Private Equity Fund Structures in Europe
An EVCA Tax & Legal Committee Special Paper - June 2010

Contributors
Dorda Brugger Jordis – Austria
ALTIUS – Belgium
Tiberghien – Belgium
Accura Law Firm – Denmark
Borenius & Kemppinen – Finland
Proskauer – France
SJ Berwin – France
Clifford Chance – Germany
P+P Pöllath + Partners – Germany
ByrneWallace – Ireland
Di Tanno e Associati – Italy
European Investment Fund – Luxembourg
Loyens & Loeff – The Netherlands
CMS Cameron McKenna – Poland
Abreu Advogados – Portugal
Baker & McKenzie – Spain
Andulf Advokat – Sweden
Lenz & Staehelin – Switzerland
3i Group – United Kingdom
SJ Berwin – United Kingdom
Proskauer – USA
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I am delighted to introduce the latest issue of the EVCA Funds Structures Paper. Although this paper represents the continuation of an initiative first launched in 1994, its publication is especially timely, given that our industry faces unprecedented regulatory change, in the shape of the Directive on Alternative Investment Fund Managers (AIFMD), currently making its way through the European legislative process.

At the time of writing, the final text of the Directive, and the precise timetable, is still uncertain. But what is clear is that it will have a huge impact on private equity and venture capital fund managers operating within the European Union (EU), as well as those outside the EU wishing to market their funds to EU-based investors. The Directive may well affect the fundamentals of the industry, such as the day-to-day operation of a fund. However, because the final form of the Directive remains uncertain, we will not attempt to anticipate here what the impact will be. Detailed briefing notes on the specific impact of the Directive will be published as soon as the final text is agreed.

Given this uncertain future for fund structures, coupled with the economic climate, governments’ support of the industry may well be tested. Nevertheless, it should be remembered that private equity and venture capital plays a significant role in strengthening European economies – even in times of economic turbulence or downturn.

Over the past decade, many private equity and venture capital investment funds have been faced with complex structuring issues. This is because some European countries have standard solutions for domestic funds that are not appropriate for use in other European countries. These issues will be unaffected by a single European regulatory framework, no matter what form AIFMD finally takes.

With this in mind, this EVCA paper aims to:

- Revive and stimulate the discussion about the issues of European fund structuring and contribute to an open dialogue and exchange of views between the industry, policy-makers, regulators and other stakeholders.
- Provide a comparison of the structures seen across member states and highlight that the AIFMD, by its nature, will not align these; consequently, we urgently need action, both at member state and EU level, to ensure national private equity and venture capital structures can be used throughout the European single market.
- Encourage best practices and necessary requirements for efficient fund structuring.

The European Commission (EC) also recently published a report on how to remove the main barriers to cross-border venture investment (1), highlighting the problems of double taxation and (the lack of) tax transparency. We welcome their initiative.

I would personally like to thank the member firms of the EVCA Tax and Legal Committee that have contributed their expertise to this paper. Without their help, this report would not have been made possible.

Yours faithfully,

Javier Echarri
EVCA Secretary-General

(1) http://ec.europa.eu/venture-capital/index_en.htm
The importance of a dynamic private equity and venture capital industry is self-evident. A buoyant private equity market, providing equity financing to small and medium-sized enterprises (SMEs), is an important driver of a more competitive, entrepreneurial, innovative and dynamic economy. The private equity and venture capital industry is vital to the development of European economies and its role in helping the EU through this period of unprecedented uncertainty should not be underestimated.

Over the past decade, the industry has experienced significant growth; it has become an increasingly important source of finance and expertise for ambitious companies seeking to develop. Between 2000 and 2009, the European private equity and venture capital industry invested in more than 72,900 companies – funds under management in 2009 totalled €532bn, spread across 4,000 funds (2).

One recent phenomenon is the flourishing of pan-European private equity funds, with local teams sourcing deals in more than one European country and investors from all over Europe (and often the rest of the world). However, the industry as a whole works below its potential due to constraints in effective fund structuring. Certainly, there are natural obstacles arising from differences of language and legal and regulatory requirements. But on top of this, many private equity investment funds are faced with complex structuring issues because some European countries have standard solutions for domestic funds which will not be appropriate for use in other European countries. Complexities multiply when funds have investors from several countries and make investments in more than one country.

The most common fund structure used for private equity and venture capital investments is the UK limited partnership. Based on the principle of transparency, it prevents double taxation arising – something that would make investing in private markets uneconomic for investors. Indeed, one of the key concerns a cross-border fund manager must deal with is to ensure its activities (or those of any adviser) do not lead to the creation of a permanent establishment for the fund, or for the investors in that fund, in any jurisdiction other than that in which the fund is based (or in which the investors are resident). But this is not always easy.

Private equity and venture capital could make a greater contribution to the European economy if only we had a more consistent tax environment across the EU – one that took greater account of the industry’s specific concerns. If funds were able to freely operate across borders, they would achieve economies of scale. In addition, we would see more sector specialists, which would increase investment sizes, diversify portfolios and, ultimately, boost investors’ returns. Most importantly, perhaps, lower costs would encourage new entrants to the market, thereby increasing competition.

In December 2001, EVCA issued a position paper on the structure of private equity investment funds, which was reproduced in the Private Equity Fund Structures in Europe paper published by EVCA in January 2006. This paper updates our position and restates our recommendations.

(2) Source: EVCA/PEREP_Analytics.
Given the specificities of the private equity and venture capital business model, which is active primarily through long-term commitments in private companies, investment funds need flexible management according to the different phases of their investment cycle.

A country’s investment fund structures should accommodate the needs of both domestic and non-domestic investors. Any failing in this area could lead to investors seeking out foreign structures (incurring significant set-up and transaction costs) and, therefore, fewer domestic investors committing funds in that country. The legal structure of a fund needs to allow the fund manager to channel capital freely to the most promising entrepreneurial projects. Without this, investee companies will struggle to expand their businesses, especially in the early phase of their development.

To achieve optimal conditions for a national fund structure, the following issues should be addressed:

**Tax transparency of the fund**

The most efficient tax structure for investments in private equity and venture capital is one based on the principle of tax transparency. Put simply, it is necessary to prevent double taxation: first, at the fund level, when it receives income or realises an investment; and second, when an investor receives income or capital from the fund. Tax transparency ensures investors are only subject to tax in their home jurisdictions, just as they would be if the same way as when investing directly in company shares. Investors should not be in a worse position investing in unlisted companies through a fund than they would have been if they invested directly in the underlying companies.

Certain fund vehicles are generally considered as tax transparent in most European member states (MSs), such as limited partnerships(3) and funds for joint account(4). But for transparent structures to work effectively across Europe, it is essential that all MSs mutually recognise these types of transparent structures. That is not the case.

**Suitable domestic fund structures in all member states**

To reach peak efficiency, fund structures would have to be harmonised or fully regulated on a pan-European basis. This solution: (i) would reduce the costs related with the fund’s incorporation and management; (ii) could simplify the fund’s taxation; and (iii) should encourage foreign investment in all MSs by enhancing the free movement of capital.

**A fund structure suitable for international investors or for investors in other countries**

Certain MSs, where investments are made, may charge tax on capital gains made by non-residents. Therefore, a suitable international fund structure should ideally be transparent, in order to prevent double taxation; the taxing at source of capital gains should also be minimised. In addition, from a perception point of view, establishing a tax-transparent fund structure in a MS may be preferable to creating off-shore fund vehicles. The fund structure should be flexible enough to allow international investment by accommodating requirements of particular investors from countries that do not recognise certain vehicles as tax transparent.

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(3) For example: the English LP, German KG or Dutch CV.
(4) For example: the French FCPR, Spanish FCR or Luxembourgish FCP.
Preventing permanent establishment of the fund and/or the investors

It is essential that the fund does not create a permanent establishment that could result in taxation for itself or for the investors in the country/countries in which the management or advisory team operates or invests. This would make investing in these private markets unattractive to investors.

Using a structure not based on the above mentioned principle is likely to make the fund unattractive for investors. If the main goal is to enforce the free movement of capital, double taxation of the fund’s profits as a result of creating permanent establishments is inefficient and complex and can potentially deter investment.

No VAT to be levied on the management charge

It is desirable that no value added tax (VAT) is payable on management charges or carried interest, in order to attract more investors. Management charges and carried interest should be efficiently structured, which would be best achieved by ensuring they arise as a share of the fund. Additionally, irrecoverable value added tax on management and advisory charges and other costs should be minimised.

No undue restriction on the type of investments that can be made

To enhance the competitiveness of the fund and strengthen the free movement of capital by establishing a system based on the recognition of the structures used in other countries, MSs should not impose undue restrictions on the type of investments that can be made.

For a transparent fund structure to work effectively, it is essential that European structures meeting the above mentioned requirements be mutually recognised as fully transparent in each European country, both source and residence. Countries without a structure meeting the above requirements should be encouraged to adopt one.
The Matrix below identifies whether each country has a structure which fits with the objectives and principles set out in the original EVCA position paper and repeated in the chapter above.

In each country, we have selected the most typical and appropriate fund structure used in that jurisdiction. We have also included the US and Switzerland to enable readers to compare these developments within the wider international context.

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<td>Y(47)</td>
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(5) Applicable to the still prevailing fund structures. Currently, there is no prevailing structure for new funds.
(6) Tax exemption.
(7) Depending on structure/clarification with fiscal authorities recommended.
(8) Depending on the structure.
(9) For tax benefits, restrictions have to be considered, although they can be avoided by using another, less tax advantageous, structure.
(10) Note that investing through a Private Privak de facto might result in tax transparency.
(11) Under certain conditions, option is granted to avoid VAT on management charges (provided falling within the scope of Director power as stated in the by-laws). Moreover, it is possible to “reduce” the VAT cost by assuring that certain services can benefit from specific VAT exemptions (e.g. transactions in shares).
(12) It should be noted that the Private Privak is subject to some restrictions on the type of investments that can be made (for example, no direct participations in quoted companies).
(13) However, there are some restrictions relating to investments in specific sectors, such as the defence sector.
(14) A limited partnership structure does, in general, not create a permanent establishment for foreign investors, despite that the management company is Danish and has authority to act on behalf of the LP.
(15) The VAT treatment of management charges depends on the services rendered. The services rendered will partly be subject to VAT (ordinary management services) and VAT-exempt (services related to acquisition and disposals of shares). If the services are VAT exempt they will instead be subject to payroll tax.
(16) Individuals fully taxable in Denmark are taxable of carried interest, with up to 56.5% corresponding to the tax rate for salary income.
(a) Finnish limited partnership is not tax transparent for Finnish investors. A partnership is an accounting unit and its profits are taxed as income of the partners.

(b) If the Finnish limited partnership is engaged only in venture capital/private equity investments as defined in Finnish tax laws and praxis, the limited non-resident partner is taxed for his share of the profits of the partnership in Finland only to the extent that the income would be taxed in Finland if the partner received it directly. The special treatment applies provided there is an applicable tax treaty between Finland and the partner’s state of residence and that the investments are made through a Finnish limited partnership. It is possible that in situations where the actual investment decisions are made in Finland or a foreign investor permanently uses a related Finnish adviser, a foreign venture capital fund or its investor could be deemed to have a permanent establishment in Finland.

(c) It is possible to structure the carried interest of the fund managers to be taxed at a proportional tax rate instead of a progressive tax rate.

(d) The management company can choose not to charge VAT, but in that case it cannot itself deduct VAT and has to pay a tax on the wages it pays out, so that ultimately it needs to raise the amount of management fee it asks from the investors.

(e) Provided that the limited partnership is structured as a non-trading limited partnership.

(f) The use of a non-trading German limited partnership as a fund should generally not create a permanent establishment in Germany.

(g) Hungarian fund vehicles regulated by domestic law are the Private Equity Fund and Investment Fund, but in practice these are hardly used. Non-Hungarian investors usually prefer to use non-Hungarian fund vehicles. Therefore, in the attached matrix, our comments relate to structures involving non-Hungarian fund vehicles.

(h) The tax treatment of non-Hungarian vehicles will vary, but if treated as tax-transparent in their jurisdictions, then Hungary should in principle accept this approach.

(i) Usually these are non-Hungary-based.

(j) Depends on actual structure.

(k) Yes, if structured in a way that these retain the same character as the distribution that gave rise to them (e.g. capital gains, dividends etc).

(l) Despite the fact that the Fondo Chiuso is not tax transparent, international investors from White Countries benefit from the refund of the 12.5% tax on the yearly yield applied at fund level, which in substance leads to the same results of tax transparency.

(m) Under regulatory provisions, certain restrictions on investments are provided and can be derogated under certain conditions.

(n) The Luxembourg SICAR may be established under the form for fiscally transparent (SCS) or fiscally opaque (SARL, SA, SCA and SCSA) undertakings.

(o) Each foreign investor will be considered to be engaged in the conduct of a business through a Dutch permanent establishment to which the shares in the portfolio companies must be allocated. In computing the taxable profit of the permanent establishment, however, the benefits (gain and dividend) derived from the portfolio companies should generally be exempted under the participation exemption.

(p) Although the fund itself is not tax transparent, it may provide for tax transparency effect. Namely, the fund is exempt from income tax in Poland. Tax is paid upon the distribution of the profits of the fund to the investors. The rate of tax depends on the status of the investor. Individuals and corporations being Polish tax residents are subject to 19% income tax. Non-Polish residents can benefit from a lower rate of tax or even a full exemption on the participation in profits of closed-end investment funds.

(q) Simply investing through the closed-end investment fund does not give rise to recognised permanent establishment in Poland. The fund itself is exempt from income tax.

(r) Carried interest is understood as participation of the managers in the fund’s profits once returns are paid to the investors.

(s) Investments made by a closed-end investment fund are subject to several restrictions related, for example, to the types of investments and level of commitment that result in diversity of its investments. All restrictions are in line with EU law.

(t) It should be noted that it is possible to “reduce” the VAT cost by localising certain services outside the EU (e.g. administrative services) or by assuring that certain services can benefit from specific VAT exemptions (e.g. transactions regarding shares).

(u) The mere fact of investing through an SCR/FCR would not give rise per se to a permanent establishment in Spain.

(v) The standard SCR/FCR current regulations do not easily allow the structuring of tax-efficient carried interest for the promoters. However, depending on the specific circumstances, efficient structures may be implemented.

(w) These management charges are usually VAT exempted in Spain. However, advisory fees charged to the manager bear VAT, which is usually a cost for the manager.

(x) When a tax efficient carried interest structure can be implemented, VAT is typically avoided.

(y) Only partly, depending on the type of security.

(z) Depending on the activity.

{a} As long as it will be taxed as capital gain.

{b} Further to the entry in force on January 1, 2007 of a new legislation, Swiss private equity structures are generally structured as limited partnership for collective investments (SCPC: société en commandite de placements collectifs). As long as this investment vehicle does not own real estate, it is not subject to income tax (tax transparency).

{c} Swiss domestic law does in principle not recognise any tax liability in Switzerland for foreign investors.

{d} For domestic investors, a UK limited partnership is tax transparent for the purposes of income and capital gains.

{e} Other than foreign financial traders, investors in a typical limited partnership private equity fund managed in the UK should not have a taxable permanent establishment in the UK.

{f} VAT efficient structures can be put in place.

{g} Carried interest structured as a partnership interest should not be subject to VAT in the UK.

{h} To avoid a permanent establishment for non-US investors and to otherwise permit non-US investors to obtain beneficial US federal income tax treatment, certain investments such as investments in (i) real estate or real estate intensive companies, (ii) originated loans, or (iii) operating companies formed as tax-transparent entities should be avoided.
Conclusions and Recommendations

Countries such as the UK, Luxembourg and Finland already have appropriate structures in place that meet the needs of private equity fund managers and the investors in their funds. But, as the above table shows, Europe as a whole has much room for improvement. Most MSs and their governments have some distance to go if their investment environments are to be conducive to single-market use.

EVCA encourages MSs to develop structures which meet the objectives based on the principle of transparency and also encourages national governments to afford similar treatment to funds established in other MSs when doing business in the host country.

In addition, EVCA welcomes the European Commission Expert Group report on removing tax obstacles to cross-border venture capital investments(51). Its recommendations for improving the fiscal framework, which apply equally to private equity investment across EU borders, are something EVCA supports wholeheartedly, promoting, as they do, a levelling of the playing field for private equity and venture capital investment.

Ideally, the European Commission would create a pan-European single fund structure for private equity and venture capital investment funds alongside existing national structures. It would be a single fund structure that permits European institutional investors to invest freely in private equity and venture capital on a pan-European basis, without prohibitions and exorbitant costs. This fund structure would ensure investors were in no worse a position by investing through a fund than by investing directly in the underlying companies. On top of this, certainty in legal and tax treatments would simplify both fundraising and administration.

This remains the ultimate goal, but we realise it may not be practicable.

In the absence of a single pan-European fund structure, EVCA advocates the mutual recognition of existing national structures. This would ensure that all the fund's investors and managers, regardless of their country of origin, receive the same opportunities and benefits. As fiscally transparent structures are legally enforced in many EU countries, it would be sufficient for MSs to recognise this characteristic as a necessary common criteria. For transparent structures to work effectively, it is essential that they be mutually recognised in each European country.

The mutual acceptance of European country structures would catalyse cross-border activity, boosting the levels of capital available for European private companies and, ultimately, returns for underlying trans-national institutional investors.

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