations.

Objectives

The object of SFEs is to assist young entrepreneurs:

- to launch new companies; and
- to acquire existing SMEs or shares in SMEs (SMEs are defined for these purposes).

At present, this category covers management buy-ins and/or management buy-outs involving SMEs by 'young entrepreneurs'.

Geographic limits

SFEs were designed to promote new ventures involving 'young entrepreneurs' and SMEs. Their aim was to avoid funds draining away into existing industrialized areas. They were intended:

- to be at the heart of regional development policy;
- to be at the heart of the initiatives aimed at enhancing the capital markets; and
- to foster new enterprises.

It seems to follow that their activities, at least those which are subsidized, are confined to Portugal.

Share capital requirements

The minimum capital requirements for SFEs vary according to whether the SFE has its head office in a disfavoured zone in Portugal (these are defined by regulations). The requirements are:

- SFEs with a head office established in a disfavoured zone: ESC 300 00 million (approximately ECU 1.7 million); and
- SFEs with a head office outside a disfavoured zone: ESC 600 00 million (approximately ECU 3.4 million).

SFEs in disfavoured zones are clearly greatly advantaged.

The required share capital can be represented by any one of the categories of share provided for in the case of joint stock companies under the 'code for commercial companies'. These include ordinary and preference stocks, registered stocks and registered bearer stocks and bearer stocks.

Qualified shareholdings (i.e. those of a certain size) must be registered with the Central Bank.

Funding

There are some limits on the sources which SFEs may use to raise funds for their activities. SFEs are, in general, subject to the same basic limitations as SCRs (see SCRs, 'Funding', above). SFEs may, however, borrow from non-resident financial institutions by means of loans having a maturity of up to five years. In the case of the SCRs the limit is two years.

The percentage limits on foreign borrowings and with regard to bond issues are also the same as those applying to SCRs.

Permitted investment activities

SFEs may undertake a wide range of investment and lending activities. They may:

- subscribe for and underwrite shares with regard to the flotation of SMEs (if managed by 'young entrepreneurs');
- subscribe for and underwrite bonds and other securities issued by SMEs (owned and managed by 'young entrepreneurs'). 'Securities' includes commercial paper and notes; and
- grant loans to 'young entrepreneurs', permitting them to:

incorporate SMEs;

buy out stock capital of SMEs they manage (where these are owned by 'young entrepreneurs');

issue guarantees on behalf of 'young entrepreneurs' (but not otherwise);

borrow money to buy out or to buy in SMEs they intend to manage;

borrow money to pay up stock capital increases; and

manage entrusted funds placed with SMEs which are owned and managed by 'young entrepreneurs'.

Some limitations are imposed on lending and investment (see SCRs, 'Permitted investment activities') by SFEs. These are identical to those imposed on SCRs with certain important exceptions:

There is an additional restriction imposed on SFEs to the effect that they must invest a minimum of 40% in holdings in disfavoured zones. SFEs do benefit, however, from the progressive enforcement of this requirement. They must achieve investments of 20% of their net worth by the end of the first year, 30% by the end of the second and 40% by the end of the third.

The 40% condition is strict and burdensome. It is difficult to achieve the 40% threshold in an economy in which industry and investment is concentrated outside disfavoured zones.

The applicable investment limits referred to above are reduced by a half when the 'young entrepreneur' being funded intends to rescue an SME facing bankruptcy.

Permitted ancillary services

SFEs can provide various ancillary services. The list is more extensive than in the case of SCRs. They may:

- take part in the financial recovery of SMEs;
- lease premises temporarily;
- assist 'young entrepreneurs' to manage SMEs;
- prepare economic feasibility studies (for enterprises of all sizes);
- arrange project financing studies; and
- design schemes for financial recovery, marketing and mergers and acquisitions, provided that they aim at achieving improved production and the promotion of new technology.

No other ancillary services can be provided by SFEs.

Supervision and prudential regulation

SFEs are controlled by the Central Bank. They are not, however, subject to close supervision. SCCs are not subject to solvency ratios.

Privileges

SFEs benefit from certain tax exemptions. These are covered in the next chapter.

II. Issues of taxation

1. *Introduction*

The SME is often confronted with the difficulty of attracting financial means from third parties.

On the one hand, financial institutions feel rather reticent to grant a loan to the SME.

On the other hand, because of the high risk of the investment, only very few persons will be willing to increase the capital (and thereby the loan capacity) of the SME.

The venture capital company (VCC) can therefore play an important role in the expansion of the SME.

The VCC and the target company (SME) will have to determine how the capital is to be injected. It may very well be that there is a conflict of interest between both parties in determining how the injection will be executed.

In case of debt financing by the VCC, the interest payments are for the SME in principle tax-deductible expenses. This deduction has a negative impact on the results and on the cash flow position of the SME. But the interest received by the VCC is exempt from corporate income tax.

It may very well be that this situation is not at all desirable. Indeed, the SME will probably be in need of extra means at a time when heavy investments are planned which will already have a negative impact on the results (depreciation of the investment). From a tax point of view such a situation may also prove to be unwise. The interest deduction cannot be properly used because of insufficient profits (creation of losses).

To meet both economic and tax demands, two main options are available:

- the VCC decides to participate in the capital of the SME;
- a loan agreement is concluded under circumstances where the interest rate is in the beginning rather low.

In case of equity finance, the following problems arise.

Dividend income

If the VCC is in need of a more or less regular income to finance its own investment, this will have to be done by way of dividend distribution. This may present a great deal of problems.

Dividends are normally not tax-deductible so that the dividend capacity of the SME will normally be lower than the interest payment capacity.

In case of dividend distribution both the VCC and the individual shareholder will receive a dividend. The dividend taxation of individuals is often very disadvantageous.

The VCC receiving dividends will be exempt from corporate income tax.

When the recipient is a resident company holding at least 25% of the SME's capital during at least two years, only 5% of the domestic source dividends are taxable. If the resident company has no substantial holding, it can only claim a tax credit that is only a partial compensation for the corporate tax paid by the SME.

Domestic-source gross dividends (other than those of shares held by VCCs) are liable to a 5% substitute inheritance and gift tax which is a deductible expense for resident companies.

Capital gains income

This could be interesting since, in this case, the SME can retain all its profits. The following problems exist:

Capital gains realized on the sale of the shares are exempt from corporate income tax, where the entire consideration received is reinvested within two years in either the acquisition, the manufacture or the construction of tangible fixed assets or in the acquisition of other shares or quotas in resident companies or government securities which may not be disposed of for a minimum period of two years (except in case of a merger or a split-off of the target company). But capital gains realized by the VCC are exempt from corporate income tax.

In the next sections (Equity/Debt finance), a summary is given of all important items that could influence the decision-making of the VCC and the SME.

In the last part (Practical taxation guidance), we try to give practical guidance, resulting from the information in the sections Equity/Debt finance.

2. *Equity finance*

2.1. Creation of the VCC

Are there registration or other duties?

The incorporation of a company attracts:

- a real estate transfer tax (SISA) at the rate of 10% (urban sites or buildings) or 8% (rural immovables) on the contribution of immovables;
- the Portuguese notary fees on its formation;
- registration fees chargeable by the National Registry for Legal Entities (RNPC) and the Commercial Registry (CR);
- costs for publication in the Official Gazette (ESC 3 650 to 13 000);
- charges for listing on the Stock Exchange (0.05% of the share capital; 0.025% for bonds and other debt instruments).

Are there conditions to be met in respect of the legal forms of the VCC? Are there any specific forms available?

In Portugal a VCC must be organized as an SA. Its minimum capital must be ESC 600 000 000. Of this capital 50% must be paid in cash upon incorporation and deposited as a liquidity guarantee with the Government General Deposits Bank.

The VCC can take the form of a Sociedade de capital de risco SCR (risk capital company), a Sociedade de fomento empresarial — SFE (seed capital company), or a Sociedade de desenvolvimento regional — SDR (regional development company).

The main activity of an SCR consists of assisting and promoting other companies through a temporary (maximum 12 years) participation in their capital.

The main purpose of an SFE is to support young businessmen in small and medium-sized enterprises. This support includes underwriting issues of shares, bonds or other securities, granting loans and guarantees and providing the appropriate technical assistance.

Are there limits as to the degree of participation of the VCC in the SME?

- SCR

Individual participations in each SME may not exceed 20% of the SCR's capital and the total participation may not exceed three times the SCR's capital.

- SFE

Individual participations may not exceed 20% of the SFE's capital and the total participation may not exceed three times the SFE's capital.

A minimum of 30% of the total sales must relate directly or indirectly to exports.

The gross value-added to exports must be at least 50% of the total turnover.

There must be a positive foreign exchange balance.

2.2. Tax situation of the SME

Creation and increase of capital

Are there registration or other duties? Are there exemptions for certain zones, projects, activities?

See Section 2.1.

The stamp duty on contributions in cash at the rate of 1% is reduced to 0.8% for civil entities and raised to 1.11% for general partnerships, limited partnerships and the EIRL. The formation of commercial companies is not currently subject to stamp tax.

Transfers of immovable property which result from merger or cooperation agreements entered into before 31 December 1991 are exempt from SISA (transfer tax) and CA (immovable property tax).

Capital increases are generally subject to the 1% stamp tax. But capital increases effected under the external financing method by means of cash contributions benefit from a permanent exemption from stamp tax. Increases of capital under the self-financing method by means of capitalization of reserves are also exempt.

Is indirect tax treatment different for the following types of shares: ordinary shares, preference shares, redeemable shares, others?

The tax treatment of these shares is not different as far as registration duties are concerned.

Corporate taxation

Are the costs related to the creation or increase of capital deductible?

Start-up expenses and expenses arising in connection with capital increases are depreciated on a straight-line basis at 33.33%.

Are there specific regimes for certain SMEs (certain zones, activities, projects)?

As a preliminary remark, it should be mentioned that besides the tax incentives various financial incentives are available which are mainly based on EEC-funded investment incentive schemes.

(i) Advance rulings or tax incentives

Interested parties may request an advance ruling from the Minister for Finance or the Director-General for Taxation, relating to a hypothetical entitlement to tax incentives. These advance rulings are binding for the tax administration unless they are overruled by a court order.

(ii) Financial incentives

Most important financial incentives in Portugal are provided for under separate systems which encompass several EEC-funded investment incentives schemes. The incentives take the form of non-repayable government subsidies, namely:

- the SIBR (regional-based incentives scheme);
- the SIFT (financial incentive scheme for investments in tourism);
- the SIVRE (incentive scheme for a rational utilization of energy);
- the SISAT (financial incentive scheme for advanced telecommunication services);
- the Sinpedip (system of financial incentives to EEC-funded PEDIP, i.e. specific development programme for Portuguese industry);
- the SIMC (financial incentive scheme for trade modernization);
- the SIPE (incentive scheme to develop local potential). This last incentive scheme will be discussed in detail.

The EEC-funded SIPE scheme is designed to subsidize investments made by SMEs in the manufacturing, extractive, hotel or car rental industries. Qualifying invest-

ment costs must relate to viability studies and sectoral studies to identify development potential and prospective new markets or to risk studies aiming at access of shares and bonds to official listing on the domestic Stock Exchange.

The SIPE scheme provides cash grants of up to 70% of the qualifying investment costs, limited to ESC 15 000 000 per study. Application for these cash grants should be made to IAPMEI (SMEs Support Institute) which deals with them three times per year. The amount of the SIPE subsidy must be set aside in a special reserve account of the beneficiary and cannot be distributed, but it can be used for capitalization after three tax periods have elapsed from the date of receipt.

(iii) Incentive scheme for Madeira/Azores free zones

There are two operation free zones in Portugal, namely at Caniçal on the island of Madeira and on the island of Santa Maria.

The actual tax incentive scheme applicable to companies which obtain authorization from one of the respective regional authorities to establish business operations in the free zones is foreseen in Article 41 of the Portuguese tax benefit law, approved by Decree Law No 215/89 of 9 July 1989. The incentive scheme consists of both financial and fiscal incentives.

These financial incentives take the form of non-repayable cash grants amounting to:

- with respect to the Madeira free zone:

up to 50% of the personnel training-related costs;

up to 50% of the investment costs in actual acquisitions of energy-saving manufacturing equipments bringing about energy savings.

- with respect to the Santa Maria free zone:

up to 100% of the professional training costs of the Portuguese employees resident in the Azores region;

up to 50% of the rental costs of buildings during a maximum period of 5 years;

up to 50% of the purchase costs of new equipment and machinery needed for the establishment, conversion or expansion of production facilities;

up to 50% of the building costs of industrial plants.

The following tax incentives are available:

Until 31 December 2011, individuals and corporate bodies resident in the Madeira/Azores free zones are exempt from IRS (personal income tax) or IRC (corporate income tax) on income or profits from banking, commercial or industrial activities or services carried out in the free zones.

Shareholders of companies resident in the free zones are exempt from IRS/IRC on the following income paid by such companies:

dividends;

interest on loans and capital advances made by these shareholders to the company;

dividends declared but not withdrawn.

Individuals or corporations outside the free zone are exempt from IRS/IRC with respect to royalties paid by enterprises operating in the free zones.

Interest on loans received by foreign or national credit institutions from companies resident in the free zones who have borrowed money for investment or expansion in the free zone is exempt from IRC.

Other tax benefits include:

- exemption from SiSA (transfer tax) and from inheritance and gift tax (see below) relating to the acquisition of real estate, as well as relating to transfers of shares, quotas (LDA), participating rights or other assets of a firm established and operating in the free zones;

- exemption from municipal real estate tax (CA) with regard to immovable property situated in the free zones and intended to be used for business activities.

Rates

For tax years ending after 1 January 1991, the general rate of IRC is 36%. The basic IRC is increased in many municipalities by a 10% local surcharge (optional). This surcharge and the IRC are not deductible in computing taxable profits. In addition to the municipal surcharge on IRC, there are two basic real estate-related taxes which are mandatory for all 304 municipalities.

These taxes (transfer tax and immovable property tax) are levied in the case of transfers which relate to immovable property.

Are there specific regimes for certain SMEs?

See under 'Corporate taxation'.

How does a redemption of shares affect the tax position of the SME?

An SME can issue redeemable preference shares, which are redeemable at a fixed date or at the date established by the general shareholders' meeting. Only shares which are fully paid up can be redeemable. Redemption must be made at par value, unless the Charter of Incorporation allows the payment of a premium. The SME must allocate to a special reserve an amount equal to the par value of the redeemed shares.

Dividend distribution

Does a different tax regime apply to dividend distribution to X (shareholder of the SME) on the one hand and to the VCC on the other hand?

Yes.

When the recipient of the dividends is an SCR (venture capital company) or an SFE (enterpreneurial promotion company), a full corporate income tax exemption applies.

When the recipient is a resident company holding at least 25% of the SME's capital for at least two years, only 5% of the domestic-source dividends are taxable. The gift and inheritance tax is also due (5% of the dividend) which operates as a withholding tax.

Example:

The 95% relief is calculated on the dividend or profit distribution net of:

- the 5% substitute inheritance and gift tax;
- the withholding tax (e.g. 20% for dividends from quoted shares).

Gross dividend	100
Substitute inheritance and gift tax	(–5)
Net dividend	95
20% withholding tax	–20
	75
95% deduction	–71.75
Taxable dividend	3.75

When the SME has its registered office in the Madeira/Azores free zones, the dividends received by the shareholders are exempt from IRC/IRS.

The individual shareholder is subject to IRS (personal income tax) on the full domestic source dividends received, but an amount equal to 35% of the underlying corporate tax may be credited against the recipient's own IRS. The same tax regime applies to resident companies not holding 25% of the SME's capital during at least two years.

Note that domestic-source gross dividends (other than those of shares held by SCRs and SFEs) are liable to a 5% substitute inheritance and gift tax which is a deductible expense for resident companies.

Does a different tax regime apply according to the different types of shares (ordinary, preference, redeemable and other shares)?

These shares are not treated differently.

Is the tax base affected by the distribution of dividends?

Dividends paid are considered to be profit distributions, and as such they are not deductible as costs.

Is the tax rate affected by the distribution of dividends?

The tax rate is not affected by the distribution of dividends.

Is a withholding tax withheld? Rate? Exemptions?

An exemption from withholding tax applies to domestic-source dividends

- received by an SCR or an SFE;
- received by a resident company holding at least 25% of the SME's capital.

When the recipient of the dividends is an individual shareholder, a withholding tax is applicable at the rate of:

- 25% for dividends from unquoted shares in an SA or a partnership limited by shares;
- 20% for dividends from quoted shares;
- 15% for profits distributed by a limited liability company or a limited partnership.

This withholding tax is an advance payment of the shareholder's corporate or personal income tax. But individuals can choose to treat it as a final withholding tax.

2.3. Taxation of the VCC

Corporate taxation

Are the costs related to the creation of the VCC deductible?

These costs are depreciated on a straight-line basis at 33.33%.

Are management costs and interest deductible?

Yes, they are considered as tax allowable expenses.

How are dividends taxed?

The tax incentive scheme for SCRs and SFEs incorporated in the period from 1 January 1989 through 31 December 1990 (31 December 1992 for SDRs) consists of an IRC exemption (except for interest on deposits which is taxed under IRC at a rate of 20%) with respect to the year of incorporation and the four-year period thereafter (increased to a seven-year period there-after for SFEs). It is not to be expected that this tax-incentive scheme will be extended in the future.

What is the capital gains taxation if the shares of the SME are sold?

The capital gains realized by SCRs and SFEs incorporated within the exemption period are exempt from IRC.

But even if these conditions are not met or if the period has passed, the capital gains are exempt from IRC where the entire consideration received is reinvested within two years in either the acquisition, the manufacture or the construction of tangible fixed assets or in the acquisition of other shares or quotas in resident companies or government securities which may not be disposed of for a minimum period of two years (except in case of a merger or a split-off of the target company).

If only part of the consideration is reinvested, then only the proportionate amount of the gain qualifies for exemption. The above exemption does not apply with respect to:

- capital gains from disposal of shares held for less than 12 months (unless they were already held prior to 1989);
- acquisition by a company of its own shares or quotas;
- transfers for consideration by a company of its shares, quotas or securities to any of its shareholders, quotaholders or members, except for the capital increase.

What about capital losses?

Capital losses are considered as ordinary losses. Ordinary losses incurred by normal corporate taxpayers may be offset against taxable profits for one or more of the five subsequent financial years.

What is the tax position of the VCC in case of redemption of the shares by the SME?

Capital gains realized by the VCC in case of redemption of shares by the SME are exempt from IRC.

Are there specific regimes?

See above.

Rates

There is an exemption from IRC for SCRs during the first five years of business.

There is an exemption from IRC for SFEs during the first eight years of business.

Is there recoverability of the tax withheld by the SME?

An exemption from withholding tax on account of IRC applies to dividends received by SCRs and SFEs.

Distribution of dividends by the VCC

Does a different tax regime apply according to the different types of shares: ordinary, preference, redeemable, other shares?

No. The tax treatment of the different types of shares is the same.

Is the tax base affected by the distribution of dividends?

Dividends are not deductible as costs.

Is the tax rate affected by the distribution of dividends?

No.

Is a withholding tax withheld? Rate? Exemptions?

When the recipient of the dividends is an individual, a withholding tax of 25% (dividends from unquoted shares) applies. This withholding tax is final, unless the private investor elects to treat it as a payment on account. A refund is granted if the amount of tax withheld exceeds the ultimate income tax liability.

The same tax regime applies to resident companies receiving dividends from a VCC (but the withholding tax is an advance payment).

When a resident company holds at least 25% of the capital of the VCC, an exemption from withholding tax is applicable.

Transfer of shares

In case of transfer of shares of the SME, do special taxes apply to these transfers?

No.

Tax situation of X/individual shareholder

Is the interest paid on the loans granted in view of the purchase of the shares of the SME deductible?

No.

How are dividends taxed?

With respect to domestic-source dividends, a resident recipient may credit against his tax 35% of the underlying corporate income tax (at 36%) attributable to such dividends.

Example:

Assuming that an SA's taxable profits are 10 000 and its total distributed profits (after 36% corporate tax) are 6 400 out of which of a resident individual shareholder receives 1 000. His dividend credit would be:

$$\frac{1\,000}{6\,400} \times 36 \times 35 = 196.8$$

That shareholder's taxable income for tax purposes would be 1 000 + 196.8 = 1 196.8. It can be said that this credit is 11.3% of the dividend received.

In case the SME is not a company but an unincorporated enterprise

Partnerships can be organized under three different legal forms:

1. General partnership
This type of partnership is frequently used by professional individuals who are associated in firms and is tax-transparent.

2. Limited partnership
This partnership consists of one or more general partners and one or more limited partners. A general partner's liability is unlimited, while a silent partner's liability is limited. Whether such a partnership is tax-transparent or not depends on the activity: not tax-transparent in case of a commercial activity, tax-transparent in case of an industrial activity.

3. Partnership limited by shares
This form of partnership also has one or more general partners and one or more limited holders of the partnership's share capital. The liability of the general partner is unlimited, the liability of a holder of the partnership's share capital is limited. If such a partnership is carrying on a non-commercial activity, it is tax transparent.

An individual entrepreneur may also limit his liability to the firm's registered capital through the incorporation of an EIRL (individual enterprise with limited liability). The minimum capital for an EIRL is ESC 400 000.

If the SME has one of the abovementioned legal forms, it is subject to fiscal transparency: the profits — whether distributed or retained — are directly imputed to their shareholders/quotaholders (VCC) and taxed as income in their hands, but losses cannot be imputed.

These transparent entities are not exempt from corporate income tax per se, but are granted a 'technical exemption' meaning that they are not directly taxed under the corporate income tax code.

3. *Debt finance*

Preliminary question: Is there a debt/equity ratio to be respected?

No, except for special-purpose companies (SCR, SFE).

3.1. Tax situation of the SME

Does the distinction between the following types of loans have implications on the tax situation of the SME:

- *ordinary loans;*
- *convertible loans;*
- *profit-sharing loans;*
- *other types?*

No.

What is the deduction regime for the different types of loans?

As a general rule, interest is deductible if actually paid.

Are there specific regimes available?

No.

What is the situation if the VCC also participates in the SME?

When related parties are involved, the maximum allowable interest deduction in the case of shareholder loans is currently three percentage points over the Portuguese Central Bank's prevailing rate. It is now proposed that the applicable interest rate shall be the higher of the London Interbank interest rate (LIBOR) and the rate prevailing on the international capital markets, plus one percentage point above such higher rate.

What is the withholding tax in each case of the different types of loans?

Interest received by SCRs/SFCs is exempt from withholding tax.

3.2. Tax situation of the VCC that grants a loan to the SME

What is the situation concerning the different types of loans: ordinary loans, convertible loans, profit-sharing loans?

No different tax treatment applies.

In respect of the taxability of the interest, are there exemptions or reductions for certain zones or activities?

The interest received by the SCR or SFE is exempt from IRC.

How are the capital gains on receivables taxed?

They are exempt from IRC when realized by an SCR or SFE.

What if the loan is converted into capital with capital gains or losses?

Capital gains are fully taxed except for VCCs incorporated between 1 January 1989 and 31 December 1990. Capital losses always remain deductible.

Are capital losses on receivables realized by the VCC deductible?

Yes.

Are interest payments deductible?

Interest is deductible if actually paid.

Is there a withholding tax on interest paid by the VCC?

A withholding tax at the rate of 25% is withheld. A withholding tax at the rate of 15% appears in the case of shareholders' loans.

3.3. Tax situation of the fund

A venture capital fund (FCR or 'fundes de investimento de capital risico') is a closed-ended investment fund. Three of its investments must consist of participating interests in unlisted companies with great growth potential. The management company (which may hold a maximum of 5% of the participation units in each FCR) may take the form of a venture capital company (CSR), an entrepreneurial promotion company (SFE), a regional development company (SDR) or an investment bank or company.

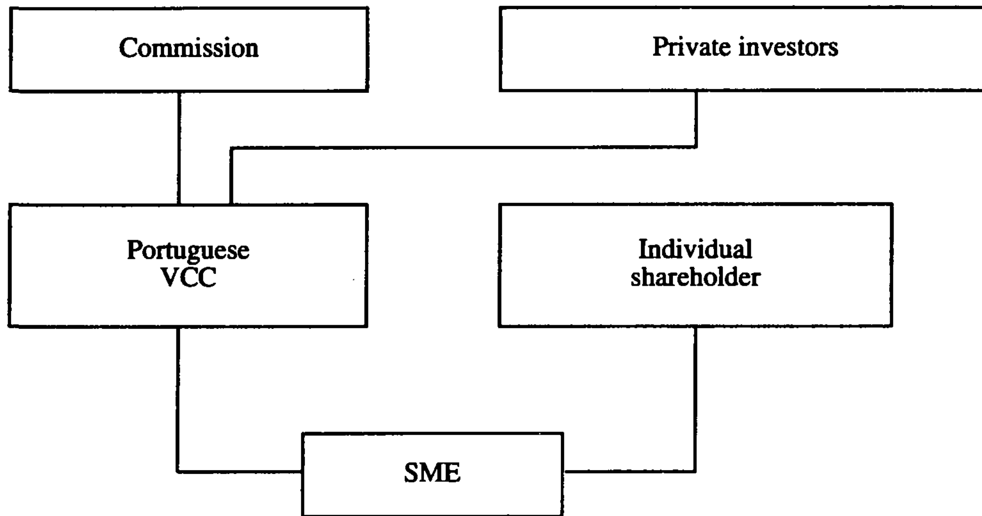
By the end of the third year after the formation of the FCR, at least 60% of its total investments must consist of loan capital and unlisted shares. The maximum investment in any company is 15% of the FCR's equity capital and the maximum total investment is 50% of the equity of the FCR. The investment funds are represented by certificates which are transferable and which may be quoted on the Stock Exchange.

Individuals holding certificates of FCRs are exempt from personal income tax (IRS) on distributions from such FCRs, but a withholding tax applies on income distributed to the funds. Companies holding certificates of FCRs are taxed on the distributed income. The withholding tax on such distributions is paid by the fund, but is treated as a payment on account with the company. The managing company is obliged to publish the amount distributed and the amount of tax withheld.

Practical taxation guidance

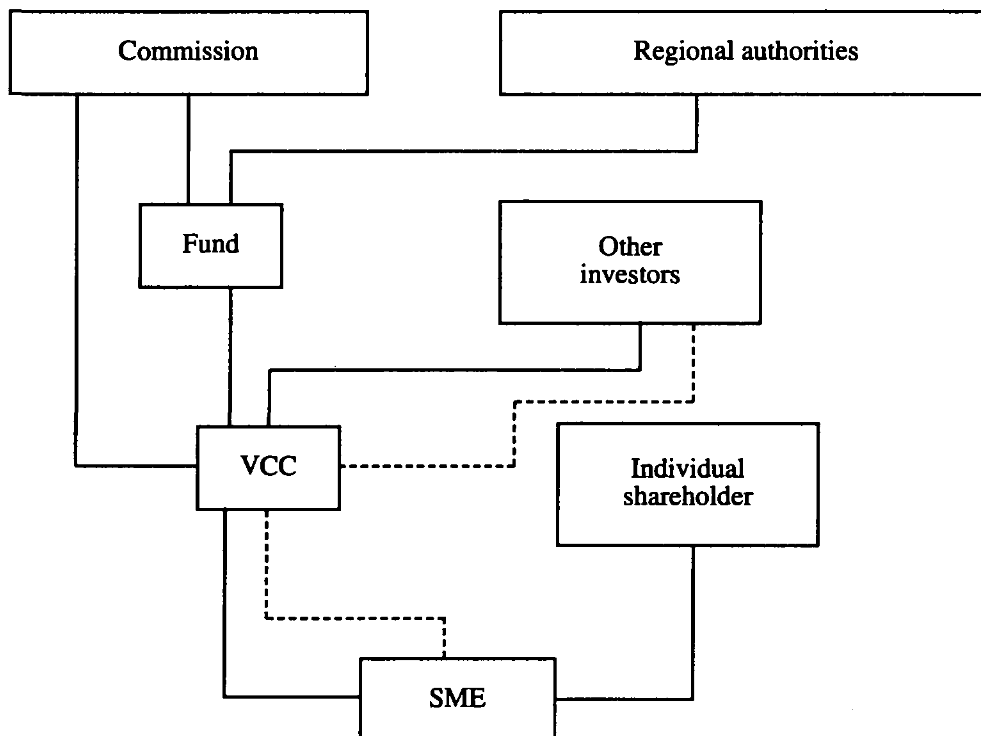
I. Equity finance

1. Scheme



II. Debt finance

1. Scheme



2. *Comments on structure*

2.1. *Position of the SME*

Costs of increasing capital:

Capital increases are generally subject to a 1% stamp tax. Increases of capital under the self-financing method by means of capitalization of reserves are exempt. Capital increases effected under the external financing method by means of cash contributions benefit from a permanent exemption from stamp tax. Expenses arising in connection with capital increases are depreciated on a straight-line basis at 33.33%.

Taxable base:

The profits of the SME are positively influenced by the capital increase. If the capital increase leads to a profit situation, this profit is normally taxed at 36% (IRC = corporate income tax). The basic IRC is increased in many municipalities by a 10% local surcharge (optional). This surcharge and the IRC are not deductible in computing taxable profits.
In addition to the municipal surcharge on IRC, there are two basic real-estate-related taxes (transfer tax and immovable property tax).

Tax rate:

The profits are taxed at 36% (+ municipal surcharge, + real-estate-related taxes)

When the SME is situated in the Madeira/Azores free zones, the profit will be exempted from IRC until 31 December 2011.

Redemption of shares:

An SME can issue redeemable preference shares, which are redeemable at a fixed rate or at a date established by the general shareholders' meeting.

2.1. *Position of the SME*

Costs of granting a loan:

No costs.

Taxable base:

The interest payments are normally deductible expenses and have a negative impact on the results and on the cash flow.
This situation may prove unwise because a loss position may be created.
In case the VCC participates in the SME to which the VCC grants a loan, the maximum allowable interest deduction is currently three percentage points over the Portuguese Central Bank's prevailing discount rate.

Tax rate:

The deductible interest payments are taxed at the corporate tax rate.

Reimbursement of the loan:

This reimbursement has no impact on the taxable result.

Only shares which are fully paid up can be redeemable. Redemption must be made at par value, unless the Charter of Incorporation allows the payment of a premium. The SME must allocate to a special reserve an amount equal to the par value of the redeemed shares.
Capital gains realized in case of redemption of shares are taxed with the shareholder. When realized by the VCC, they are tax-exempt.

Dividend distribution:

The dividends are part of the taxable base.

On dividends distributed to the individual shareholder, a withholding tax of 25% or 20% applies.
The dividends are subject to IRS (personal income tax), but an amount of 20% of the underlying corporate tax may be credited against the recipient's own IRS.

On dividends distributed to the VCC a full corporate income tax exemption applies. An exemption from withholding tax is applicable.

On dividends distributed to a resident company holding at least 25% of the SME's capital for at least two years, a 95% exemption applies. In case the resident company has no substantial holding in the SME, the tax regime of the individual shareholder applies.

SME is situated in the Madeira/Azores free zones:

Income or profits from banking, commercial or industrial activities carried out in the free zones will be exempt from IRC until 31 December 2011.

Interest payments:

The interest paid to VCCs is exempt from withholding tax.

The interest paid to resident companies and individual shareholders is subject to a withholding tax at the rate of 15%.

The shareholders of the SME will be exempt from IRC/IRS on the following income paid by the SME:

- dividends;
- interest on loans and capital advances made by these shareholders to the company;
- dividends declared but not withdrawn.

2.2. *Position of the VCC*

Taxable base:

(a) Dividend income

This income is exempted from corporate tax (IRC) for VCCs incorporated in the period from 1 January 1989 through 30 December 1990 with respect to the year of incorporation and the four-year period thereafter.

There is no withholding tax on this dividend income. When the VCC is situated in the Madeira/Azores free zones, the exemption period ends on 31 December 2011.

(b) Capital gains taxation

The capital gains realized by VCCs within the exemption period (see above) are exempt from corporate income tax.

(c) Capital loss on shares

They are considered as ordinary losses and are tax-deductible.

Dividend distribution:

The normal rules apply. When the VCC is situated in the free zones of Madeira/Azores, the distributed dividends are exempted from personal/corporate income tax with the shareholders.

2.2. *Position of the VCC*

Taxable base:

(a) Interest income

This interest income is exempted from corporate income tax for VCCs incorporated in the period from 1 January 1989 through 30 December 1990 with respect to the year of incorporation and the four-year period thereafter.

There is no withholding tax on this interest income. When the VCC is situated in the Madeira/Azores free zones, the exemption period ends on 31 December 2011.

(b) Capital gains taxation

The capital gains realized by VCCs within the exemption period (see above) are exempt from corporate income tax.

(c) Capital loss on loans

They are considered as ordinary losses and are tax-deductible.

Interest payment to the fund:

This interest is deductible if it is actually paid. A withholding tax of 25% is withheld.

Transfers of shares:	*Transfers of loans*:
No special taxes apply.	No special taxes apply.
2.3. *Position of the individual shareholder*	2.3. *Position of the individual shareholder*
Dividend income:	Dividend income:
The dividends received are included in his taxable income. But the individual shareholder may credit against his tax 20% of the underlying corporate income tax (at 36%) attributable to such dividends. The withholding tax is an advance payment of his personal income tax. But the individual shareholder can choose to treat it as a final withholding tax.	See left side.
2.4. *Position of the fund*	2.4. *Position of the fund*
No dividend income (see scheme).	The interest income is taxable in the hands of the fund's members.
3. *Unincorporated SMEs*	3. *Unincorporated SMEs*
If the VCC participates in the SME, the profits of the SME – whether distributed or retained – are directly imputed to the VCC and taxed as income with the VCC, but losses cannot be imputed.	If the VCC grants a loan, the interest is deductible with the SME. The interest received by the VCC is tax exempt.

Conclusion

Equity finance	*Debt finance*
1. *Major disadvantages*	2. *Major disadvantages*
Costs related to increase of capital;	
The capital increase will normally lead to a higher taxable base and thus a higher tax burden with the SME;	The deductible interest payments may lead to a loss position of the SME;
The dividend and capital gains exemption does not always apply;	When the VCC participates in the SME, the interest deduction is limited with the SME;

The tax situation of the individual shareholder may be very disadvantageous as to the purchase of shares;

Domestic source dividends (other than those of shares held by VCCs) are liable to a 5% substitute inheritance and gift tax.

2. *Major advantages*

Capital increases effected under the external fnancing method by means of cash contributions benefit from a permanent exemption from stamp tax;

When the VCC and/or the SME are established in the Madeira/Azores free zones, they can benefit from an exemption of corporate income tax. Their shareholders are not taxed on their dividends;

On dividends distributed to the VCC by the SME, a full corporate income tax exemption applies. There is no withholding tax on this dividend income;

Capital gains realized by the VCC are exempt from corporate income tax;

Capital losses are treated as ordinary losses and are tax deductible;

On dividends distributed to a resident company, a 95% exemption applies if the recipient holds at least 25% of the capital of the distributing company during at least two years. There is no withholding tax withheld.

There is a withholding tax of 25% on interest paid by the VCC, which cannot be credited by the fund.

2. *Major advantages*

There are no costs relating to the granting of the loan;

The taxable base of the SME will normally be reduced, which saves corporate income tax.

Portugal	Equity				Debt			
	VCC with qualifying participation[1]	VCC without qualifying participation	VCC is an SFE/ SCR[2]	SME resident Madeira/ Azores free zones[3]		Ordinary VCC	VCC is an SFE/ SCR[2]	SME in Madeira/ Azores free zones – VCC participates in SME[3]
SME profit before tax	100	100	100	100	Deductible with SME	Yes	Yes	Yes
Corporation tax 36%	–36	–36	–36		Interest payment	(–100)	(–100)	(–100)
					Withholding tax 25%[9]	25		
Gross dividend	64	64	64	100	Interest income before tax at recipient's level	75	100	100
Substitute inheritance and gift tax 5%[4]	–3.2	–3.2	0	– 0	Taxable base	100	0	0
Withholding tax 25%[5]	0[5]	– 16	0[5]	–25	CIT 36%	– 36	0	0
					Tax borne at source	25	0	0
					Tax still due/ restitution	– 11	0	0

Portugal	Equity				Debt			
	VCC with qualifying participation[1]	VCC without qualifying participation	VCC is an SFE/ SCR[2]	SME resident Madeira/ Azores free zones[3]		Ordinary VCC	VCC is an SFE/ SCR[2]	SME in Madeira/ Azores free zones – VCC participates in SME[3]
Net dividend before tax at recipient's level	60.8	44.8	64	75	Net income after tax	64	100	100
Taxable base	6.24[6]	76.6[7]						
CIT 36% at VCC's level	2.25	–27.57	0	0				
Tax borne at source	0	28.6[8]	0	25				
Restitution	0	1.03	0	25				
Net dividend after tax	58.55	45.83	64	100				

[1] When the VCC is a resident company holding at least 25% of the SME's capital for a minimum of two years (or for a shorter period of time if held from the date of incorporation of the SME), a 95% relief from taxation applies. For some specific entities, such as sociedades de capital de risico – SCRs (risk capital companies), sociedades de fomento enpresarial – SFEs (seed capital companies), sociedades de desenvolvimento regional – SDR (regional development companies), etc., this 95% relief applies independently of the percentage of participation and the holding period.

[2] SCRs/SFEs enjoy a temporary exemption from CIT, if they are incorporated between 1 January 1989 and 31 December 1990.

[3] SME is thus exempt from CIT until 31 December 2011; so is VCC on income received from such an SME, even when VCC is not situated in the free zones.

[4] 10% maximum municipal surcharge.

[5] Substitute inheritance and gift tax is deductible as an expense.

[6] No withholding tax is due on dividends received by a resident VCC holding at least 25% of the SME's capital for a minimum period of two years (or for a shorter period of time if held from the date of incorporation of the SME) or by VCCs having the form of an SFE, an SCR or an SDR.
[7] Gross dividend – 95% of net dividend before tax (57.38).
[8] Net dividend is grossed up with the substitute inheritance and gift tax, the withholding tax and 35% of CIT paid by SME (13.8 in this case), which is creditable against VCC's liability to CIT.
[9] Creditable part of CIT paid by SME (13.8) + withholding tax (15.1); any excess is refunded.

III. Other issues

Impact assessment

1. SDRs – A source of funds for SMEs

Mainly oriented towards local development programmes, SDRs may be a useful partner for any SMEs wishing to settle in a particular region.

In theory, SMEs should find SDRs to be:

- an available partner;
- a lender specialized in funding project start-ups;
- a personnel trainer;
- a renderer of several services that are essential for the success of a project; and
- a support in capital markets (in a way SMEs are unable to arrange everything themselves).

All these facilities are available at a capital cost which is less than that charged in the open market.

In reality, however, the position is very different. The SCR as an idea was not received enthusiastically by investors. Just four SDRs were incorporated or are projected so far. Existing SDRs seldom attract projects with economic impact in the regions where they operate.

SDRs lack dynamism. The reasons for the present situation are the following:

- SDRs' activities are over-governmentalized and depend on government discretionary decisions;
- the procedure for incorporating SDRs is too bureaucratic and time-consuming (both government and local authorities must issue approvals);
- the geographic limitations on SDRs' activities are too burdensome, namely, if local imbalances exist (as is the case in Portugal); and
- the management of SDRs is a very complex process involving splitting accounts over two different tax frames and, consequently, being bound by allocation criteria which tax officers may enforce.

The real difficulty is to find stable funding on a local level, as SDRs must.

It can be concluded from reading the regulations applicable to SDRs that they face a serious lack of funds, at least for the time being.

The following should be noted:

- the capital markets perform poorly (if they work at all);
- it is quite impossible to float large-scale bond issues;
- the secondary market for bonds offers no liquidity – with the exception of public debt securities;
- the stock market has been slow since October 1987;
- banks do not willingly grant medium- and long-term loans when a borrower is unable to offer a turnover of at least the same size – that is precisely what SDRs cannot offer either; and
- depositors (Portuguese emigrants) will wish to keep their deposits liquid and to obtain ancillary services.

These are advantages SDRs do not offer spontaneously (or, in some cases, they do not have the permission to offer, or render them):

- local authorities face treasury problems – and they have no stable sources of funding other than by means of transfers from the central government budget;
- SDRs will not be highly rated and Portuguese investors are, basically, risk averse. This is so even where the SDR is backed by government because the reimbursement of sovereign guarantees is a lengthy process;

- the portfolios of SDRs will, most probably, not turn over. This is certainly not an appealing feature for investors.

2. SCRs – A source of funds for SMEs

The rules applying to SCRs represent a further effort towards enhancing the Portuguese capital markets. The various tax incentives available were seen by investors and entrepreneurs as compensation for the risks inherent in the equity investment made.

SCRs were intended as a means of securitizing SMEs that could not directly approach the capital markets.

SCRs do face certain major problems. These include:

- how to fund their own activities;
- how to turn over their portfolios; and
- how to avoid double taxation on collected dividends.

The liabilities assumed by SCRs are hard to manage. They were intended to intermediate in the capital markets and, consequently, they must stick to medium- and long-term security deals on both sides of the balance sheet. The question is how do investors rate SCRs' securities?

Experience shows that investors give a cold reception to SCRs' securities

In reality, a further problem emerges from the fact that the Portuguese capital market barely exists, with the exception of the public debt securities market. Consequently, investors have low expectations with regard to being able to cash in securities (shares or bonds) issued by poorly rated companies. SCRs rely for their investment capital, however, on the willingness of investors to place their money with SCRs.

In Portugal, nowadays, companies' gross profits are taxed at a rate of 40.25%. Dividends are taxed as well.

Although there are some legal methods available for partly preventing double taxation, the reality is undeniable; dividends, as taxable income, support a marginal tax burden varying from 40.25 to 64.30%.

At such levels, it is extremely hard to increase equity through retained current profits.

In short, SCRs do exist but they suffer from poor conditions in which to succeed.

3. SFEs – A source of funds for SMEs

As stated above, SFEs are intended to assist 'young entrepreneurs' and are a source of funding for them.

It is understood and hoped that SFEs will share with or pass on to the SMEs concerned the benefit of the tax exemptions they enjoy. SMEs may benefit at the same time from other benefits and subsidies.

SFEs do face certain difficulties:

- the applicable regulations are seen as being too complex and bureaucratic and do not encourage initiative;
- funding and risk diversification; and
- owing to the lack of capital markets, SFEs are forced to sell their investment holdings to other investors if they wish to avoid exhausting their investment capital.
  For the above reasons, namely regulatory strictness, funding difficulties and difficulty in realizing investment holdings, SFEs are never seen.

IV. Comparative legal and regulatory issues

General observations

The lack of success of venture capital organizations would suggest that this is an area for radical reform by borrowing the positive features found to exist in other Member States.

Spain

Introduction

The Spanish venture capital market is characterized by intervention from the public sector, notably the autonomous communities. However, the end of the 1980s saw an increase in private sector venture capital organizations. No significant legal obstacles have been identified, although, as in Italy, small enterprises are reluctant to bring in outside shareholders.

From a tax point of view, major efforts have been performed to promote the technique of risk capital. For instance, when the VCC operates under the special form of a 'sociedad de capital riesgo' a 100% relief from corporate income tax on dividends received from qualifying shares is applicable. Such VCCs also benefit from an exemption from taxation on capital gains arising on the disposal of securities.

On the other hand, if the VCC has not taken this special form, partial double taxation may result on dividend income (if certain conditions are not met) and capital gains on shares are fully taxable.

Tax benefits exist for SMEs situated in certain areas (the 'promotional zones'). These benefits have taken the form of a reduction of rates of indirect and local taxation.

I. Legal and regulatory issues

1. *Typical investment vehicle used*

The following legal entities are used for the provision of venture capital to SMEs:

- The venture capital company ('VCC'). This type of company acts as an intermediary which puts the investor in touch with the SME. It is a public limited company having the exclusive aim of fostering non-financial companies by means of a temporary share in their capital.
- The venture capital fund ('VCF'). These have the same aim as VCCs but they are patrimonial funds. In other words, they do not have a separate legal personality. They consist of a block of capital invested by the individual investors and managed under an agreement with a management company.

(In Spanish, the VCCs and VCFs are collectively known as 'Sociedadès y fondos de capital riesgo').

2. *Applicable legal measures*

- Royal Decree 3061 of 29 December 1979 on the system of business administration.
- Ministerial Order of 24 September 1980.
  This deals with the registration of companies and venture capital funds.
- Royal Decree Act 1/1986 of 14 March regarding urgent administrative, financial, fiscal and labour measures. Article 4 refers to VCCs specifically. It deals with their definition, requirements, the introduction of the secondary market and of the Stock Exchange.
- Royal Decree Act 710/1986.
- Ministerial Order of 26 September 1986.
  These provided for the listing of venture capital companies on the secondary markets.
- The General State Budget Act 1988 (Act 33/1987 of 22 December).
  This limits the level of shareholding an individual can acquire in a VCC or VCF.

3. *The investment vehicle*

Royal Decree 1/1986 defines the aim of venture capital companies. The Royal Decree adopts a similar definition to that contained in the company tax law for company promotion companies, a precedent for the actual VCCs (27 December 1978, Articles 26-28). There are some differences between the regulations, however. The most important is that the 1986 Royal Decree covers both companies (VCCs) and funds (VCFs). The latter have the same aim as VCCs but must be administered by a management company, with the concurrence/ consent of the deposit-holder (or custodian of the investor's moneys).

The VCC regulations prevent them from acting as the management company for a VCF. This is seen as a limitation on one of the VCCs' most worthwhile activities. VCCs cannot have VCF participations in their portfolio either.

The 1986 Royal Decree is considered as insufficient by the specialists in the field. Most companies and funds, therefore, choose not to operate under it. Instead, they follow the company promotion regime set out under the company tax law and subsequent laws.

Share capital requirements

VCCs must have a share capital of at least PTA 200 million. VCFs must have an initial capital of at least PTA 275 million.

Under the General State Budget Act 1988, the direct or indirect shareholding of any member or participant must not exceed 20% of the share capital of a VCC or VCF. These limitations do not, however, apply to public organizations. The latter would include local and regional

authorities and probably also the European Commission.

The conditions applicable to the number of members and their share in the capital of the VCCs and VCFs may be acceptable as far as VCFs are concerned. They are, however, regarded as excessive as far as VCCs are concerned and remain an obstacle to the establishment of these entities.

Investment policy

The following restrictions apply:

- At least 50% of the share capital of VCCs and VCFs must be invested in shares not listed on the primary market of the Stock Exchange. The level of the indirect participations held by VCCs and VCFs in shares listed on the primary market must not exceed 45% of their paid-up share capital.
- Two thresholds have to be complied with. Firstly, a maximum of 75% of the assets of a VCC or VCF can consist of external financing of target companies. The minimum maturity of the financing must be three years. Secondly, the total external financing given by a VCC or VCF to a particular target company must not exceed 45% of the external financing which the target company has been granted from all sources and to which similar maturity periods apply.
- VCCs must hold at least 10% but less than 30% of the share capital of any company in which they take a participation. This requirement is seen as unnecessary and represents an obstacle to the creation of these companies.
- They must establish a purchase and selling price with regard to the shares they hold. These prices cannot differ by more than 10% of the face value of the shares held. In cases where the VCC holds bonds rather than shares, the difference between the purchase and selling prices cannot exceed 3% of the face value of the bonds. This only applies if the company being invested in is listed on the secondary market.
- With regard to the above, at least 2% of the shares of the company invested in by the VCC which is listed on the secondary market must be quoted at the sales and purchase prices mentioned in the previous paragraph.
- VCCs and VCFs are prohibited from making participating loans. This effectively prevents them from building up prior contacts with companies needing venture capital. The making of such early contacts is often seen as the ideal way to establish successful participations later on by means of equity holdings.

Registration

Both VCCs and VCFs must be authorized prior to commencing their activities. They have to be registered in the special Registry at the Ministry of Economy and Finance.

Due to the view taken by the specialists of the inadequacy of the 1986 Royal Decree, however (see above), in 1989 only five VCCs and four fund management companies out of a total of 30 were registered under these provisions.

The registration procedure is regarded as a formality and does not present any significant obstacles.

The secondary stock market

Royal Decree 1/1986 also contains provisions which set out benefits aimed at stimulating the secondary stock market.

Minimum requirements for obtaining a quotation on the secondary stock market are contained in a different Royal Decree. These requirements will apply to both VCCs and VCFs and also to SMEs which qualify for a quotation.

The requirements are as follows:

- The company seeking a quotation should have a minimum share capital of PTA 5 million.

At least 20% of the share capital must be available for purchase by the company seeking a quotation. Only 80% of the capital will, therefore, be negotiable.

- If the share capital is invested in convertible bonds or mortgage bonds they must be issued by companies already listed on the secondary market.
- The company's balance sheet and profit and loss account must be audited by experts registered in the General Treasury and Financial Policies Headquarters.
- A contract must be entered into with the invested company which agrees to assume responsibility for conducting/performing all the duties related to the sale and purchase of the shares on the market.

As stated above under 'Investment policy' the purchase and sales prices of companies with a secondary market quotation are controlled to a certain extent. It is also stipulated that where the supply of shares exceeds demand or the demand for shares exceeds the supply, then shares must be distributed proportionately according to that demand or supply.

Details of dealings in shares admitted to the secondary market will be included in the *Official Exchange Quotation Gazette.*

Quoted companies are required to file their audited report, balance sheet, profit and loss account and results annually.

Companies with a quotation must pay fees. In the case of a quoted VCC, these fees are reduced by 50%.

The secondary market has not been successful.

II. Issues of taxation

1. *Introduction*

The SME is often confronted with the difficulty of attracting financial means from third parties.

Indeed, on the one hand, to contract a loan with a bank, the SME has most of the time too low an equity, so that the financial institutions feel rather reticent to grant any loan.

On the other hand, because of the high risk of the investment, only very few persons will be willing to increase the capital (and therewith the loan capacity) of the SME.

The VCC can therefore play an important role in the expansion of the SME.

The VCC and the target company (SME) will have to determine how the capital is to be injected. It may very well be that there is a conflict of interest between both parties in determining how the injection will be executed.

In general, the (tax) differences between debt financing and equity financing can be established as follows:

In case of debt financing by the VCC, the interest payments are in principle tax-deductible expenses for the SME, which have a negative impact on the results (possibly into a loss position) and on the cash flow of the SME. The VCC will be fully taxable on the interest income.

It may very well be that this situation is not at all desirable. Indeed, the SME will probably be in need of extra means at a time when heavy investments are planned which will already have a negative impact on the results (depreciation of the investment). From a tax point of view such a situation may also prove to be unwise. The interest deduction cannot be properly used because of insufficient profits (creation of losses) whereas the interest income with the VCC is immediately taxed.

To meet both economic and tax demands, two main options are available:

- either the loan agreement is concluded under circumstances where the interest rate is in the beginning rather low (e.g. profit-sharing loan or convertible loan); or
- the VCC decides to participate in the capital of the SME.

In case of equity finance, the following problems arise:

Dividend income: if the VCC is in need of a more or less regular income to finance its own investment, this will have to be done by way of dividend distribution. This may cause some problems.

Dividends are normally not tax-deductible, so that the dividend payment capacity will normally be lower than the interest payment capacity.

In case of dividend distribution both the VCC and the individual shareholder will receive a dividend. The dividend taxation of individuals is treated in the same way as for companies, but because the tax rates for individuals are higher, their position may be very disadvantageous. To avoid this problem, the VCC might opt for preference shares, so that dividends can be distributed to the VCC and not to the individual shareholder.

In principle, dividends received constitute taxable income for the VCC. Withholding tax and corporate income tax borne at the source, however, are fully creditable by the VCC against its total income tax liability.

Exemptions, however, are available.

Capital gains income: this could be interesting since, in this way, the SME retains all its profits. If the value of the SME decreases, the capital loss realized on the sale of the shares is tax-deductible.

A problem is that if the value of the SME increases, the capital gain will, in principle,be taxed, although under certain conditions an exemption of capital gains taxation is possible (see below). Therefore, one could consider a redemption of shares. This means that the SME repurchases its own shares.

The problems which arise for the VCC could in case of equity finance be avoided if the VCC operates as a VCC authorized by Royal Decree 1 of 14 March 1986. Such a VCC enjoys a 100% relief from corporate income tax on dividends received from qualifying securities and on capital gains arising on disposal of these securities.

In the next section (Equity/Debt finance), a summary is given of all important items that could influence the decision-making of the VCC and the SME.

In the last section (Practical taxation guidance), we try to give practical guidance, resulting from the information in the sections Equity/Debt finance.

2. *Equity finance*

2.1. Introduction

Are there registration or other duties?

Contributions in cash or in kind are not themselves subject to tax on the formation of capital but to transfer tax ('impuesto general sobre transmisiones patrimoniales y actos juridicos documentados'). This tax is applied on the nominal capital, regardless of whether fully paid up or not, at a 1% rate.

However, a 99 % relief from transfer tax exists for the constitution of capital of a VCC operating under the Royal Decree of 14 March 1986.

Other costs are:

- lawyers' fees;
- other specialists' fees (e.g. expert tax advice);
- Chamber of Commerce fees, levied annually at a rate equivalent to 1.5% of the corporate tax payable;
- costs for publication in the *Official Gazette of the Mercantile Registry;*
- charges for listing on the Stock Exchange.

Are there conditions to be met in respect of the legal form of the VCC?

A VCC will most likely operate in Spain under the form of a corporation ('sociedad anonima') or a limited liability company ('sociedad de responsabilidad limitada'). In both types of companies, the liability of the shareholders is limited by the amount paid or unpaid on their share capital.

Are there any specific forms available?

Yes.

Royal Decree Law No 1 of 14 March 1986 authorized the formation of venture capital companies ('sociedad de capital riesgo'). This VCC is an SA (corporation) the share capital of which must be at least PTA 200 million.

At least 50% must be paid up at the time the company is formed and the remaining 50% within three years. A minimum of five shareholders is required. The 1988 Budget Law establishes that no shareholder shall have a majority interest and gives a new structure to the assets of these companies. VCCs require prior administrative approval and are required to be specifically registered as such with the Ministry of Economy and Finance as well as the Mercantile Registry (necessary for all SAs). Such VCCs are entitled to certain tax benefits (see below).

Note that a company's life may be indefinite. A company with a limited life may officially extend its life but a transfer tax (1%) on net worth will be payable. Therefore, a company should be given an indefinite life to avoid future transfer tax. However, because of the 99% relief of transfer tax applicable to VCCs, this is not really relevant to the VCC.

Are there limits as to the participation of the VCC in the SME?

No.

2.2. Tax situation of the SME

Creation of the SME (increase of capital)

Are there registration or other duties?

See Section 2.1.

Transfer tax is levied on both the incorporation of companies and their capital increases. The applicable tax rate is equal to 1% on the nominal value of the shares or participations issued plus the amount of any premium.

Increase of capital resulting from the conversion of retained income or reserves is also subject to the 1% transfer tax.

Are there exemptions for certain zones, projects, activities?

Exceptionally, existing companies may be granted tax exemptions on the transformation and any other modification (e.g. an increase of capital) carried out before 30 June 1992, in order to comply with the provisions of Act 19 of 25 July 1989.

Certain tax concessions exist for the Canary Islands, Ceuta and Melilla. These concessions apply principally to indirect taxes (and import duties). However, 'indirect taxes' are not specified; therefore it is uncertain whether exemptions from registration duties are available.

In general, there is a variety of incentives for areas known as promotional zones. It is advisable to obtain information from the relevant authorities (the State, autonomous communities and local authorities) as to which incentives might be available for any projected investment (i.e. tax incentives; exemption from registration duties).

Is the indirect tax treatment different for the following types of shares: ordinary shares; preference shares; redeemable shares; others?

The tax treatment of these shares is not treated differently whatever the registration duties concerned.

Corporate taxation (SME)

Are the costs related to the creation/increase of the capital deductible?

Yes.

Transfer tax and other costs (e.g. registration costs related to the issue of share capital) are considered to be deferred expenses for company income tax (CIT) purposes of the company issuing the shares or the participations and can be fully depreciated within a maximum period of five years.

Are there specific regimes for certain SMEs?

No.

However, the corporate tax law introduced a system of tax credits in respect of investment and job creation. These credits are, as we assume, not limited to the capital of the SME.

There are also rules which regulate the promotional zones (Act 50 of 23 December 1965 and Royal Decree 1153 of 11 December 1987) and which grant (amongst other things) a subvention (not specified) of a percentage of the approved investment.

A system of tax credit exists in respect of investment and job creation, created by the corporate tax law (current situation April 1991).

General investment tax credit: a 5% credit against CIT is available on, amongst other things, investments in:

- new fixed assets, excluding lands;
- research and development of new products or industrial processes, the credit being 15% on intangible expenditure and 30% on new fixed assets.

Employment tax credit: PTA 500 000 for each man-year of increase in the average of personnel.

Tax credit limitations: credit for general investment, 25%. Any unused tax credit may be carried forward for the next five years.

Rates

Normal tax rates: the normal tax rate is 35%, increased by a 1.5% (deductible) surcharge payable to the local Chamber of Commerce and Industry.

Reduced rates: these reductions have taken the form of a reduction of rates of indirect and local taxation.

In accordance with the rules that regulated the 'grandes areas de expansion industrial' (greater industrial development areas), the 'polos de promocion y desarollo' (designated development areas) and the 'zonas de urgente reindustrializacion' (urgent reindustrialization zones), certain industries have a reduction of up to 95% of the local taxes on the establishment or expansion of industrial plants, based on location. It should be noted that in accordance with the law governing municipal taxes, local tax incentives for regional investment expired on 1 January 1990, except for those actually granted for a longer period.

How does a redemption of shares affect the tax position of the SME?

Distributions derived from a redemption of shares should be treated as dividends and taxed as a distribution of profits by the SME.

Dividend taxation

Does a different tax regime apply to dividend distribution to the individual shareholder of the SME, on the one hand, and the VCC on the other?

No, dividends are taxed at a 35% rate.

Does a different tax regime apply according to the different types of shares?

No.

Is the tax base affected by the distribution of dividends (deductible dividend)?

No, dividends paid are not deductible for CIT purposes.

Is the tax rate affected by the distribution of dividends?

No.

Is a withholding tax withheld? Rate? Exemption?

Yes. Dividends, profit participations and, in general, any other type of profit obtained as a result of being a partner, member or shareholder is in principle subject to a 25% withholding tax.

However, for payments to resident companies there is no requirement to withhold any withholding tax on payments that represent income derived from normal business activities of entities resident in Spain which are subject to corporate tax.

2.3. Taxation of the VCC

Corporate taxation

Are the costs related to creation of a VCC deductible?

Yes.

Are management costs and interest deductible?

Management costs are not specifically named as deductible. However, all wages, salaries, bonuses, commissions payable to staff and directors' fees are deductible.

Interest paid is, in principle, tax deductible. Interest on share capital, however, is a non-deductible expense.

How are dividends taxed?

Dividends received are generally included in taxable income, and are taxable at the normal rate.

If withholding tax is withheld (see above) the dividend income of the recipient company is grossed up with the withholding tax and the recipient company may credit this tax against its company income tax; excess withholding tax is refunded.

Dividends received by the VCC from the Spanish SME are subject to the company income tax, but an amount equal to 50% of the effective rate of tax paid by the SME on that part of the profits from which the dividends are paid may be credited against the VCC's own company income tax.

This credit is increased to 100% if:

- the dividends are distributed by a corporate entity (the SME), controlled (in)directly by the recipient corporate entity having more than a 25% interest, provided that such control has been exercised without interruption throughout the tax period;
- the dividends are distributed by a corporate entity (the SME) within a joint venture constituting a separate legal entity.

Moreover, if the VCC owns (in)directly more than 90% of the capital of the SME for a minimum holding period of two years it may apply to the Minister for Finance to be taxed on the basis of a consolidated balance sheet, which would mean complete exemption for intercorporate dividends.

If the VCC operates under the special form of a sociedad de capital riesgo (Royal Decree 1 of 14 March 1986) a 100% relief from corporate income tax on dividends received from qualifying shares is applicable.

What is the capital gains taxation if the shares of the SME are sold?

Spain does not levy a special capital gains tax, capital gains being subject to corporate income tax. Capital gains are treated in the same manner as ordinary corporate income and are normally taxable in the tax period in which they are derived and recorded in the company's books.

However, an important exemption from corporate income tax is granted in respect of those gains arising on the disposal of fixed assets necessary for the purposes of carrying out business activities, provided that the total proceeds are reinvested in assets of a similar type to be used for the same purposes, and further provided that such reinvestment is made within a period not exceeding two years. This period may be extended to four years if in the first year the entity submits an investment plan to the authorities and also invests in the first two years a minimum of 25% of the gains.

VCCs operating under the Royal Decree 1 of 14 March 1986 benefit from a corporate income tax exemption, via tax credit, on capital gains arising on the disposal of securities.

Capital losses:

Spanish tax law makes no distinction between ordinary losses and capital losses. Therefore, capital losses are deductible in computing taxable income for purposes of corporate income tax. All losses may be carried forward to the five immediately successive tax periods. No carry-back of losses is allowed under Spanish tax law.

What is the tax position of the VCC in case of redemption of the shares by the SME?

As we assume the capital gains resulting from this operation are subject to taxation. In case of redemption of qualifying securities by the SME the VCC operating under the Royal Decree 1 of 14 March 1986 will be tax-exempt.

Are there specific regimes?

Yes, *the* 'transparencia fiscal' regime exists in Spain if more than 50% of the capital of the VCC belongs to 10 shareholders or less and the VCC is considered to be an investment entity (whose shares are not quoted on a stock exchange), the VCC is not directly subject to corporate tax. Instead, it is assessed through its stockholders or partners on the basis of those profits. If such stockholders or partners are corporations or companies,

they are subject to corporate tax. If they are individuals, they are subject to individual income tax.

This system (transparencia fiscal) is applied to the following entities:

- investment entities whose shares are not quoted on a stock exchange;
- investment portfolio entities (more than half of the assets being invested in securities);
- entities who merely possess assets, provided that more than half of such assets are not utilized for professional or business activities;
- legal entities established to carry out a professional activity in which the partners are all professionals of the said activity.

It has to be mentioned that the tax credit on dividends received is not available to those recipient corporate entities who are subject to the tax under the 'transparencia fiscal' system. Considering the fact that the VCC can benefit from a 100% relief from tax on dividends received from qualifying securities, it is not desirable to choose for this 'transparencia fiscal' regime.

Rates

Could you please give some additional information what types of VCCs operating under the Royal Decree 1 are concerned?

Is there recoverability of the tax withheld by the SME?

If withholding tax is withheld, this tax is recoverable.

Distribution of dividends by the VCC

Does a different tax regime apply according to the different types of shares?

No.

Is the tax base affected by the distribution of dividends (deductible dividend)?

No.

Is the tax rate affected by the distribution of dividends?

No.

Is a withholding tax withheld?

See above.

Since VCCs are in some cases exempt from CIT on dividends received, and taking into account that a condition for the withholding tax exemption is that the income (dividends) must be derived from normal business activities which are subject to corporate income tax, we would like you to give us some additional information concerning the applicability of the withholding tax exemption in this case.

Concerning the investors in the VCC, who are subject to individual income taxation, a 25% withholding tax is levied. If these investors are residents in Spain, the withholding tax is deductible from the fiscal CIT liability, and refundable to the extent to which it exceeds that liability.

Transfer of shares

Pursuant to Act 24/1988 (Art. 108), the transfer of any shares (quoted/unquoted) (with intervention of a notary or a stockbroker) is exempt from transfer tax, unless the transfer leads to the acquisition of control over a company in which 50% or more of its assets consists of Spanish-situs real estate (such transfer is subject to 6% transfer tax).

2.4. Tax situation of X (individual shareholder)

Is the interest paid on the loan granted in view of the purchase of the shares of the SME deductible?

No.

How are dividends taxed?

Dividends from domestic (and foreign) sources are generally included in taxable income for individual tax purposes. Stock dividends distributed out of a capital premium reserve are not deemed to constitute taxable income.

Domestic dividends and interest are subject to income tax for their gross amount, i.e. before deduction of any tax withheld at the source. Individuals who receive dividends from a corporation resident in Spain which is subject to the normal corporate income tax are entitled to a special credit amounting to 10% of the dividend received, which may be credited against their income tax liability. If this special tax credit exceeds the income tax due, no refund is granted.

Dividends from Spanish sources are also subject to withholding tax at source at a rate of 25%, which is a prelevy on the income tax and which is fully credited against the income tax due. A refund is granted if the withholding taxes exceed the final tax.

2.5. In case the SME is not a company but an unincorporated enterprise

If the VCC participates in such an enterprise, how does this affect the position of the enterprise?

When the VCC participates in such an enterprise the VCC and the SME are subject to tax under the 'transparencia fiscal system'.

Is a transparent company created?

Yes.

If so, what are the tax implications (both for the enterprise and the VCC)?

The partners or shareholders are taxed in their income tax category (transparency principle). In that case, the tax credit for dividends received (see above) is not applicable. Losses incurred by the transparent company entity cannot be used by the partners or shareholders.

3. *Debt finance*

Preliminary question: is there a debt/equity ratio to be respected?

There are no statutory rules with regard to the debt/equity ratio for Spanish companies.

3.1. Tax situation of the SME

Does the distinction between the different types of loans granted to the SME have implications for the tax situation of the SME? (e.g. ordinary loans, convertible loans, profit-sharing loans, other types)?

No.

What is the deduction regime for the different types of loans?

Interest on loans is deductible as financial expenses on an accrual basis, provided that they can be considered necessary for the company's activity.

What is the situation if the VCC also participates in the SME?

Since the taxable event should be classified, under the General Tax Act's provisions, according to its economic substance rather than its form it should be taken into account that this could lead the tax authorities to consider in some particular cases that a hidden capital contribution has been made and, therefore, to disallow all or part of the interest paid.

What is the withholding tax in each case of the different types of loans?

The standard withholding tax of 25% applies. There is no distinction between the different types of loans. This withholding tax is deductible from CIT liability (of the VCC) and refundable to the extent to which its exceeds such liability.

3.2. Tax situation of the company that grants a loan to the SME

What is the situation concerning the different types of loans?

The interest income is fully taxable.

In respect of the taxability of the interest, are there exemptions or reductions for certain zones or activities?

Regional industrial development corporations benefit from a 99% relief from CIT on interest received from companies in which they participate.

How are capital gains on receivables taxed?

As ordinary corporate income.

What if the loan is converted into capital with capital gains or losses?

Gains will be taxable, losses are deductible.

Are capital losses deductible for purposes of CIT?

Yes.

Are interest payments deductible (for the acquisition of the funds)?

Yes, since interest is in general deductible.

Is there a withholding tax on interest paid by the VCC?

Yes.

Are there exemptions available (e.g. in case of payments to the European Commission)?

Yes.

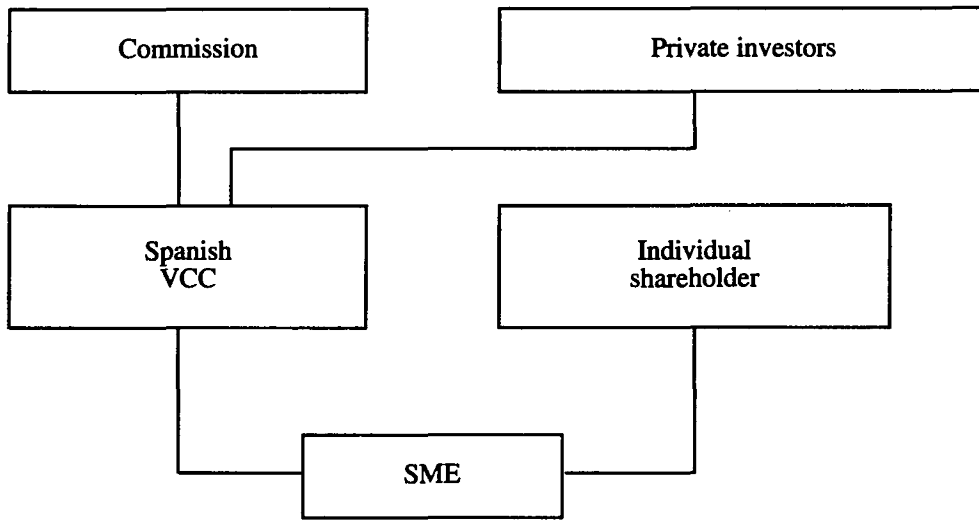
3.3. Tax situation of the Fund

Royal Decree 1 of 14 March 1986 authorized the formation of venture capital funds ('fondos de capital riesgo'). These venture capital funds must have an initial capital of PTA 275 million. A minimum of five participations is required. The 1988 Budget Act establishes that any shareholder or participant shall not have a majority interest. These funds are taxed in the hands of their partners.

Practical taxation guidance

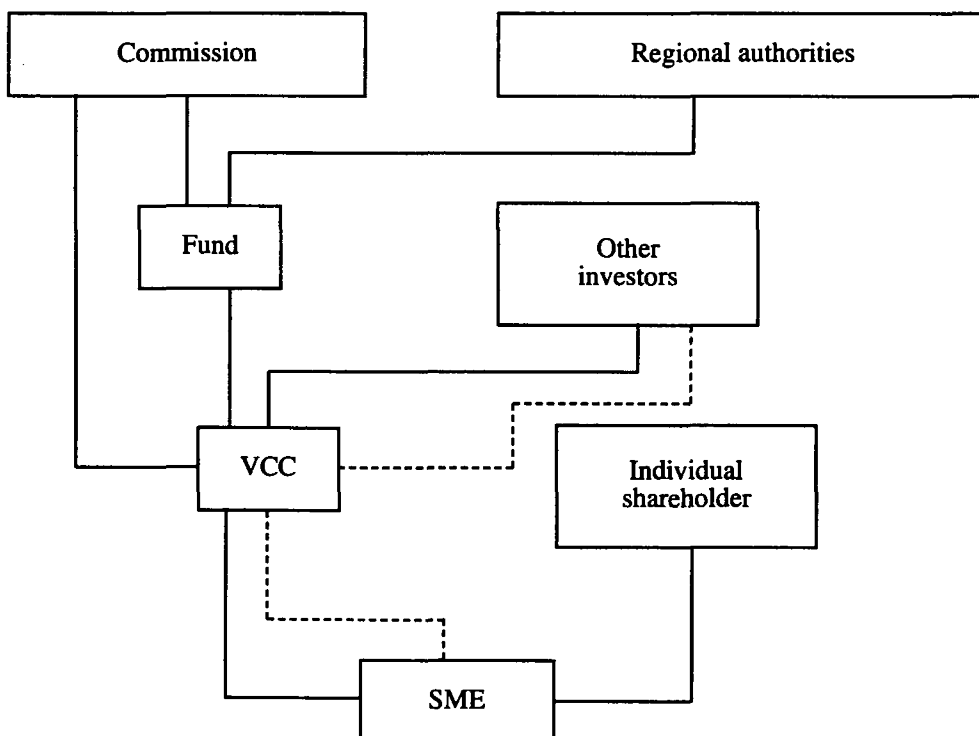
I. Equity finance

1. Scheme



II. Debt finance

1. Scheme



2. *Comments on structure*

2.1. *Position of the SME*

Costs of increasing capital:

Capital duty of 1%; notarial fees, etc.
These costs are tax-deductible.
These costs, being tax-deductible for the SME, have a negative impact on the results.

A 99% relief is available for VCCs operating under the Royal Decree.

Taxable base:

Corporate income tax:

The profits of the SME are positively influenced by the capital increase.
This means that if normally losses would have occurred, because of the capital increase a better result can be shown.
If the capital increase leads to a profit situation, this profit is normally taxed at 35%.

Tax rate:

The profits are taxed at 35%.

Redemption of shares:

2.1. *Position of the SME*

Costs of granting loan:

No costs.

Taxable base:

Corporate income tax:

The interest payments are normally deductible expenses that have a negative impact on the results and on the cash flow.

This situation may prove unwise because a loss position may be created (no immediate use of interest deduction) and other advantages related to profit are lost (e.g. reconversion status, etc.).
This disadvantage may partially disappear if it is a profit-sharing loan.

In case the VCC participates in the SME to which the VCC also grants a loan, the interest payments are not deductible when interest rates are excessively high. Such interest constitutes a hidden profit distribution.

Tax rate:

The deductible interest income payments save a taxation of corporate tax and net worth tax.

Reimbursement of the loan:

A redemption of shares is treated as a dividend distribution of the SME to the extent that hidden gains are expressed.	Has normally no impact on the taxable result.
Dividend distribution:	Interest payment:
The dividends are part of the taxable base.	The deductible interest paid to the VCC is normally exempt from withholding tax.
On the dividends distributed to the individual shareholder, a withholding tax of 25% applies; on the dividends distributed to the VCC, the same withholding tax applies. Exemption is available for distribution to the VCC (see above).	The deductible interest paid to the VCC is normally exempt from withholding tax.
2.2. *Position of the VCC*	2.2. *Position of the VCC*
Taxable base:	Taxable base:
(a) Dividend income	(a) Interest income
The dividend income is grossed up with the withholding tax. This tax is fully creditable (and refundable) by the VCC against its total income tax liability. A credit of 50 or 100% (see above) is available for the VCC on dividends received. VCCs operating under Royal Decree 1 of 14 March 1986 are exempt from taxation on dividends received from qualifying securities. If the VCC owns more than 90% of the capital of the SME a complete exemption is available.	This income is fully taxable at 35%.
(b) Capital gains taxation	(b) Capital gains taxation
In principle taxed. VCCs operating under Royal Decree 1 of 14 March 1986 benefit from an income tax exemption on gains realized on the disposal of securities.	The capital gain realized at the moment of converting the loan into capital is in principle fully taxable. Deferral is not available.

(c) Capital loss on shares	(c) Capital loss on loans
	In principle deductible.
Dividend distribution:	Interest payment to fund:
The normal rules apply. Is an exemption from withholding tax available on dividend distribution to the Commission?	Tax-deductible.
Transfer of shares.:	Transfer of loans:
No special tax applies.	No special tax applies.
2.3. *Position of the individual shareholder*	2.3. *Position of the individual shareholer*
Dividend income:	Dividend income:
Dividends received grossed up with withholding tax are included in his taxable income. Any excess is refundable. A 10% credit is also available, but is not refundable.	See left side.
Purchase of the shares:	There is no transfer of shares to the extent a loan is granted. The interest burden remains thus with the SME.
The financing of this operation may be difficult since the individual shareholder can normally not deduct the interest burden.	
2.4. *Position of the fund*	2.4. *Position of the fund*
No dividend income (see scheme).	The interest income is taxable in the hands of its partners.
3. *Unincorporated SMEs*	3. *Unincoporated SMEs*
If the VCC participates in the SME (sharing of profits and losses), an equivalent part of the profits/losses is as such attributed to the VCC which is normally taxed on this income ('transparencia fiscal' system).	If the VCC grants a loan, the interest is deductible with the SME and fully taxable with the VCC.

Conclusion

Equity finance	*Debt finance*
1. *Major disadvantages*	1. *Major disadvantages*
Costs related to increase of capital (capital duty abolished as from 1 January 1992);	The deductible interest payments may lead to a loss position of the SME, whereas the interest income with the VCC is immediately taxable;
The capital increase will normally lead to a higher taxable base and thus a higher tax burden with the SME;	Some interest payments are treated as hidden profit distribution;
Capital gains on shares are in principle taxable;	Capital gains on loans are taxable.
The tax situation of the individual shareholder may be very disadvantageous as to the purchase of shares.	
2. *Major advantages*	2. *Major advantages*
Double taxation is reduced or avoided by the credit system applicable to dividends received; exemption is also available;	No costs are related to the granting of the loan (with the exception of profit-sharing loans);
Capital losses are deductible;	The taxable base of the SME will normally be reduced;
Capital gains on disposal of qualifying securities can be tax exempt for VCCs operating under the Royal Decree;	The risk of double taxation (with SME/VCC) doe normally not exist; The capital losses are deductible for corporate income tax purposes;
Tax exemption on capital gains is also available in case of reinvestment.	The private shareholder is not confronted with a purchase of shares.

Spain	Equity			Debt		
	VCC under RD No 1 14.3.1986[1]	VCC with qualifying participation[2]	VCC without qualifying participation		Ordinary VCC	Regional industrial development corporation[4]
SME profit before tax	100	100	100	Interest payment deductible with SME	Yes[5] (–100)	Yes[5] (–100)
Corporation tax 35%	–35	–35	–35	Withholding tax 25%[6]	–25	–25
Gross dividend	65	65	65	Interest income before tax at recipient's level	75	75
Withholding tax 25%	0	–16.25	–16.25	CIT 35%	–26.25	0
				Tax borne at source	25	25
				Tax still due or restitution	1.25	25
Net dividend before tax at recipient's level	65	48.75	48.75	Interest income after tax	73.75	100
Taxable base	0	100	82.5			
CIT 35%	0	–35	–28.87			
Tax borne at source[3]	0	51.25	33.75			
Restitution	0	16.25	4.88			
Net dividend after tax	66	65	53.63			

[1] VCCs operating under the form provided by Royal Decree No 1 of 14 March 1986 enjoy a 100% relief from CIT on dividends received form qualifying shares. Also no withholding tax is due on these dividends.

[2] Normally, an amount equal to 50% of the effective rate of tax paid by the SME on that part of the profits out of which the dividends are paid may be credited against the VCC's own CIT. This credit is increased to 100% if VCC has less than 25% participation during at least one year (SME is controlled (in)directly by VCC) or in case the dividends are distributed within a joint venture constituting a separate legal entity.
Moreover, for VCCs owning (in)directly less than 90% of the SME's capital for a minimum of two years: taxation on consolidated balance sheet is possible; this will entitle to complete exemption for intercorporate dividends.

[3] (Only) excess withholding tax is refunded.

[4] Regional industrial development corporations benefit from a 99% relief from CIT on interest received from companies in which they participate.

[5] Deductible, provided they can be considered necessary for the company's activity.

[6] Creditable against CIT liability and refundable to the extent it exceeds such liability.

III. Other issues

1. *Local and regional authority issues*

The autonomous communities promote venture capital companies in their regions in which they are the majority shareholder. These are known as 'Scricas'('sociedad de capital riesgo de las Comunidades Autónomas').

By contrast to the 'SODIs', the private sector industrial development companies owned by the National Industry Institute, the Scricas are not uniform. Their organization and workings differ considerably according to the approach taken by each autonomous community.

Nine autonomous communities have, to date, used Scricas as an instrument of venture capital. These are: Andalusia, the Princedom of Asturias, the Balearic Islands, Cantabria, Castile-La Mancha, Catalonia, Extremadura, Navarre and the Basque Country. At the end of 1990, only six of them remained as majority shareholders.

In certain other cases the Scricas have been liquidated due to the existence of a private sector SODI active in the same field as the Scricas. Some privatizations of Scricas have also been carried out. This has been achieved by increases in the number of private shareholders. Alternatively, some privatizations have been conducted by constituting a venture capital management company and placing its funds with private investors. The latter technique has been used in the Basque country in order to achieve greater private investment by means of the subscription of participations in VCCs.

During 1990 the company Fomento Empresarial SA was liquidated. This was dependent on the Development Institute of Andalusia (IFA).

The total resources of public institutions in VCCs and VCFs increased by 21.6% in 1990 to a total of PTA 8 524 million. Despite this increase, the relative share of public capital in the Spanish venture capital sector fell by 8%.

The autonomous communities contribute most of the resources to the Scricas. They contribute 65.5%, the Savings Banks contribute 16.2% and non-financial private companies 8.8%.

Despite a moderate increase in available resources to PTA 1 596 million in 1990, over half the available capital was invested in new rounds of financing for companies already in the portfolio. The remainder of the capital allowed investments to be made for the first time in 18 companies.

2. *Impact assessment*

In Spain the first private venture capital company, Sefinnova, was created in 1978. The second, the Bancaya de Promoción Empresarial, was created in 1983.

The total resources of the venture capital sector had risen to PTA 51 273 million by the end of 1988 (not including the shares exchanged between venture capital organizations). This represented a large increase over the previous year of some 31.3%. During the period 1985 to 1988 the average cumulative increase was 28%.

Out of the total of PTA 51 273 million, 93% consists of the own resources of VCCs and the rest is borrowed money (the borrowings have been made almost exclusively by five public sector venture capital companies).

VCFs (i.e. funds) accounted for only 1% of the venture capital resources available in 1986. In 1988 this figure had risen to 24% demonstrating the loss in importance of the VCCs. By the end of 1990, there were 18 VCFs. Their funds were being managed by 13 separate management companies and they accounted for 61% of the sector's resources.

The public sector VCCs suffered a decline in importance in 1988. They went from having 69% of the sector's total resources in 1987 to 59.1% in 1988. This has been due, in part, to the initiatives taken by the private sector.

Financial activity in the venture capital sector actually fell in 1988 to PTA 7 082 million as compared to PTA 7 714 million in 1987. There are two reasons for this:

- Some of the new VCCs and VCFs have not been working at full capacity either due to a lack of interesting projects or to delays in their being set up;
- the question of whether or not to transfer the SODIs to the autonomous communities arose during this period. This idea was abandoned. Nevertheless, their activity during the period had been geared towards reorganization rather than new investment.

SMEs invested in by the VCCs provided work for over 27 000 people. From the mid-1970s to 1988, a total of 988 companies received advice and financial support from VCCs. In 1988, investments were made in 128 companies.

According to the most recent research carried out, venture capital is consolidating in Spain. The own resources of all the venture capital organizations rose to PTA 110 132 million at the end of 1990. This represents a 43% growth with respect to the previous year's figure. Own resources are expected to grow a further 20% in 1991.

There are three reasons for this tremendous growth:

- private investment has increased;
- in the private sector there has been a great deal of interest from foreign investors (they now account for 34% of the available own resources);
- on a national level, financial institutions supplied 20.9% of the funds and non-financial private companies 12.8%.

IV. Comparative legal and regulatory issues

1. *Absent positive features*

The following positive features in other Member States are not found in Spain:

- Belgium

Debt finance can be provided by VCCs in the form of an ordinary subordinated loan. Regional venture capital is regulated clearly by law.

- Denmark

More flexible and diverse schemes exist for the creation of vehicles to provide venture capital.

The severe regulatory control, including an obligation for external audits to be carried out, make the safest vehicles for venture capital investors concerned about security.

Jointly owned shipping firms have a similar structure to that of a partnership with personal liability of the partners. The only important difference is that the part owner of a shipping firm only responds in proportion to his share of the liabilities of the jointly owned shipping firm.

Convertible bonds: the general assemblies of public and private limited companies can decide to obtain loans against bonds giving the lender a right to convert his claim into shares of the company.

- France

Sociétés financières d'innovation: tax advantages. Their object must be to facilitate the industrial implementation of technological research as well as the development of yet unexploited inventions.

- Germany

Capital holding company and venture capital company. There are no special rules regarding the formation of these companies. They may enter into participating loans.

The participating holding companies have tried to counter this type of thinking by way of intensive dissemination of information and through the use of a standard contractual form.

- Greece

Greek legislation limits the scope of provision of venture capital to financing investments of high technology and innovation.

- Ireland

There are a large number of vehicles used for the operation of venture capital in Ireland.

The usual methods of State agencies becoming involved in assisting enterprises is through grants, training and subsidies. However, various agencies have the power to engage in venture capital investment and a recent amendment to national law enables local authorities to become active.

- Luxembourg

Especially in the audiovisual sector, these laws caused huge amounts to be invested in Luxembourg.

- The Netherlands

Any legal private entity can operate as a venture capitalist. Provision of venture capital funds to SMEs with a good performance record, co-financing of innovative projects.

The ROMs fill in the gaps left over by the PMs and PPMs.

- Portugal

When the funds are in convertible form they can be translated into equity capital and thus, perhaps, improve the solvency ratio.

If these features were introduced in Spain, they would be likely to promote the use of venture capital.

We should bear in mind that in Spain we can find a similar situation to that described for Italy: 'small enterprises still are mainly conforming to closed property models'. We cannot foresee how a solution, like the one in Germany, could work in Spain in order to encourage a greater distinction between personal and company property.

Important problems also arise from the fact that, like in Italy, venture capital companies do not work in Spain as venture capital entities. 'In practice, such holding companies, by means of having acquired participations, aimed to rescue enterprises in a critical position more than to invest in enterprises showing good development potential from the income and managerial point of view.'

These features could be introduced in Spain in the following ways:

Venture capital companies could be allowed to provide finance in the form of participating loans (as in Germany) or by convertible debt (see the comment on Portugal above).

The German venture capital companies are similar to Spanish venture capital companies as the stress is placed on risk and the policy of participation is aimed mostly at financially weak and young SMEs. They seek to support these enterprises in the realization and marketing of innovative and above average products or product ideas.

Investment companies are not venture capital companies but collective investment companies and therefore a *tertius genus* regulated separately in Spain.

A regulation providing a more flexible way of creating venture capital entities (allowing all legal entities to participate) within a wider legal framework and less regulatory constraints would result in better opportunities for Spanish SMEs, e.g. granting tax benefits to venture capital operations (in Ireland 'the Irish venture capital market is relatively sophisticated with an availability of a wide range of vehicles and methods') instead of granting benefits only to operations conducted by companies incorporated as venture capital companies. A more rigorous external control such as the one in Germany could make up for the lack of preliminary control over the incorporation and structure of the company.

A diversity of legal schemes like those in the Netherlands may create different solutions to different problems and therefore fill in the gaps and reach more SMEs.

A further limitation in the part of the economy where venture capital may participate in SMEs, e.g. along the lines of the Greek model or the Luxembourg one, may also produce an improvement in market conditions and in control over the results obtained.

2. *Absent techniques*

None identified.

United Kingdom

Introduction

The United Kingdom venture capital industry is the largest in Europe and second only to the United States in importance. It can fairly be described as a finance industry which serves SMEs with considerable effect.

As far as tax matters are concerned, no major obstacles appear. However, it should be taken into account that capital gains are in principle taxable at full (or reduced) corporate income tax rates, and that, in case the SME is being financed by a debt, certain interest payments are treated as profit distribution.

Favourable on the other hand is that dividends received are never included in a company's taxable income and are thus tax-exempt, that reduced tax rates apply to companies with taxable profits not exceeding a certain amount and that some companies (e.g. building societies) can claim a preferential tax regime, which might be of particular interest to SMEs.

I. Legal and regulatory issues

1. *Typical investment vehicle used*

The most common form of vehicle used is that of the limited company specializing in the provision of venture capital. In addition the provision of venture capital is assisted by the use of investment and unit trusts, unusually limited partnerships, and by the Business Expansion Scheme and other government-created funds.

2. *Applicable legal measures*

- Companies Acts 1985 and 1989;
- Financial Services Act 1986;
- Income and Corporation Taxes Act 1988;
- Finance Act 1983, which introduced the Business Expansion Scheme and amended by later finance acts;
- Finance Act 1989;
- Capital Gains Taxes Act 1979;
- Welsh Development Agency Acts 1975/88 and Statutory Instrument 2028 of 1975;
- Statutory Instrument 1082 of 1982 which created the Industrial Development Board for Northern Ireland;
- Scottish Enterprise and New Towns (Scotland) Act 1990;
- Local Government and Housing Act 1989.

3. *The investment vehicle*

As indicated the principal vehicle by which venture capital is provided to SMEs in the UK is through dedicated venture capital companies. In addition to the requirements of the Companies Acts which affect all limited companies there are requirements imposed by the Financial Services Act 1986 (FSA 1986) which call for the authorization of persons carrying on investment business (see Section 7 of the FSA 1986).

Membership of self-regulatory organizations (SROs) such as the Investment Management Regulatory Organization (IMRO) is necessary. Other self-regulatory organizations including the Life Assurance and Unit Trusts Regulatory Organization (Lautro) and the Securities and Futures Association (SFA) may be relevant to organizations involved in the provision of venture capital, e.g. unit trusts (see also the Authorized Unit Trust Schemes (Investment and Borrowing Powers) Regulations 1988 S.I. 1988/284 and the Amendment Regulations SI 1989/1437 which restrict the percentage holding in unquoted companies, i.e. the likely SME recipient).

There are joining and annual fees payable to the relevant SRO. These fees vary according to the size of the company. These fees are not insignificant. It is difficult to tell whether such fees deter new entrants into the venture capital field. Since, however, the provision of venture capital is presently restricted by the number of suitable SMEs as opposed to the availability of venture capital such fees cannot be seen as a real restriction.

When a company employs more than 10 members of staff a compliance officer must be appointed. Generally the SROs assist venture capital companies by providing authorization in broad terms for their activities. Applicants must, however, provide a business plan and detailed capital adequacy information. It is considered that there is no need for any new or greater restriction or regulation on the activities of venture capital companies.

SFA financial regulations require, *inter alia*, that venture capital firms must have a minimum capital exceeding UKL 10 000.

The Business Expansion Scheme (BES) operates by way of income tax and capital gains tax relief. An individual may invest up to UKL 40 000 in any one tax year

in one or more BES companies and can deduct the full amount of his investment from his taxable income.

Regional development boards or local enterprise boards often exist as companies limited by guarantee or companies in ordinary form with the interested local authority holding a controlling interest.

4. *The recipient of venture capital*

Equity finance

There are two tiers of public markets for equities, namely the listed securities market and the unlisted securities market. The provision of venture capital to SMEs will rarely involve the listed market since it would be unusual to find an SME on the listed market. The provisions of the listed securities market can, therefore, be ignored for the purposes of this study.

The unlisted securities market (USM) has less rigorous requirements in respect of market value (no minimum market value requirement), only a two-year trading requirement, and only 10% of the equity capital needs be in public hands when trading begins.

In any event the provision of venture capital is seen as an established means of financing the 'unquoted' corporate sector, particularly high-growth small and medium-sized companies. Accordingly the provision of venture capital to SMEs is likely to involve the acquisition of shares outside the USM.

Different classes of shares can exist in UK SMEs. The venture capital investor may prefer to invest the greater part of his or her capital in preference shares which will provide for a first call on the assets of the SME as well as providing an income (in addition to capital growth). The regulation of the transfer and registration of shares in SMEs is not seen as an obstacle to the provision of venture capital.

Debt finance

Venture capital companies will normally look for security when providing a loan. Charges over real estate require registration to protect the lender's interest at the appropriate local land registry. A system of land registration covers the majority of the United Kingdom. Where this is not in force a lender may take the title deeds as security. Registration charges are minor and present no obstacle.

The Companies Acts 1985 and 1989 provide for a system of fixed and floating charges over the assets of a company/SME and for registration of such charges to protect the lenders interests. The registration process is not seen as an obstacle.

5. *The provision of venture capital*

The British Venture Capital Association (the main representative body for the UK venture capital industry) has 121 full members active in making long-term equity investments. There are, in addition, associate members which provide advice or provide investment as a minor part of their activities. The BCVA directory accordingly identifies the majority of significant venture capital investors in the UK.

Equity finance

Equity finance may involve direct investment in differing forms of equities in an SME and in assisting management buy-outs or management buy-ins. Often venture capital companies will expect to participate in the running and development of an SME through a place on the board of directors. An SME may regard this in practice as an obstacle to the use of venture capital. An SME will be required to present a business plan which identifies its current state of health and intended business development in an attempt to persuade the venture capital company to invest. As indicated both management buy-outs and buy-ins are recognized methods of

using venture capital to assist in the continued development of an SME.

Debt finance

The provision of venture capital by way of loan is available in the UK, although most venture capital companies' investments take the form of equity finance. If ultimately the SME prospers to the extent of seeking a flotation on the stock market, information will be required as to the nature and extent of debt securities and equities in order to meet listing requirements.

II. Issues of taxation

1. *Introduction*

The SME is often confronted with the difficulty of attracting finance from third parties.

On the one hand, to obtain a loan from a bank, the SME usually has too little equity, so that financial institutions are reluctant to grant any loan without security.

On the other hand, because of the high risk of the investment, only very few persons will be willing to increase the capital (and therewith the loan capacity) of the SME.

The venture capital company (VCC) can therefore play an important role in the expansion of the SME.

The VCC and the target company (SME) will have to determine how the capital is to be injected. It may very well be that there is a conflict of interest between both parties in determining how funds will be injected.

In general, the (tax) differences between debt financing and equity financing can be established as follows:

In the case of debt financing by the VCC, the interest payments by the SME are, in principle, tax-deductible expenses, which have a negative impact on the results (possibly into a loss position) and on the cash flow of the SME. The VCC will be fully taxable on the interest income.

It may very well be that this situation is undesirable. Indeed, the SME will probably be in need of extra means at a moment when heavy investments are planned, which will already have a negative impact on the results (depreciation of the investment).

From a tax point of view such a situation may also prove to be unwise. The interest deduction cannot be properly used because of insufficient profits (creation of losses), whereas the interest income with the VCC is immediately taxed. This results in a high tax cost of financing the operations.

To meet both economic and tax demands, two main options are available:

- either the loan agreement is concluded under circumstances where the interest rate is in the beginning rather low (e.g. profit-sharing loan or convertible loan); or
- the VCC decides to participate in the capital of the SME.

In the case of equity finance, the following problems arise:

Dividend income: if the VCC is in need of a more or less regular income to finance its own investment, this will have to be done by way of dividend distribution. This may present problems.

Dividends are not tax-deductible on behalf of the SME, so that the dividend capacity will normally be lower than the interest capacity.

In the case of a dividend distribution, both the VCC and the individual shareholder will receive a dividend. Dividends are taxed in the hands of the individual shareholder as ordinary taxable income. However, the ACT which is payable by the company on the dividend can be credited against the individual's liability to income tax.

Dividends received by the VCC are considered 'franked investment income' (FII). In general, these dividends are not taxed and will be set off against franked payments (dividends of the VCC plus tax credits).

Franked investment income

The dividend distribution plus the tax credit in the hands of the recipient company is FII (excluding group income, where the group or consortium has elected to pay dividends within the group without ACT being

paid). Where the recipient company makes a qualifying distribution to its own shareholders, ACT is paid only on the excess of its franked payments over franked investment income received in the same period.

Where franked investment income exceeds franked payments, the excess is carried forward to future accounting periods and set off against franked payments made in those periods. The excess may also be used to obtain a tax repayment, where the VCC has tax losses.

Capital gains

However,

- capital gains are taxed at normal corporate tax rates; and
- if the value of the SME decreases, capital losses realized on the sale of the shares are in principle tax-deductible. Generally they can only be deducted from capital gains; but in certain circumstances (where the VCC is taxed as an investment company and the SME is an unquoted trading company) relief may be given against income.

In the next section (Equity/Debt finance), a summary will be given of the important items that could influence the decision making of the VCC and the SME.

In the last section practical taxation guidance is given, resulting from the information in the sections Equity/ Debt finance.

2. *Equity finance*

2.1. Introduction

Registration duties or similar taxes

Are there any registration or other duties?

The fee payable on registration by a limited company incorporated in the UK is a fixed company registration charge of UKL 50. There are no other capital duties (e.g. a registration duty) on the contribution to the capital of the company.

The creation of a company involves legal and printing costs of the statutory books and providing the company's seal. The minimum cost is likely to be in the order of UKL 200.

There are no Chamber of Commerce fees in the UK.

There are no stamp duties on the creation of a company. However, stamp duty at the rate of 1/2% is, for the time being, usually payable on a transfer of shares.

There are initial and annual fees for Stock Exchange listing, on a scale which depends on the capitalization of the company.

Legal forms of the VCC

Are there conditions to be met in respect of the legal forms of the VCC? Are there any specific forms available?

There are no restrictions as to the legal forms in which a VCC can be carried on.

A VCC can be established either as a public limited company or as a private limited company.

Limits of participation in the SME

Are there limits as to the degree of participation of the VCC in the SME?

There are no limits for the degree of participation of the VCC in an SME.

2.2. Tax situation of the SME

Creation of the SME

Are there registration or other duties? Are there exemptions for certain zones, projects, activities?

- The creation of a company

The creation of a company involves the same costs and duties as those applicable for a VCC.

- The increase of the capital

There are no registration duties upon the increase in issued share capital through the contribution of new capital or on the capitalization of reserves. No other duties or taxes are levied on the increase of share capital.

Is the indirect tax treatment different for the following types of shares: ordinary shares, preference shares, redeemable shares?

No distinction is made for the purpose of indirect taxation between these different types of shares.

Corporate taxation

Are the costs related to the creation or increase of the capital deductible?

For the determination of the taxable base of the corporation, company formation expenses and other expenses of raising share or capital are considered non-deductible from business income, whereas incidental costs of raising loan finance are generally deductible from profits.

Are there specific regimes for certain SMEs (certain zones, activities, projects)?

Although there are specific regimes in certain zones, there are no specific tax regimes or incentives which encourage the creation of capital in a SME.

Rates

The rate of corporation tax is fixed for each financial year ending 31 March. The rate of corporation tax for the year ending March 1991 was 34%, the corporation tax rate for 1992 is 33%.

Resident companies whose taxable profits do not exceed UKL 250 000 are taxed at a preferential low rate of 25% on their profits.

If the company has one or more active companies (including non-resident companies) at any time during the accounting period, the reduced rate of tax applies only if its profits do not exceed the amount produced by dividing UKL 250 000 by the number of active members of the group.

Where the profits fall between UKL 250 000 and UKL 1.25 million, there is tapering relief of 1/40.

Are there special regimes for certain SMEs (certain zones, activities, projects)?

There are preferential tax regimes for insurance companies, building societies, and certain other entities.

How does a redemption of shares affect the tax position of the SME?

A redemption of shares is generally considered a distribution of the profits of the company. However, several exemptions are provided. Most importantly, unless there has been a 'bonus' issue of shares or securities (i.e. not for new consideration) the return of the original consideration given is not regarded as a distribution.

Dividend distribution

Does a different tax regime apply to dividend distribution to X (individual shareholder of the SME) on the one hand and to the VCC on the other hand?

In principle there are no differences in the tax regime applicable to dividend distribution to a shareholder (individual) or to a VCC. In both cases the dividends are not deductible.

Does a different tax regime apply according to the different types of shares: ordinary, preference, redeemable or other shares?

No, there is no different regime.

Is the tax base affected by the distribution of dividends?

Dividends and other qualifying distributions are not deductible in computing profits for corporation tax.

Is the tax rate affected by the distribution of dividends?

The tax rates are not affected by the distribution of dividends.

Is a withholding tax withheld? Rate? Exemptions?

There are no withholding taxes on dividends paid (except under certain double tax treaties) but a UK resident company paying a dividend or making any other qualifying distribution of profits has to make a payment of 'advanced corporation tax' (ACT) for the period in which the distribution is made.

The rate of ACT is determined each year by the fraction:

$$\frac{\text{Basic rate of income tax}}{\text{100-Basic rate of income tax}}$$

The ACT for 1992 amounts to 25% of the dividend and tax credit amounts to 1/3 of the net dividend.

Dividend plus tax credit	100
Cash to shareholder	75
ACT to revenue	25

ACT paid by a company is set against corporation tax liability on profits of the accounting period in which the distribution is made. The amount of ACT which can be deducted from the corporation tax liability for any period is, however, restricted to 25% of the taxable profits, but with the ability for further relief by carry-back for up to six previous years, or carry-forward indefinitely.

Also, a UK resident company may transfer any ACT relating to distributions comprising dividends made in an accounting period to a UK subsidiary so held during the whole of the accounting period for which the ACT was paid.

- The distribution of a dividend to an individual shareholder

(a) Principle

UK resident shareholders are entitled to a tax credit on dividends and other distributions received from UK resident companies equal to the ACT paid thereon by the company. The shareholder is liable to income tax on the aggregate amount of the distribution and the related tax credit, but the credit can be set off against the shareholder's tax liability or refunded if appropriate.

(b) Exceptions

There are no exceptions provided for individual shareholders on the regime of the ACT.

- The distribution of a dividend to the VCC

(a) In the case of a qualifying distribution, ACT will be paid by the SME. Distributions received by a UK company plus the related tax credit are considered 'franked investment income' (FII). They are exempt from corporation tax in the hands of the recipient company, and are set off against the company's 'franked payments' (distributions made plus the related ACT) in calculating tax payable or repayable, i.e., ACT is payable only in respect of the excess of franked payments over franked investment income.

(b) Exception

On intragroup dividends, the payment of ACT is optional if a valid election is in force between the payer and recipient.

A 'group' normally means two or more UK resident companies where the parent company beneficially owns (whether directly or indirectly) at least 75% of the nominal issued share capital of the subsidiary company or companies. For some tax purposes a 'group' is defined as existing where the parent owns over 50% of the equity (a '51% group'). For the purposes of dividend payments a 51% group is generally sufficient.

2.3. Taxation of the VCC

Corporation tax

Are the costs related to the creation of the VCC deductible?

Company formation expenses and other expenses of raising share capital are considered capital non-deductible expenses.

Are management costs and interest deductible?

Director's fees are tax-deductible. Annual payments including loan interest and patent royalties can be deducted as 'charges on income'.

'Short interest' (broadly interest on loans of less than one year) is deductible by trading companies in computing trading income if paid for trading purposes. All interest paid to a recognized UK bank by trading or investment companies is deductible as a charge on income. Whether venture capital companies are to be taxed as trading or investment companies will depend on the facts in each case, and has been subject of recent litigation.

How are dividends taxed?

In computing the taxable profits of the company, dividends and other distributions received from UK resident companies are excluded; these are regarded as FII for corporation tax purposes and are not subject to further taxation in the hands of a corporate recipient.

What is the tax position of the VCC in case of redemption of the shares by the SME?

In the case of a VCC which is treated as holding shares as trading stock, any profit or loss on redemption will be taken into account for trading profit. In other cases, a capital gain or loss may arise, which will be subject to tax unless the VCC has a specific exemption (for example, investment trust status).

Are there specific regimes?

VCCs are subject to normal and reduced corporate tax rates as explained above. If certain conditions are fulfilled (the company has tax losses), surplus FII can be repaid. This is not specific to VCCs but may be particularly useful to them in practice.

Example:

Franked investment income	15 000
Franked payments	(12 500)
Surplus franked investment income	2 500
Trading loss (current period)	(45 000)
Rents	5 000
Loss available for relief	(37 500)

Tax credit repaid UKL 2 500 x 25% = UKL 625

However, the credit will be deducted from the amount of future ACT payments credited against future ACT liability, and the loss reinstated.

A VCC which qualifies as an 'investment trust' is not subject to tax on its capital gains. The main (restrictive) conditions are that it must be quoted on the Stock Exchange, must derive its income from shares or securities, have no holding worth more than 15% of its total investments, cannot distribute surplus on realizing investments, but must distribute at least 85% of income each period.

Distribution of dividends by the VCC

The distribution of dividends by the VCC to its shareholders will be subject to the same rules as outlined for the distribution of a dividend from the SME to its shareholders (company or individual).

As a consequence no distinction is made between the different types of shares. The tax base is not affected by the distribution of dividends. The ACT will be withheld on the positive difference between the franked payments and the franked investment income.

There are no specific regimes available for the VCC.

Transfer of the shares

How are the capital gains taxed if the shares of the SME are sold? What about capital losses?

Except in the case of investment trusts, no special tax regime is provided on the transfer of the shares of the SME. The gains realized at the moment of the disposal of the shares (sale proceeds less cost and incidental expenses) are capital gains subject to corporation tax at the same rate as income profits, i.e. 33% or 25%, but after relief for inflation.

A deferment of corporation tax on capital gains is provided when shares or securities are transferred in the course of a bona fide company capital reorganization, reduction, reconstruction, merger or takeover. The effect of the deferment is in general that the original base cost of the asset is maintained and furthermore increased or reduced by the amount of incidental costs on the disposal, and the adjusted cost is carried forward against a subsequent disposal of the asset or its replacement, as the case may be.

Situation of X/individual shareholder

How are the dividends taxed?

Dividends received (net income plus the ACT paid) by an individual are taxed as ordinary income and the ACT is credited on the final tax balance.

Is the interest paid on the loans granted in view of the purchase of the shares of the SME deductible?

Interest paid on the loans granted in view of the purchase of the shares of the SME or VCC is generally not considered a deductible item, except if these shares are in a close company (controlled by its directors or five or fewer participators) and represent a material interest.

How are capital gains taxed?

Capital gains are added to taxable income and taxed at ordinary rates, after relief for inflation.

In the case where the SME is not a company but an unincorporated enterprise

If the VCC participates in such an enterprise, how does this affect the position of the enterprise? Can a transparent company (partnership) be created? If so, what are the tax implications (both for the enterprise and the VCC)? Or is a new tax subject created? What are the tax implications then?

The VCC can participate in an unincorporated association or a partnership in a transparent company.

For the tax implications for both enterprises a distinction should be made between the unincorporated association which is not qualified as a partnership, and a partnership.

The first category of association is subject to corporation tax.

Under a partnership a corporate member is subject to corporation tax on its share of the partnership profits, with the partnership itself being treated as transparent for tax purposes.

The Business Expansion Scheme

One special scheme exists to encourage the injection of equity finance, which is available to individual UK shareholders but not to VCCs. It is called the Business Expansion Scheme (formerly the Business Start-Up Scheme). The rules are complicated, but basically relief is given from income tax where an individual subscribes for new ordinary shares in a qualifying company, carrying no preferential rights over other shares. This means that if the individual's top tax rate is 40% and he subscribes for UKL 1 000 of BES shares, the true cost to him is only UKL 600. The individual must not be an employee, partner or director of the company, must not have or be able to acquire more than a 30% interest, and must not dispose of the shares within five years.

The main conditions for the company are that it must be unquoted and UK resident, and its trade should not be 'risky' (there is a list of trades which are excluded).

3. *Debt finance*

Preliminary question: is there a debt/equity ratio to be respected?

In the UK there is no debt/equity ratio to be respected, as a matter of domestic law.

What if the ratio is not respected?

If, however, the debt/equity ratio is abnormally high and interest is payable abroad, clearance may be refused to pay free of 25% withholding tax (or at a reduced rate) under the relevant double tax treaty, or the interest may be recharacterized as a distribution.

3.1. Tax situation of the SME

Does the distinction between the following types of loans have implications for the tax situation of the SME:

- *normal commercial loans;*
- *convertible loans;*
- *profit-sharing loans?*

A distinction should be made between: normal commercial loans, convertible loans, and profit-sharing loans. Interest payments on securities convertible directly or indirectly into shares of the company and on securities having variable interest according to the results of the business of the company are in certain circumstances regarded as a dividend distribution (payment to shareholders).

What is the deduction regime for the different types of loans? Are there specific regimes available? What is the situation if the VCC also participates in the SME?

Interest on ordinary loans is deductible. Interest on a convertible loan, the terms of which are not similar to those of a comparable quoted security, or on a profit-sharing loan, is treated as a distribution except to the extent that it is paid to another company which is subject to UK corporation tax.

What is the withholding tax in each case of the different types of loans?

Ordinary interest payments are subject to a withholding tax of 25%, except in the case of 'short' interest (on loans not capable of lasting for more than a year).

On interest payments regarded as a distribution of the profits of a company, ACT must be paid. The ACT gives rise to a tax credit on behalf of a UK resident company or individual receiving the income.

3.2. Tax situation of the company that grants a loan to the SME

What is the situation for the different types of loans: ordinary loans, convertible loans, profit-sharing loans, other types?

See the above stated principles on the payment of interest on certain loans.

In respect of the taxability of the interest, are there exemptions or reductions for certain zones or activities?

There are no exemptions or reductions of the taxability of the interest in certain zones or for certain activities.

How are the capital gains on receivables taxable? What if the loan is converted into capital with capital gains and losses?

Capital gains on receivables considered 'debts on a security' are ordinary capital gains and are taxed at rates between 25% and 33%. In general, loans converted into share capital do not give rise to a taxable capital gain or loss but the new holding is treated as having been

acquired at the same cost and at the same time as the original loan. Capital gains taxation will only occur at the moment of the disposal of the shares received. However, there is an exemption for 'qualifying corporate bonds': debts on a security denominated in pound sterling and not convertible or redeemable in another currency, and representing normal commercial loans.

Are capital losses on receivables realized by the VCC deductible?

Capital losses related to the disposal of the loans (debts on a security other than qualifying corporate bonds) are considered as ordinary capital losses and can only be set off against capital gains.

Are interest payments deductible (for the acquistion of the funds)?

Interest payments are generally deductible items, either as an expense wholly or exclusively made for the purpose of the trading business or as a charge on income.

Is there withholding tax on interest paid by the VCC? Are exemptions available (e.g. in case of payment to the European Commission)?

Withholding taxes are imposed on annual interest. The withholding tax amounts to 25%, unless a lower or zero rate applies under a relevant tax treaty.

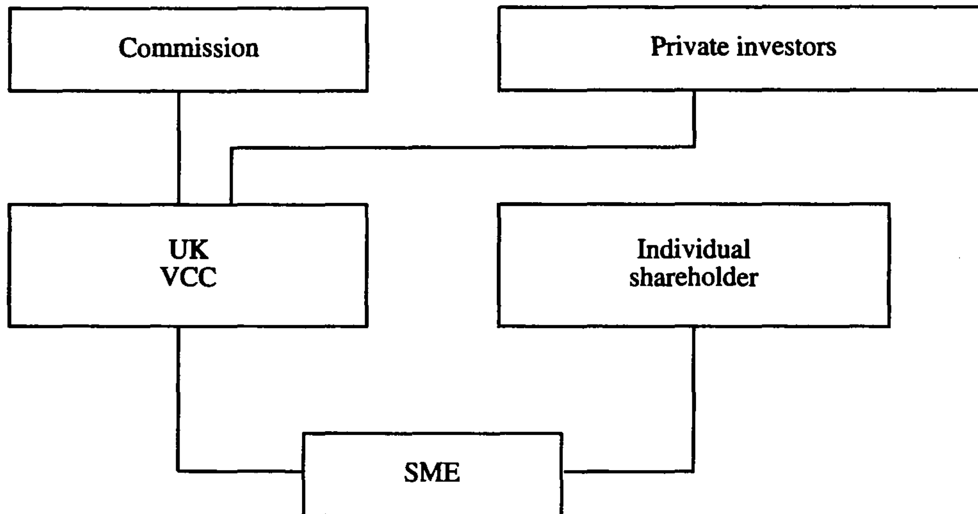
3.3. Discount finance

As an alternative to a loan which bears a market rate of interest, the SME may issue deep discount debt with zero or a reduced rate of interest, for short periods up to a year (e.g. pound sterling commercial paper) or longer periods of up to say five years (medium-term notes). The main incentives to do so will be that the interest burden is reduced, but a tax deduction may be claimed on an annual basis for the accruing discount (except when the holder is a connected party). A UK resident holder of the debt, other than a financial trading institution, will only be taxed on the discount on maturity, as income. There is thus a useful timing asymmetry for tax purposes.

Practical taxation guidance

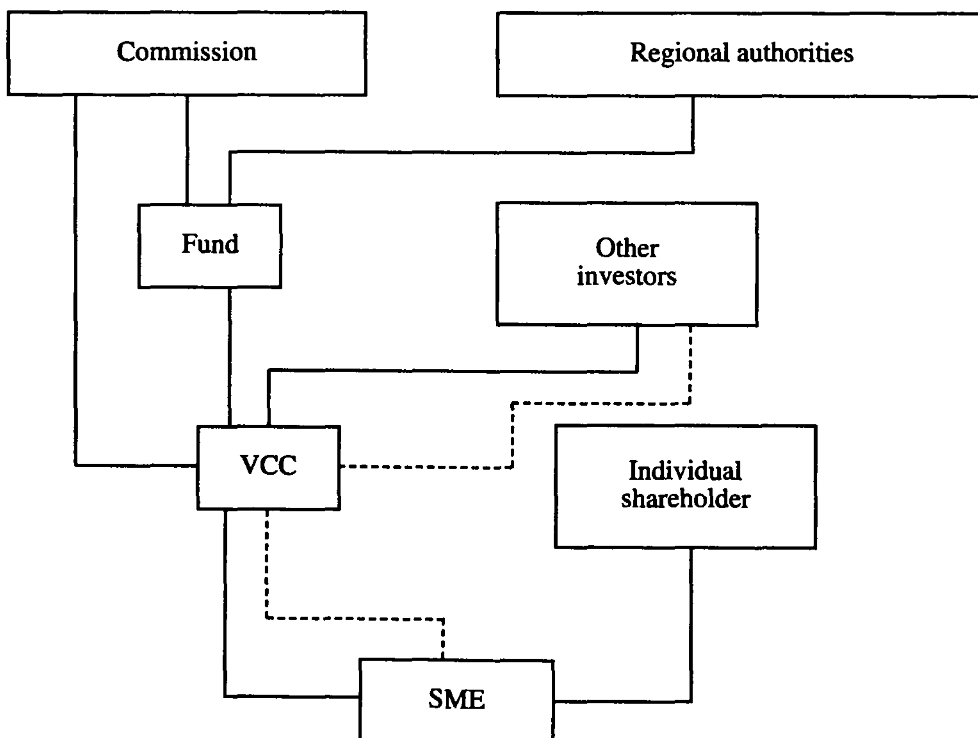
I. Equity finance

1. Scheme



II. Debt finance

1. Scheme



2. *Comments on structure*

2.1. *Position of the SME*

Costs of increasing capital:

There are several fixed registration duties.
These costs can, in absolute figures, not be a real obstacle, since they are rather limited. However, they are not tax-deductible.

Taxable base:

The profits of the SME are positively influenced by the capital increase.
This means that if normally losses would have occurred, because of the capital increase a better result can be shown.

If the capital increase leads to a profit situation, this profit is normally taxed at 35%.

Tax rate:

The profits are taxed at 35%.

There are reduced tax rates (25%) for income not exceeding UKL 250 000.

There are preferential rates (25%) of tax for insurance companies, building societies and several other entities.

Redemption of shares:

A redemption of shares is generally considered a distribution of the profits of the company. However, several exemptions are provided.

2.1. *Position of the SME*

Costs of obtaining a loan:

There are not registration duties. However, a fee may be asked by the financial institution for several services rendered (e.g. for the opening of the file). That fee is tax-deductible.

Taxable base:

The interest payments are normally deductible expenses that have a negative impact on the results and on the cash flow.

This situation may prove unwise because a loss position may be created (no immediate use of interest deduction).

Tax rate:

The deductible interest payments save a taxation at the corporate tax rate.

Reimbursement of the loan:

Has normally no impact on the taxable result.

Dividend distribution:

The dividends are part of the taxable base.

On the dividends distributed to the individual shareholder, an ACT of 25% applies; on the dividends distributed to the VCC, the same ACT applies. However, provided several conditions are met (group companies, etc.), no ACT is applied.

2.2. *Position of the VCC*

Taxable base:

(a) Dividend income

This income is in principle not taxed (FII).
There is no double taxation.

(b) Capital gains taxation

Capital gains on the realization of shares are taxed at ordinary rates, after allowing for inflation.

(c) Capital loss on shares

The capital losses can be set off against capital gains.

(d) Interests paid for the financing of a participation are deductible.

Dividend distribution:

Not tax-deductible.

Interest payment:

Interest paid to the VCC is considered a deductible item. It is normally subject to a withholding tax of 25%.

2.2. *Position of the VCC*

Taxable base:

(a) Interest income

This income is fully taxable at 35%.

(b) Capital gains taxation

Capital gains on receivables considered debt on a security are ordinary capital gains. The conversion of the loan into capital does not give rise to a taxable capital gain or loss but the new holding is treated as having been acquired at the same cost and at the same time as the original loan.

(c) Capital loss on loans

Capital losses on the disposal of the loans are considered as ordinary capital losses and can be set off against capital gains.

Interest payment to fund:

Interest payments to the fund are tax deductible.

Transfer of shares:

The transfer of shares is subject to a stamp duty of 1/2%. The transfer can generate capital gains which will be taxable.

Transfer of loans:

No special tax applies.

2.3. *Position of the individual shareholder*

Dividend income:

Dividends received are included in the taxable basis and are taxed at the ordinary rates. ACT may be credited against the final tax to pay.

Purchase of the shares:

The financing of this operation may be difficult since the individual shareholder can normally not deduct the interest.

2.3. *Position of the individual creditor*

Interest income:

Interest (net distributed plus the wihholding tax) is taxed. The withholding tax is creditable and the excess is refundable.

2.4. *Position of the fund*

The position of the fund is the same as a normal trading company.

2.4. *Position of the fund*

The interest income is taxable in the hands of its participants; as such it will also be taxable in the hands of the fund.

3. *Unincorporated SMEs*

If the VCC participates in an unincorporated association or a partnership a distinction should be made between partnerships which are qualified and those which are considered unqualified. Under a partnership a corporate member is subject to corporation tax on his share of the partnership's profits. The partnership will be treated as transparent for tax purposes.

3. *Unincorporated SMEs*

If the VCC grants a loan, the interest is deductible with the SME and fully taxable with the VCC.

Conclusion

Equity finance

1. *Major disadvantages*

Debt finance

1. *Major disadvantages*

Costs related to increase of capital; moreover, they are not tax-deductible;

The capital increase will normally lead to a higher taxable base and thus a higher tax burden with the SME;

Capital gains are taxed in principle;

The tax situation of the individual shareholder may be very disadvantageous as to the taxation of dividends, since the dividend income is taxed at ordinary rates.

2. *Major advantages*

Dividends received are not included in taxable base of a company and thus in principle tax exempt;

Interest is generally deductible.

The deductible intest payments may lead to a loss position of the SME, whereas the interest income with the VCC is immediately taxable;

Some interest payments are treated as profit distribution;

In principle capital gains on loans are taxable; capital losses are only deductible from capital gains.

2. *Major advantages*

No indirect taxes are levied on the granting of the loan;

The taxable base of the SME will normally be reduced, which saves corporate income tax;

The risk of double taxation (with SME/VCC) does normally not exist;

Capital losses are deductible to the extent that there are capital gains.

United Kingdom	Equity		Debt		
	VCC	VCC liable at reduced rate		Interest payments on ordinary loans[4]	Interest payments on convertible or profit-sharing loans
SME profit before tax	100	100	Interest payment deductible with SME	Yes (–100)	No/Yes[5]
CIT 33% (25% = VCC liable at reduced rate)	–33	–25	With-holding tax 25%[6]	–25	0 See equity
Dividend at recipient's level	67	75	Interest income before tax at recipe-ent's level	75	Same taxation[7]
ACT 25/75[1]	22	25	Taxable base	100	
			CIT 33%	33	
FII of recipient[2]	89[3]	100[3]	Tax borne at source	25	
			Tax still due	8	
			Interest income after tax	67	

[1] ACT paid by SME is set against its CIT-liability on profits of the accounting period in which the distribution is made. The amount of ACT deductible from CIT liability is restricted to 25% of the taxable profits but carry-back (limited to 6 previous years) or carry-forward are possible. In case of intra-group dividends (share-holding of 51%) the payment of ACT is optional.

[2] Franked investment income is consituted by the amount of dividends received plus the related tax credit.

[3] Dividend distributions made plus related ACT.

[4] An alternative to debt finance with market rate interest may be discount finance, with special tax incentives.
[5] Interest on certain types of securities (convertible or profit-sharing loans) are treated as a distribution except for interest on such loans paid to another company subject to UK corporation tax. In that case, such interest is taxed as interest on ordinary loans.
[6] Not due in case of interest on loans not capable of lasting more than 1 year.
[7] On interest payments regarded as a profit distribution, ACT must be paid, which gives rise to a tax credit on behalf of the UK resident VCC receiving the income.

III. Other issues

1. *Local and regional authority issues*

The Local Government and Housing Act 1989 provides for the promotion of economic development and may enable a local authority to provide venture capital, subject to spending constraints. Before the introduction of the Local Government and Housing Act 1989 less than 1% of local authority expenditure went directly towards economic development.

Although development agencies and local enterprise agencies/boards do exist their overall contribution to the provision of venture capital must be regarded as a very small element of the total venture capital industry. None the less their role is important in providing added assistance in those geographical areas most in need of support and in particular in the support of SMEs unable to present a business plan acceptable to venture capital companies. Regional development agencies have a wide discretion as to types of investment, albeit that there is an emphasis on manufacturing industry.

Local enterprise boards have an investment range between UKL 10 000 and UKL 750 000.

2. *Impact assessment*

It is difficult to identify any significant legal or practical obstacles to the provision of venture capital. By 1989 the annual investment of venture capital in the UK had reached UKL 1.65 billion with an annualized growth rate of 50% since 1981. It is considered that the venture capital industry is likely to enter a period of market maturity in the near future in the UK. The present view is that there is a shortage of suitable SMEs in which venture capitalists are prepared to invest and undoubtedly UK venture capitalists will look increasingly towards other Member States for suitable investment opportunities.

Some SMEs are unable to obtain venture capital as their business plan has proved unattractive to commercial venture capitalists. It is unlikely that local or regional authorities will receive increased funding solely for the purposes of assisting these 'higher risk' SMEs.

IV. Comparative legal and regulatory issues

1. *Absent positive features*

The existence of private regional companies (SDRs) benefiting from tax advantages and targeted at areas of specific need is a positive measure not present in the United Kingdom (France, Section I.3).

The same holds for innovation and development finance companies and closed-ended investment funds (Italy, Section I.3).

Likewise this can be said of seed capital companies benefiting from tax exemptions (Portugal, Section I.3).

(a) The existence of dedicated legislation and a scheme to create private regional venture capital companies/ innovation and development finance companies/seed capital companies is not directly present in the United Kingdom. There is, however, no restriction in the United Kingdom on companies choosing to operate in one area only.

(b) Given the advanced state of the United Kingdom venture capital industry such companies would require direct concessions by way of, *inter alia*, tax relief before they would be of any use. Additionally, greater funding for regional and local development with power to assist higher risk SMEs unable to secure venture capital from commercial venture capitalists would be required. The supply by regional or local authorities of venture capital to high risk SMEs is a matter for policy consideration.

(c) Specific legislation would be required to provide, e.g., the tax concessions needed. It is considered that the provision of 'regional only' venture capital companies requires no further legal framework.

2. *General recommendations*

Given the effective nature of the United Kingdom venture capital markets it is considered that further regulation may have a detrimental effect. Similarly, given that there is near-market maturity it is considered unlikely that regulatory or statutory measures other than, e.g., direct or indirect tax advantages will be of benefit to venture capitalists and SMEs seeking their assistance. It is presently considered that there is a shortage of suitable potential SMEs recipients of venture capital. As identified above, greater involvement by local or regional authorities with higher risk SMEs is a matter for policy consideration.

3. *Absent techniques*

Venture capital is plainly a significant financial engineering technique in the United Kingdom. It is not considered that there are any subsidiary or component financial engineering techniques absent from the United Kingdom venture capital markets.

Comparative tax study

Equity

Position of the SME

Costs of creation/increase of capital

When the VCC takes a participation in the SME by increasing the latter's capital, this generally results in a capital duty of 1% or 0.5% or, as in France and the UK (in the latter country only on the occasion of the creation of the company), a lump-sum registration fee.

The following important exceptions to this rule are:

Germany and the UK: in these countries, the capital duty has been abolished;

Portugal: capital increases by means of cash contributions are exempt.

Furthermore, exemptions/reductions of capital duties for certain zones, projects, activities (for SMEs and for VCCs) are available in Portugal, Greece (for investment holding companies), the Netherlands (in case of certain types of mergers or reorganizations involving companies established in EC countries; there are additional conditions), Spain (for VCCs operating under Royal Decree No 1 of 14 March 1986) and Belgium (for T-zone, innovation or reconversion companies and for some kinds of reorganizations under specific conditions).

(c) These and other costs (e.g. annual licence tax in Italy, registration costs for publication in official gazettes in several countries, notarial fees, etc.) are in general tax deductible, except in Ireland, the UK and Denmark.

Debt

Position of the SME

Costs of granting a loan

In Belgium, Luxembourg, the Netherlands, Portugal, Spain and Germany, there are no costs involved. Germany used to have a 1% capital duty on profit-sharing loans but capital duties have been abolished as of 1 January 1992. In Italy, costs only exist if the loan is granted by a bank (0.25%). In Greece and Denmark, a duty with a percentage varying depending on the precise nature of the loan document concerned is levied. Denmark does not allow the deduction of these costs.

Equity

Taxable base

The profits of the SME are indirectly positively influenced by the capital increase.

This means that if normally losses would have occurred, because of the capital increase, a better result can be shown.

Specific regimes

Belgium: Employment zone (T-zone) companies can, under certain circumstances, enjoy a full tax exemption. Also, companies established in reconversion zones and companies defined as innovation companies are granted certain benefits (e.g. exemption from CIT on distributed profits to a certain amount). For reconversion companies (i.e. companies that have entered into a reconversion contract), the benefits are not granted to the companies themselves but to their private shareholders. A drawback, however, is that such companies cannot be newly created any longer; the regime is only applicable to existing companies.

A specific regime also exists under RD No 15, which provides for an exemption from CIT on distributed dividends, to an amount of 8% of the paid-in capital that was contributed in 1982 and 1983.

Greece: A Greek SME is only liable to CIT if it has the form of an SA. An EPE (limited liability company) is as such not subject to tax on its income, which is taxed in the hands of the partners. It is, however, anticipated that, as of 1992, EPEs will be taxed like SAs.

Furthermore, specific regimes exist in the form of exclusions from the taxable income (e.g. for profits from sales of real estate used as fixed assets). Also tax free allowance rates apply to the value of new productive investment. The percentage of profits to which such allowance may be applied depends on the investment area (60 to 100% of the profits where the lowest rate is reduced to 40% in the case of hotels or tourist facilities). This, however, does not apply to distributed profits.

France: Exemptions apply to newly created companies in depressed areas. These enterprises are granted full or partial exemption from CIT provided some conditions are met (e.g. the company must have a commercial, industrial or craft activity). Several exemptions exist for investments in areas defined by the national development programme or depressed areas.

Italy: In certain parts of Italy, companies may benefit from a tax exemption.

The Mezzogiorno: exemption from CIT and local income tax during 10 years and exemption from equalization tax.

Depressed areas in central and northern Italy: exemption from local income tax during 10 years.

Portugal: Special tax incentive schemes exist for companies situated in the Madeira/Azores free zones (e.g. exemption from CIT until 31 December 2011, on income from banking, commercial or industrial activities or services carried out in these zones).

Debt

Taxable base

Interest payments on ordinary loans are normally (i.e. if at arm's length) deductible expenses that have a negative impact on the results and on the cash flow.

This negative impact may prove to be unwise because a loss position may be created (no immediate benefit from the interest deduction). This disadvantage may partially disappear if the ordinary loan is replaced by a profit-sharing loan.

The following exceptions to the deductibility of the interest payment exist:

In Italy, in case the SME receives tax-exempt income, interest payments are only deductible to a proportion equal to the ratio of gross taxable income to total gross income. This implies no deductibility if the SME is totally exempt from CIT.

In Germany, interest paid on long-term loans, although fully deductible for CIT purposes, is only 50% deductible for trade tax purposes.

In Belgium, interest payments to a VCC participating in the SME are not deductible if the SME is a 'société de personnes'.

In the UK, interest on certain types of securities (e.g. on convertible or profit-sharing loans) is considered as not being deductible. The same applies in Ireland, but only in some limited circumstances when the interest is paid to an Irish corporate lender. In those cases, liability to ACT may be possible. In the UK, however, an exception is made provided the interest on such loans is paid to another company subject to UK corporation tax.

In the Netherlands, interest on certain types of profit-sharing loans is not tax-deductible.

Equity

Tax rate

Principle

As a general rule, normal CIT rates apply to SMEs. Some Member States also have other direct and indirect taxes, such as trade tax, surtax and net worth tax.

Exceptions

In Germany, a difference is made between non-distributed (50%) and distributed profits (36%). Special tax rates exist for Berlin source income but these will be eliminated in the future.

Luxembourg and Belgian tax law have (in the latter country only under specific circumstances), reduced rates depending on the amount of taxable income.

In Spain, reduced rates have taken the form of a reduction of indirect and local taxation. Certain industries enjoyed a reduction of up to 95% of the local taxes, but these incentives expired on 1 January 1990, except for those actually granted for a longer period. Specific regimes exist with respect to employment or the kind of investment: a tax credit is granted in these cases.

In Greece, reduced rates (i.e. reduction of withholding tax on distributed profits; see below) apply, depending on the kind of activity (e.g. mining companies).

Also in the UK, reduced rates exist for companies with taxable profits not exceeding UKL 250 000, and up to profits of UKL 1 250 000 a tapering relief applies. Preferential tax regimes are available for insurance companies, building societies and certain other entities.

France has reduced rates for long-term capital gains except on portfolio investments. Several reductions exist for investment in areas defined by the national development programme or depressed areas.

Under specific circumstances, Italian law provides for certain tax credits for SMEs falling under the scope of the law of 5 October 1991.

Finally, a reduced CIT rate of 10% is applicable under Irish law on manufacturing and many service industries. It applies to financial services only in two specified areas.

Debt

Tax rate

The deductible interest payments save a taxation at the corporate tax rate, or as the case may be, business and/or net worth tax (Spain, Luxembourg, Germany).

Equity

Redemption of shares

In Ireland, the Netherlands, Luxembourg, Belgium, Spain, France and the UK, where shares are redeemed by a company for an amount in excess of the sum originally subscribed to the company in respect of their shares, the surplus is treated as a distribution of profits akin to a dividend.

Although Greek tax law does not provide for any specific legislation, gains resulting from a redemption of shares is treated as dividend distribution. Redemption of shares is unknown in Italy.
Finally, in Denmark and Portugal, the operation cannot lead to taxation in the hands of the SME.

Debt

Reimbursement of the loan

In all Member States, this has normally no impact on the taxable result.

Equity

Dividend distribution

With the exception of Greece, dividends are in principle not tax-deductible items. In Belgium, however, a deductible dividend has been introduced under certain specific regimes (e.g. dividends distributed under RD No 15 and dividends coming from companies in reconversion zones). Furthermore, it should be noted that in Belgium reduced CIT rates for SMEs are no longer applicable if the amount of dividends distributed exceeds 13% of the capital.

In general, a withholding tax on dividends applies. In addition, a substitute gift and inheritance tax is due in Portugal. In Italy, an equalization tax may be due in case the SME is exempt from CIT.

Exemption from withholding tax is possible in some of the Member States when the VCC has a substantial holding in the SME (e.g. Portugal, Belgium, the Netherlands, Luxembourg) or because the VCC benefits from a special regime (e.g. Spain, Greece).

The UK and Ireland do not levy withholding tax but the distributing company has to pay an 'advance corporation tax' (ACT). The ACT paid by the SME can be offset against CIT liability on profits of the accounting period in which the distribution is made.

For intra-group dividends or dividends paid to consortium members (Ireland), the payment of ACT is optional.

Debt

Interest payment

In Italy, Denmark, France (for interest on loans issued since 1 January 1987), the Netherlands, Portugal (in case the VCC is a 'sociedade de fomento empresarial — SFE' or a 'sociedade de capital de risco — SCR'), Belgium (with exceptions) and Spain, no withholding tax is due on interest paid to the VCC.

Luxembourg, the Netherlands and Germany levy no withholding tax on ordinary loans, but withholding tax is due on interest on e.g. convertible or profit-sharing loans.

In Belgium, in case the interest payment qualifies as dividend, a 25% withholding tax applies, except when the VCC holds a participation of a minimum 25% in the SME during at least one year.

In Greece, a withholding tax is levied at all times. Ireland and the UK also levy a withholding tax, although many exceptions exist. Under Greek law, a stamp duty at the rate of 1.2 to 3.6% is also imposed on the payment of interest on loans.

Equity

Position of the VCC having taken a participation in the SME

Preliminary remarks

The choice of the legal form of the VCC may give rise to a different tax regime. Moreover, in some Member States specific forms are available.

The VCC will most likely operate under the form of a public limited company or a limited liability company. This is not normally the vehicle in Greece.

In Belgium, the choice of the legal form of the VCC (SA or SPRL) may have a major impact on the tax treatment of debt financing.

In most of the countries, the VCC can also operate as a partnership, e.g. in the Netherlands (VOF or 'commanditaire vennootschap') and Germany ('Personengesellschaft', taxed transparently).

Some countries have special forms for VCCs:

In Germany, a VCC can operate under the form of an 'Unternehmensbeteiligungsgesellschaft' (recognized participation company), which must be a stock corporation.

In Greece, provided the VCC has taken the form of a corporation and has a capital of at least DR 500 million, fully subscribed in cash at the time of formation (and some other conditions are met), it can benefit from a special tax regime. For example gains realized on the sale of participations in high technology and innovation businesses are not subject to income tax and are placed in a special tax-free reserve to cover future losses from sales of such participations. The VCC can also be an investment holding company.

In Portugal, a VCC can take the form of a 'sociedade de capital de risco' – SCR (risk capital company) or a 'sociedade de fomento empresarial' – SFE (seed capital company) or a 'sociedade de desenvolvinento regional' – SDR (regional development company).

In Spain, a specific form is the 'sociedad de capital riesgo' provided for by Royal Decree No 1 of 14 March 1986.

In France, specific venture capital companies exist.

In some Member States, the participation percentage of the VCC in the SME may have some tax implications:

In Belgium, if the VCC takes an interest of more than 50%, the SME cannot benefit any longer from the reduced CIT rates.

Under French law, the favourable tax treatment of venture capital companies can only be invoked amongst other things when the shareholding in the SME does not exceed 40% of the latter's voting shares.

In Germany, if more than 50% of the shares are held by the VCC and some other conditions are met, a consolidated tax return is possible ('Organschaft'). The same applies in Luxembourg if 99% (in certain circumstances 75%) of the SME's shares are held by the VCC.

In Italy, VCCs falling under the scope of the law of 5 October 1991 cannot benefit from the special tax credit granted to them if they do not have a minority participation in the SME.

Taxable base

Dividend income

The following methods can be distinguished: the tax exemption method and the tax credit method.

(1) The exemption method

In the following countries, dividend income is not subject to taxation in the hands of the VCC, and this is based on 'general tax legislation': Belgium, Denmark, France, the Netherlands, Luxembourg, Portugal, the UK and Ireland.

Belgium has a 95% exemption from CIT under the condition the VCC has enough taxable profit. Since the VCC will normally only have tax-exempt income and an interest burden, double taxation (39% with both the SME and the VCC) may be possible.

Sometimes the exemption is made conditional upon the fact of having a 'qualifying participation' (e.g. the Netherlands, 5% – in certain cases a lower percentage may be sufficient; France, 10% or FF 150 million and other conditions; Denmark, 25% during the entire year; Luxembourg, 10% or LFR 50 million during 12 months; Portugal, 25% during at least two years or a shorter period if held from the date of incorporation of the participating company.)

If this condition of a qualifying participation is not met, the dividend income is in principle taxed as ordinary income, which leads to a double taxation (e.g. the Netherlands and Luxembourg).

In Denmark, France and Portugal, in case the participation exemption does not apply, it is possible for the VCC to claim a (refundable) tax credit to redress the situation of double taxation. This tax credit can lead to a partial (Denmark and Portugal) or practically full compensation (France). It should, however, be noted that in those countries the VCC can be totally exempted from tax on dividends under specific circumstances (e.g. certain Danish investment companies).

Some of these countries and others may provide for an exemption through specific legislation regarding only those VCCs that comply with certain conditions:

Belgium: for open-ended and closed-ended investment companies (BEVEKs or BEVAKs) dividend and interest income is excluded from the taxable base.

Luxembourg: Dividends received by a 1929 holding company are not taxed due to the fact that these companies are only subject to a 0.2 % 'taxe d'abonnement'. In this case, however, the 15% withholding tax cannot be recovered.

France: French venture capital companies ('sociétés de capital risque'), the purpose of which is to participate in non-quoted companies, are subject to a very favourable tax treatment under certain conditions. Such VCCs are exempt from CIT on their dividend income and on the capital gains attached to their portfolio.

Denmark: Certain investment companies are exempt from tax on dividends if specific conditions are met (e.g. the company's purpose and actual business is solely to own and administrate shares of other companies).

Portugal: The tax incentive scheme for SCRs, SDRs and SFEs incorporated in the period from 1 January 1989 to 31 December 1990 (31 December 1992 for SDRs) consists of a CIT exemption with respect to the year of incorporation and the four-year period thereafter (increased to a period of seven years for SFEs).

Furthermore SCRs, SFEs as well as insurance companies, SDRs, investment banks and companies, and specific holding companies can benefit from a general 95% exemption on dividend income.

If the VCC holds a participation in an SME resident in the Madeira/Azores free zones, it is fully exempt from CIT on dividends paid by such SMEs.

If the VCC is established in one of these free zones, dividend income remains tax exempt.

Spain: VCCs operating under Royal Decree No 1 of 14 March 1986 enjoy a 100% relief from CIT on dividends received from qualifying shares. For VCCs owning more than 90% of SMEs' capital for more than two years, a taxation on a consolidated balance sheet is possible, which would mean complete exemption for intercorporate dividends.

Germany: VCCs for which the special form of an 'Unternehmensbeteiligungsgesellschaft' (recognized participation company) has been used can enjoy the exemption from trade tax on income, net worth tax and trade tax on capital. This is, however, only an advantage in comparison to normal investment (holding) companies if the participation is below 10% so that the affiliation privilege does not apply.

Greece: VCCs having the form of an investment holding company will be obliged to give notice of this to the SME so that no withholding tax (which is the final taxation on received dividends for Greek SAs) is paid on the dividends paid to the investment holding company.

Italy: VCCs operating in the Mezzogiorno cannot obtain the same benefits as the SME situated there. In fact, unlike SMEs, which are entitled to a 100% exemption from corporate and local income tax, VCCs are only entitled to a 100% exemption from local income tax (ILOR) on profits reinvested in the Mezzogiorno.

Companies operating in the new off-shore financial centre of Trieste (branches and subsidiaries of credit institutions, brokerage companies, insurance companies, financial companies borrowing funds on international markets, foreign intermediary companies and foreign companies assisting international trade) are excluded from corporate income tax (IRPEG) and are subject to local income tax (ILOR) at half the normal rate.

For VCCs falling under the scope of the Law of 5 October 1991: until 31 December 1993, financial companies whose exclusive business purpose it is to participate temporarily in the risk capital of small enterprises are entitled, in each tax period, to a tax credit equal to 5% of the increase in value of the participations purchased in each tax period and still in portfolio at the end of the tax period (31 December). However, the tax credit cannot exceed LIT 200 million.

(2) Tax credit method

Other countries than those mentioned under (1) consider dividend income in general always as taxable income. The taxable base is constituted by the net dividend, grossed up with the:

- withholding tax if withheld (for an exception see Spain and Greece under (1));
- the withholding tax, and underlying CIT (Germany and Italy); note that in Germany, an exemption from trade tax on income and on capital and from net worth tax exists for participations of at least 10%. The withholding taxes, and for Germany also the CIT borne at source, are fully creditable against CIT liability of the shareholder and any excess is refundable, whereas the tax credit in Italy is not refundable. Moreover, to the extent that the profits of the SME are not taxed, an equalization tax of 56.25% is due in Italy, which is strictly connected with the abovementioned tax credit to which the VCC may be entitled.

Spain has a particular regime for VCCs that do not fall under the scope of the exemption for dividend income (see under (1)): the dividends received are subject to CIT but an amount of 50% of the effective tax rate paid by the SME on that part of the profits out of which the dividends are paid may be credited against the VCC's own CIT. In certain circumstances, this credit can be increased to 100%.

Under Greek law, only undistributed profits of a corporation are liable to tax at the SME level. All dividends distributed are deductible from corporate net profits in determining the CIT liability of the SME. The withholding tax is thus the only tax due on dividends. In case the SME is a limited liability company (EPE), the withholding tax is 15% and can be credited against CIT liability of the partners; any excess is refundable. It is, however, anticipated that this special tax regime on EPE profits will be abolished and a CIT of 35% on EPE profits will be introduced in the near future. Finally, an important exception to the abovementioned regime is that dividends distributed to investment holding companies are not subject to withholding tax (see under (1)).

Debt

Position of the VCC

Taxable base

Interest income

Interest income is fully taxable at normal CIT rates in every country, unless the VCC is totally exempt from CIT. Exceptions to this rule are for:

Belgium: open-ended and closed-ended investment companies (BEVEKs or BEVAKs) which are not taxed on interest income.

Luxembourg: the 1929 holding companies, which are fully tax-exempt.

Portugal: companies situated in the Madeira/Azores free zones and SCRs, SFEs and SDRs incorporated in 1989 or 1990 (from 1989 to 1992 for SDRs), that are tax-exempt.

Spain provides for a specific exemption for interest income under certain circumstances; also a reduction of local income tax to 8.2% applies in this case. So does Italy, for VCCs operating in the Mezzogiorno or in the new offshore financial centre of Trieste where a reduction of local income tax applies also in the latter case.

In Belgium and Luxembourg, this income is in principle taxable at normal rates whereas the interest deduction with the SME in certain cases only benefits from the saving of reduced rates.

Finally, the UK resident holder of a deep discount debt, other than a financial trading institution, will only be taxed on the discount on maturity.

Equity

Capital gains taxation

Capital gains realized on the sale of shares

Capital gains are in principle tax-exempt in Belgium (for shares of which the dividends apply for a participation exemption), the Netherlands (if a qualifying participation exists) and Luxembourg (under the same circumstances but conditions are slightly different from those applicable to the participation exemption), Denmark (if shares are held for more than three years) and Greece (if the gains are placed in a special reserve).

In all other countries, capital gains on shares constitute taxable income, in principle taxed at ordinary rates. However, exceptions exist: e.g. deferral may be possible if certain conditions are fulfilled; in France reduced rates for long-term gains apply.

In some of the abovementioned countries and others, VCCs are exempt from taxation on capital gains due to a specific regime: Luxembourg (1929 holding companies); Portugal (companies situated in the Madeira/Azores free zones); Spain (VCCs operating under Royal Decree No 1 of 14 March 1986); France (venture capital companies) and Greece (investment holding company).

Capital gains realized on the occasion of the redemption of shares

The capital gains realized on the redemption of shares are treated in the same way as dividend income in Belgium, Luxembourg (no withholding tax is withheld in these countries on the occasion of this operation), the Netherlands, Greece, France (to the amount of the cash payments received which exceed the original contributions, or if higher, the purchase costs of the shares, with no right to the 'avoir fiscal' in this case; however, provided this kind of distribution results from a regular decision of the SME's shareholders' meeting and benefits all shareholders in proportion of their share capital, the 'avoir fiscal' will be attached to the distribution), and Spain (assuming the VCC is not operating under Royal Decree No 1 of 14 March 1986.

In all other Member States, the profit realized on the redeemed shares is considered as capital gain and taxed as such.

Under Danish law, the whole sales price is in principle subject to CIT and is taxed according to the rules applying to dividends. Exemption is obtained upon application in which case the gain is taxed according to normal capital gains tax rules. If redemption takes place in the calendar year when the winding-up is completed, the profit is taxable as capital gains.

Furthermore, gains realized by exempt companies remain untaxed (e.g. Luxembourg 1929 holding company 1929, Portuguese VCC situated in the Madeira/Azores free zones).

Debt

Capital gains taxation

Capital gains realized at the moment of converting the loan into capital are fully taxable in Germany, Spain, France, Luxembourg (with the exception of the 1929 holding companies), Denmark, the Netherlands, Belgium, Portugal (with exemption for companies incorporated in 1989–90) and Greece (except for investment holding companies).

In Ireland, generally no tax is due on such capital gains, unless the granting of loans constitutes a trade.

In the the UK, the taxation is postponed until the moment of realization of the shares.

In Italy, only a registration duty of 1% is due.

Equity

Capital loss on shares

Except for Belgium (except in case of liquidation), the Netherlands (except if participation exemption does not apply or in case of liquidation of the SME) and Denmark (if the shares were owned for more than three years), such capital losses are deductible from the taxable income or can be set off against capital gains, as is the case in Greece (where losses have to be set off against similar gains or used to reduce the special reserve), the UK, Ireland and France (where long-term capital losses may only be set off against long-term capital gains).

Debt

Capital losses on loans

All countries but the UK consider such losses as deductible. Under Irish law however, such losses are only deductible in limited circumstances. As far as the UK is concerned, the tax deductibility of losses on ordinary loans is not allowed; only in case of 'debts on a security' (i.e. traded or marketable debt) can capital losses be relieved against other capital gains.

Equity

Dividend distribution

The normal rules apply (see p. 367). However, dividend distributions to the European Commission are exempt from withholding tax (Art. 3 of the Protocol concerning the prerogatives and immunities of the European Community).

As far as the UK is concerned, ACT must be paid by the distributing company. Distributions received by a UK company plus the related tax credit are considered 'franked investment income' (FII). They are exempted from corporation tax in the hands of the recipient company and are set off against the company's 'franked payment' (distributions made plus related ACT) in calculating tax payable or repayable. That is, ACT is payable only in respect of the excess of franked payment over FII. Derogation from this regime is optional on intra-group dividends.

Practically the same regime is applicable in Ireland, except for preference share dividends, which are liable to CIT in the hands of the VCC. Moreover, ACT paid by the SME cannot be set off against the VCC's CIT liability.

Furthermore, the payment of a dividend by a closely held Irish VCC may help to avoid the 20% surcharge on undistributed investment income of such a company.

Debt

Interest payments to investors

Deductibility

Interest payments, determined on an at arm's length basis, are deductible in all Member States.

However, in Germany, only 50% of the interest on long-term debts is deductible for trade tax purposes and no deduction at all is possible to the extent of related tax-exempt income. In Luxembourg, no deduction applies to the extent the expense relates to exempt income. If, however, the expense exceeds exempt income in any given year, the excess expense is deductible.

Withholding tax

Withholding tax applies in Belgium (large exemptions are, however, available), in Italy (for private investors, the withholding tax is the final tax), in Greece (possibility of reduced rates), Portugal and Spain.

No withholding tax is due in Denmark, France (for loans issued since 1 January 1987), the Netherlands (except sometimes in case of profit-sharing loans), Germany (except in case of profit-sharing loans and convertible loans), Luxembourg (except for profit-sharing loans) and Italy.

Equity

Transfer of shares

No special tax is due in Belgium, the Netherlands (unless the SME is a qualifying real estate company), Portugal, Germany, Greece, Spain and Luxembourg.

In the other Member States, either a stamp duty (Ireland and the UK) or a registration duty applies (France, but exceptions are possible, and Italy). Denmark has a special tax of 1% on the market value of the transferred shares.

Debt

Transfer of loans

This operation does not entail taxation in any Member State.

Equity

Position of the individual shareholder

Dividend income

Ireland and the UK

The dividend plus the tax credit is included in the individual shareholder's taxable income. He is in fact entitled to a tax credit equal to the ACT paid by the SME and any excess is refunded.

As far as the UK is concerned, a special Business Expansion Scheme available only to individual shareholders has been set up which will run until 31 December 1993. Under this scheme, full relief is given from income tax subject only to a five year holding requirement.

Luxembourg

In case withholding tax is withheld, this may be credited against individual income tax due; any excess, however, is not refundable. A special regime applies under the 'Loi Rau' and the legislation on venture capital investment certificates which will expire in 1992 unless extended.

Other Member States

In Spain, Portugal, France, Germany and Italy, the net dividend is grossed up with the withholding tax and a tax credit, being the whole or a part of the underlying CIT (paid by the SME). The latter is creditable against the individual income tax but is usually not refundable (except for Germany and France, where individuals additionally enjoy a fixed deduction (FF 8 000/16 000) of the tax due on received dividends).

In all these countries, the withholding tax is generally a prelevy on the individual income tax and therefore fully creditable. A refund is granted in case the withholding tax exceeds the final tax. Note that in Portugal, domestic-source dividends are also liable to the 5% substitute inheritance and gift tax.

Under Dutch law, the corporate tax, unlike the withholding tax, cannot be credited against individual income tax.

In general Belgian, Portuguese and Greek tax law derogate from the abovementioned system in this way that the withholding tax constitutes the final taxation at the option of the shareholder.

In Denmark, the 30 % withholding tax is always (i.e. not optionally) final, provided the total dividend income does not exceed a certain amount. An exceeding amount is taxed at 45 % but the withholding tax is creditable in that case.

Interest on loans in view of the purchase of SME shares

The financing of this operation may be difficult in the following countries: Belgium (exceptions exist), Denmark, Italy, Portugal, Spain and France, since under these tax laws, the individual shareholder cannot in principle deduct the interest paid.

Interest relief is available in the Netherlands (except in the case of abuse of law), the UK and under certain conditions in Ireland, Luxembourg (if the expense is incurred in connection with the business carried out by the company and is not economically linked to exempt income), Germany (if the dividend income exceeds the related interest expenses) and Greece (interest has to be deducted from the dividends received from the shares acquired with the loan).

Equity

Position of the Fund

The fund does not have dividend income (see practical taxation guidance schemes).

Recommendations

A — General recommendations

A more tax-neutral treatment should be sought by granting equity finance and debt finance equal treatment, at least in a first degree (e.g. by abolishing capital contribution costs, by generalizing a full imputation system or by allowing deductibility of a primary dividend and treating it as interest in the hands of the shareholder).

The transparency as a result of a harmonization of the tax regimes of finance techniques in the European assisted regions may considerably enhance the interest of European investors, as it simplifies the decision-making process and eliminates distortions based on tax considerations while maintaining its character of tax incentives *vis-à-vis* the generally applicable tax regime.

B — Specific recommendations

Equity finance

Position of the SME

Costs of increasing the capital

As in Germany and the United Kingdom, the general abolition of the capital duty should be considered.

At least the full deductibility of these duties should also become possible in Denmark and Ireland.

Taxable base

There may be a distortion in the tax treatment of equity finance and debt finance, the latter often being more advantageous. Moreover, from an economic point of view, equity finance may be preferable to debt finance. For these and other reasons, some Member States have introduced measures promoting equity finance, e.g. the tax-deductible dividend (e.g. Belgium), a tax exemption (e.g. the Mezzogiorno region).

It is recommendable to have similar measures taken for companies active in the 'assisted regions' in Member States where no specific regimes are available.

Tax rate

A reduced rate (Ireland, Luxembourg and the UK) or a special tax credit (e.g. Spain) may also reduce the less advantageous tax treatment of equity financing.

It is recommendable for Belgium to have its legislation on reduced rates adapted in the same sense as has been done in Luxembourg so as to avoid that the benefit of the reduced rates is lost if a VCC exceeds a certain degree of participation or if a dividend distribution exceeds certain rather arbitrary limits.

As mentioned above, some Member States have introduced reduced tax rates for companies established in 'assisted regions' or carrying on specified activities (e.g. Ireland). Other Member States (e.g. the Netherlands, Germany) may consider taking similar measures.

In the Netherlands, however, SMEs often pay 40% CIT, whereas large companies pay 35% CIT as the rates are linked with the profit capacity (HFL 0 – 250 000: 40%; > HFL 250 000: 35%).

Moreover, a general reduction of the CIT rates (e.g. to 35%) is recommendable (e.g. correction in Germany: CIT rate: 50%). This would equally reduce the impact of the unfavourable tax treatment of equity finance. For all 'assisted regions', the tax rate should generally be reduced to 35% or less.

Taxes other than corporate income tax (e.g. net worth tax, trade tax, local taxes) should be reduced or even abolished for companies established in 'assisted regions' (e.g. as has been done in Italy and Spain).

Redemption of shares

This technique permits an SME to redeem its shares by a VCC or another investor and should be specified in German tax law and introduced in Italian company law without creating additional taxable events (to the extent the tax claims on hidden reserves can remain in the company).

Dividend distribution

In order to reduce the tax barriers for the participation of a VCC, a generalization of the full exemption from withholding tax should apply, even in case of a dividend distribution to a tax-exempt VCC. The Luxembourg tax law could be amended in this respect, e.g. for dividends distributed to a 1929 holding company.

As already mentioned above, a tax deductible dividend may reduce the negative discriminations and can substantially promote equity finance in the 'assisted regions'. In Belgium, this technique has had an enormous success.

For assisted regions in France, the UK and Ireland, the 'précompte' or ACT should be abolished or linked with a refundable tax credit.

Position of the VCC

The following recommendations should not necessarily affect the general tax legislation, since they can be achieved by introducing a separate tax regime for VCCs that invest in SMEs (e.g. as has been done in Greece, Portugal, Spain and France).

The main purpose of these recommendations is to avoid double taxation or to realize a tax neutrality *vis-à-vis* debt financing. In normal circumstances the dividends distributed by the SMEs are already taxed in the hands of the SME. Any taxation on income with the VCC would almost automatically lead to a partial or full double taxation, a situation that has to be avoided.

Taxable base

(a) Dividend income

Dividend income should be completely tax-exempt if the Member States opt for the exemption method.

This should imply:

- that the subject to tax test for SMEs based in assisted regions should not apply;
- a 100% exemption as exists e.g. in the Netherlands, instead of a 95% exemption, as exists e.g. in Belgium and France;
- that no minimum detention period is required, which is the situation existing in e.g. the Netherlands and Belgium, contrary to e.g. Luxembourg, Denmark and Portugal;
- that no minimum holding is required (e.g. as is the case in Belgium); such a condition exists in e.g. the Netherlands (in certain cases), France, Denmark, Luxembourg and Portugal;
- that the exemption is not linked with a profit situation; the Belgian tax law should be amended in this respect.

If the Member States apply the tax credit method, a full and refundable tax credit (by the Member State that has taxed the SME) should be provided for.

If the SME enjoys a tax exemption (e.g. Italy) or deductibility of dividends, this exemption would be neutralized when the VCC receives the dividend. Therefore, a tax sparing credit (e.g. as under tax treaties with developing countries) can be introduced.

(b) Capital gains taxation/redemption of shares/capital losses

In several Member States the capital gains on shares are tax-exempt. In order to obtain tax neutrality and to avoid stripping techniques that are detrimental to SMEs, the exemption should be unconditional and should be introduced in all Member States that apply the exemption method for dividends. In the same line of reasoning, the redemption of shares should be treated as a tax-exempt dividend or a tax-exempt capital gain.

For credit method countries, a double taxation should be avoided by a step-up in basis in the SMEs.

It would substantially promote the venture capital activity in high-risk SMEs and create neutrality *vis-à-vis* debt financing if the capital losses on shares would be tax-deductible. An amendment in this respect of the Belgian, Dutch and Danish tax legislation would therefore be recommendable. Also, the limited deductibility as e.g. in France, where long-term losses can only be offset against long-term gains, should be abolished as creating unnecessary disadvantages.

A full deduction of interest on debts to finance the acquisition of participations should be possible. Luxembourg may consider amending its legislation in that way.

It would improve venture capital activity if a tax consolidation would be possible as from a more than 50% participation, as exists in Germany and Luxembourg.

The tax exemption of dividend income or of capital gains should also imply an exemption of trade tax, net worth tax and local taxes.

Dividend distribution

A full exemption from withholding tax would improve the accessibility of the venture capital activity.

Transfer of shares

No transfer tax should be due on the transfer of shares. An amendment in this respect of the Irish, British, French, Italian and Danish tax law should be considered.

Position of the individual shareholder

Dividend income

Different regimes exist:

(a) the CIT is fully (e.g. in Germany) or partially (e.g. France, Italy, Spain and Portugal) creditable against personal income tax;

(b) the CIT is not at all creditable against personal income tax (e.g. the Netherlands and Luxembourg);

(c) the CIT and the withholding tax are the final taxation (e.g. Denmark and, at the option of the shareholder, in Belgium, Portugal, Greece).

Obviously, only a full creditability of the CIT against personal income tax (and possibly a refundability of any excess) meets the objectives of tax neutrality between debt and equity financing and of avoidance of double taxation. The Dutch system should therefore fundamentally be amended in this respect.

Interest deduction

If the individual shareholder wants to purchase a participation in an SME, held by the VCC, it is often essential to him that he can deduct the interest payments (e.g. to the bank) on the loan he has been granted in view of this acquisition. In this respect, it could be considered to have the tax law amended in the UK, Belgium (although under Belgian tax law the deduction is in limited circumstances not excluded under certain conditions), Denmark, Italy, Portugal, Spain and France.

A deductibility of interest against all other income (i.e. not restricted to dividend income) would be preferable. An amendment of the tax laws in all the Member States could be considered.

Capital gains and losses; deductions of capital contribution

Although this goes beyond the scope of this study, it seems appropriate to formulate two recommendations in a related area:

Several Member States have a tax regime whereby capital gains on shareholdings of private investors are taxable (generally only where a substantial interest of e.g. 25% is held). In order to avoid the recapture in their hands of the tax incentives granted to SMEs, a general exemption should be considered. Some Member States have introduced special measures to encourage private investors to participate in SMEs by allowing tax deductions of the capital contributions by the investor (e.g. Business Expansion Scheme in the UK, innovation companies in Belgium). The generalization of such incentives for SMEs in European assisted regions may be recommended.

Debt finance

Position of the SME

Costs of granting a loan

No duties of any nature should become due. An amendment in this respect of the Italian, Greek and Danish tax law would be recommendable.

Taxable base

The interest payments should be fully deductible. An amendment of the German tax law with respect to trade tax is therefore recommendable.

Furthermore, no exception on the deductibility should be made for profit-sharing and convertible loans, since these techniques are often preferable for economic reasons.

An amendment of the tax law in Luxembourg, Spain, Greece and Denmark should therefore be considered.

Losses resulting from debt financing should benefit from unlimited carry-over, or as the case may be, a carry-back of three years.

Withholding tax

In order to avoid unnecessary prefinancing or not to jeopardize final tax exemptions, a full exemption of withholding tax and stamp duty should apply.

The Greek tax law should be amended to abolish stamp duties.

Position of the VCC

Interest income is normally taxable at the full rate. In some Member States, specific vehicles exist that are virtually tax exempt.

It would be recommendable to have tax exemptions in all Member States for VCCs that finance SMEs in assisted regions and/or tax rate deductions

Furthermore, attracting financial means by the VCC should be possible without any tax restraint. Therefore, debt/equity ratios and limitations on the deductibility of interest payments should be eliminated. Also, stamp duties on the transfer of loans, as exist in Ireland, should be abolished.

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