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THE FINNISH VENTURE CAPITAL ASSOCIATION

KPMG

EC Consultation on cross-border venture capital - "Problems that arise in the direct tax field when venture capital is invested across borders" / Finland

Background

European Commission would like to gain further information on **actual** rather than theoretical problems encountered by individual citizens, businesses, Member States, tax administrations, intergovernmental, non-governmental and business organisations, tax practitioners and academia, which create direct tax related obstacles for cross-border venture capital investments.

Current status of direct tax obstacles for cross-border VC investments in Finland

The Finnish Venture Capital Association and KPMG Oy Ab are grateful for the opportunity to detail the current obstacles for cross border VC investments in Finland.

Since 2006 the cross-border VC investments were enhanced significantly by introduction of a specific provision in Income Tax Act (ITA), paragraph 9.5, entailing that certain foreign investors can invest into certain Finnish VC funds without creating a permanent establishment (PE) in Finland which would cause these foreign investors to be subject to tax for capital gains in Finland in addition to being subject to capital gains tax on the very same investments in their respective home jurisdictions.

The new ITA 9.5 paragraph proved out to be a successful catalyst for raising capital from foreign investors into Finnish VC funds. However, the scope of new foreign investors has been quite limited. Mainly these are other Nordic pension funds. *U.S.-origin and Asian investors* have not been incentivized to invest into Finnish VC funds by ITA para. 9.5. The current capital accumulation particularly in Asia therefore seems to be an opportunity missed by the Finnish VC industry, if action is not taken. Also another troubling matter is that no further capital injections from *international funds-of-funds* has been witnessed into Finnish VC funds despite of the enhanced tax rules under ITA para. 9.5. Funds-of-funds are namely funds that raise capital from investors and invest these into several different VC funds thus creating a more safe risk allocation for their investors than what the case would be if investors would only directly invest into one or two VC funds. The exclusion of international funds-of-funds from the Finnish VC market is a severe restraint on Finnish growth company scene's ability to raise capital to increase their growth, create further jobs and improve exports.

Tax treaties are outdated and fail to take into account present day investment structures

Most of Finland's tax treaties date back to between 1970s and 1990s. These tax treaties recognize the world as it was at the high time of large multinational corporations. The treaties facilitate all necessary means to carry out tax efficient cross-border investments by large multinational corporations. E.g. dividends and interests paid by Finnish subsidiaries are largely exempted from tax at source and capital gains derived from the sales of Finnish subsidiaries are exempted from Finnish tax. As a result the income derived from the investment is largely taxed only in the home jurisdiction of the foreign investor and there is no risk of double taxation.

The world in the 2000s and 2010s is very much different in the context of corporate finance. Multi-business conglomerates are more or less marginalized in Europe and most of the corporations follow a strategy where they concentrate their focus on a few chosen lines of business and aim to be world's no 1 on those. Investment into new businesses is no longer driven exhaustively by large corporations. Instead venture capital funds have taken the role to breed startup businesses and to develop more efficient structures for middle sized companies. The Finnish tax treaty network has not followed with the development and is sadly out of date.

Tax transparency: investment income subject to tax only in the hands of the investor

VC fund structures are based on the principle of tax transparency. Tax transparency ensures that investors suffer tax only once when they realize their investments into growth companies. In holistically Finnish VC investments this is the case. Most often the Finnish VC fund is in the form of a limited liability partnership (*kommandiittiyhtiö, Ky,* in Finnish). Investors into Ky are most often Finnish pension and insurance companies. A Ky is regarded as a wholly transparent entity in Finnish taxation. This means that the income of the Ky – received from investments made in to Finnish startups or middle sized companies – is only calculated at the level of Ky, but Ky does not pay any taxes on this income. Then the so calculated income is allocated to the investors of the Ky fund on the basis of each investor's rightful share to the profits according to the partnership agreement. Investors then pay tax on this allocated income (i.e. tax is paid only once).

When foreign investors invest into a Finnish Ky the picture gets more fuzzy. According to the Finnish legal practice a mere investment into a Finnish Ky may cause the foreign investor to create a permanent establishment in Finland and cause it to be subject to taxation in Finland on the investment income. Therefore a foreign investor is not treated similarly with Finnish investors when investments into Ky funds are in question. Also, what large multinational corporations achieved in the 1970 to 1990s through tax treaty benefits is not accessible for investors, if they seek to make modern VC type investments through fund structures into Finnish growth companies. A tax paid at source on VC type investments is not exempted in tax treaties.

Even though tax treaties are not helpful on the issue, this handicap was partially relieved through domestic law by the implementation of ITA para. 9.5 in 2006. ITA para. 9.5 stipulates that income received through a partnership share in Ky is not taxed in Finland, if the tax treaty between Finland and

the Ky partner (i.e. investor) is applicable and the income in question would not be taxable at source in Finland if it would have been received directly by the investor (i.e. without the Ky fund in-between).

Thanks to ITA para. 9.5 you nowadays can see e.g. Norwegian or Swedish pension funds making investments directly into Finnish Ky VC funds. This still leaves a great portion of capital accumulated worldwide non-accessible to Finnish growth company VC funds. Why does a majority of world's capital ring-fence Finnish Ky VC funds outside their investment scope?

The tax treaty problem remains unsolved

ITA para. 9.5 relieves the tax at source in Finland only if the tax treaty between Ky fund and the Ky partner is applicable. This means that the direct investor (limited partner) in the Ky fund (1) has to be a tax subject and (2) has to be resident in a tax treaty jurisdiction. This rarely is the case.

As explained above a very large portion of the world's investment capital is invested into funds-of-funds. By investing into an F-o-F an investor immediately gets a wide allocation of risks. For example if the investor has 10 million euros to invest, she can either invest to a direct 10% share in a 100 MEUR VC fund in one country or to a 5% share in a 200 MEUR fund of fund, which can invest into two VC 100 MEUR VC funds in two different countries. As a result through an F-o-F an investor can reduce her country risk immediately with 50%.

Funds-of-funds are usually structured as limited partnerships, because – as with Ky in Finland – these offer tax transparency also in other countries. However – from the point of view of ITA para. 9.5, the problem is the tax transparency in itself. Because limited partnerships are tax transparent, they are not tax subjects. Therefore, an F-o-F trying to invest into a Finnish Ky fund would fail the first precondition for the applicability of ITA 9.5, because the tax treaty between the country of residence of the F-of-F and Finland is not applicable because F-of-F is not a tax subject. One could argue that ITA para. 9.5 should be satisfied, if the investors in the F-of-F are tax subjects that are residents in a tax treaty jurisdiction. Unfortunately, Finnish tax offices have not agreed to this. As a result, for the time being, international F-of-Fs do not make direct investments into Finnish Ky VC Funds.

F-of-Fs are not the only investors who deem Finnish Ky VC funds non-investable. Also all investors that are resident in non-tax treaty jurisdictions refuse to invest into Finnish Kys. ITA para. 9.5 is clear on the subject that a tax treaty has to exist between Finland and the investor's home jurisdiction. This is paradoxical, because as explained above the tax treaties do not give any relief for the tax at source as such. Also, if a direct investment is made from a non-tax treaty jurisdiction into a Finnish company, for example the capital gains from the sale of the Finnish company would not be subject to tax in Finland according to domestic law. Only if the investments are pooled from several investors into a Finnish Ky fund for better risk allocation, then those investors that are in non tax treaty jurisdiction have to be singled out and their part of the profits would be taxed at source in Finland. Here again the 1970 to 1990s style large multinational corporations would be better off than modern style VC funds. As a result investments from non-tax treaty jurisdictions do not end up in Finnish VC funds.

Why do international investors use non-tax treaty jurisdictions? Finnish VC funds have little say in where for example Asian or U.S. origin investors pool their investment capital. Unfortunately, this often happens in non-tax treaty jurisdictions. The need to pool investments has a sound economic logic. Together several investors can share risks better, because by pooling investments they can allocate investment funds into several targets. Where to pool the funds is a harder question. The tax treaties have widely recognized the principle for large multinational corporations that taxes are paid on investment income in the home jurisdiction of the investor. Old-fashioned tax treaties do not recognize the same for fund structures. Therefore the investors face a decision on where to locate the vehicle that pools the investments. The natural decision driver here is to locate the vehicle in such a jurisdiction where the risk for creating a permanent establishment is the smallest and correspondingly the tax transparency and elimination of double taxation is most certain. In this competition it is usually the non-tax treaty jurisdictions that prevail. By excluding the possibility for elimination of tax at source for these types of investment vehicles, ITA para. 9.5 makes it in practice impossible for Finnish VC funds to raise capital from large international investment vehicles that are located in international financial centrums that do not have income tax treaties with Finland.

Why is tax at source then a problem? The rules for calculating taxable income for permanent establishments stipulate that income and expenses that are attributable to the PE have to be taken into account in calculating the taxable income of the PE. There are no international clear guidelines for these rules in the VC context. It is clear that all income from the investments would be allocated to the PE. In addition to this income in the home country of the investor, the investor may have large expenses from e.g. provisions that have to be made for pension payments that the investor (e.g. a pension fund) has to make in the future. To what extent the source country of the investment would accept these provisions to be deducted from the investment income in the PE's taxation is a question without a clear answer. The investors such as large pension funds face legal requirements from their home country legislation to avoid uncontrollable risks. Without clear guidelines it is simply too uncertain for them to predict how the country of source would accept deductions for their mandatory expenses. Therefore it is safest to seek a solution which provides for a pure taxation only in the home country of the investor much in the same fashion as the tax treaties provide for large multinational corporations for their strategic investments abroad.

Discriminatory tax rules evict certain financial advisory services industry from Finland

Due to above mentioned reasons Finnish Ky VC funds are able to raise capital mainly from Finnish investors and other Nordic investors that are willing to allocate funds directly into Finnish funds (i.e. without better risk allocation through funds-of-funds or similar investment vehicles). Vast proportions of world's investment capital are not accessible to Finnish Ky VC funds due to restrictive tax rules.

Due to these restrictions Finnish VC funds have ammunition to back up only the earliest phases of growth of small and medium-sized corporations. Larger Finnish growth companies are invested into through large multinational funds. This has also raised quite a lot of criticism within politicians and press in Finland recently and ownership through non-tax treaty jurisdictions is deemed unethical. Much of the criticism is paradoxically directed towards the Finnish companies that are the investment targets even

though as described above it is the domestic tax rules that do not grant similar tax treatment to fund structures as are given to large multinational corporations or domestic investors and Finnish investment target companies have little or no say at all in this.

In addition to building walls against foreign capital the Finnish tax rules on VC funds also restrict the development of financial services industry in Finland. ITA para. 9.5 is applied only to Kys. If the fund has any other legal form except a Finnish Ky, then protection is not given against the risk of permanent establishment. In a likely event that a new VC fund is formed and investors from Asia, Europe and U.S. are participating, it is often unlikely that a Finnish Ky is chosen as the legal form for the investment pooling vehicle. It is more likely that the vehicle is a foreign entity, for example a UK based LLP or a Luxembourg fund vehicle SICAV etc. ITA para. 9.5 does not give any relief against a permanent establishment risk in such a case (because the paragraph explicitly grants the relief only to a Finnish Ky). A permanent establishment can be formed for a foreign investment vehicle for instance if there is a fixed place of business in Finland (e.g. an office) which carries out functions that are not merely auxiliary or preparatory for the foreign investment vehicle. In practice this means that even if there would be an experienced venture capital team in Finland and they would be capable of managing a large VC fund which would make Europe-wide investments into growth companies, the Finnish tax rules would cause an exposure on the foreign fund (say an UK LLP) investors to be subject to tax in Finland for all investment returns that are received from these Europe-wide investments. This would be the case if the Finnish VC team's management functions would be deemed to be more than auxiliary or preparatory functions for the investment vehicle. It is clear that international investors cannot digest a risk that Finland would claim a tax at source on all investment returns and then investors would have to claim their home country expenses to be taken into account in Finnish tax computations without clear guidelines or previous case law helping out on this.

As a result of the above mentioned, the fund industry largely is situated outside of Finland especially when larger funds are looked at. This keeps the Finnish VC fund management industry more undeveloped than in other jurisdictions.

Conclusions

The consultation was requested to focus on actual rather than theoretical direct tax problems caused for VC funds within EU. From Finland's perspective the most tangible problem is the non-existence of wide scale foreign investments into Finnish VC funds managed by Finnish fund professionals. As explained above the reasons for this are to a large part tax driven. The improvement of domestic rules in 2006 gave some clear results for the better, but these results are clearly non-sufficient. If the member states are determined to compete for the world wide investment capital with Asia and the U.S., tax originated deterrents for VC industry growth should be removed as soon as possible. This would also be of help to EU commission's target to incentivize the location of investments funds into member states instead of international financial centrums.

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