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PRIVATE EQUITY AND VENTURE CAPITAL: INVESTMENT FUND STRUCTURES IN THE CZECH REPUBLIC

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Abstract

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A working private equity and venture capital market (PE/VC market) stimulates the business environment in a positive manner and impacts the level of economic growth of national economies. A study of the *Austrian Private Equity and Venture Capital Organisation/AVCO* (2004, p. 6) defines prerequisites for a correct operation of the PE/VC market. It views the legislative provision for suitable legal fund structures for PE/VC investments and their tax treatment as a key factor. In its publication, *Private Equity & Venture Capital in the Czech Republic* (2010, p. 14), the *Czech Venture Capital Association/CVCA* stresses that legal barriers are an important reason behind the limited scope of resources available to domestic PE/VC funds. Legal barriers prevent the establishment of a standard PE/VC fund in the territory of the Czech Republic, which fact in turn has a negative impact on the level of development of the domestic PE/VC market (fundraising, investment volumes, establishment of the infrastructure required for the operation of PE/VC funds). The purpose of this article is, based on an analysis of the relevant information sources, to assess how the current Czech legislation regulates the legal fund structures for PE/VC investments and their tax treatment. Proposals for a potential improvement of the situation are based on a comparison of the legislative framework applicable in the Czech Republic and the requirements defined by the *European Venture Capital Association/EVCA*, as well as the *AVCO* study (2004, 2006).

private equity, venture capital, tax and legal environment, private equity and venture capital fund structures

The private equity and venture capital (PE/VC) market in the modern sense has been developing continuously in North America and Western Europe since the late 19th century. The Czech Republic became involved in the action in the 1990's. According to *European Venture Capital Association/EVCA*, European businesses financed through PE/VC created over 1 million jobs between 2000 and 2004 alone; this represents employment rate growth of 5.4%. For comparison – during the same time period, employment rate growth in EU25 was at the level of 0.7% per year. Correct functioning of the PE/VC market presumably positively stimulates the business environment and impacts the economic growth rates of national economies (2011: EVCA – Key Facts and Figures).

A study published by the *Austrian Private Equity and Venture Capital Organisation/AVCO* in 2004 (p. 6) defines the prerequisites for the correct functioning of the PE/VC market, namely (1) the existence of suitable legal fund structures for PE/VC investments and their tax treatment, (2) the involvement of competent investors, (3) an environment offering attractive investment opportunities, potential for collaboration with complementary service providers and incentives in the form of state aid and (4) a functional capital market which ensures the liquidity of individual investments.

If the above prerequisites are satisfied, PE/VC's positive effects on domestic economy growth can develop in full, and PE/VC can represent one of the channels through which money flows from institutional investors towards SME's in order to encourage their expansion and innovation process, and to facilitate structural changes in the economy (AVCO 2004, p. 6). The *AVCO* study (2004, p. 6) views the legislative provision for suitable legal fund structures for PE/VC investments and their tax treatment as a key factor affecting the development of the PE/VC market.

In its publication, *Private Equity & Venture Capital in the Czech Republic* (2010, p. 14), the *Czech Venture Capital Association/CVCA* stresses that legal barriers are an important reason behind the limited scope of resources available to domestic PE/VC funds. According to *CVCA*, the relevant legal barriers prevent the establishment of a standard PE/VC fund in the territory of the Czech Republic. A great number of PE/VC funds operating in this country is thus domiciled in a different country and was incorporated in foreign jurisdictions.

The purpose of this article is to assess with a view to the above how the current Czech legislation regulates the legal fund structures for PE/VC investments and their tax treatment. A comparison of the legislative framework in place in the Czech Republic and requirements defined by the *European Venture Capital Association/EVCA*, as well as the *AVCO* study (2004, 2006), will then be used to formulate proposals for a potential improvement of the current situation.

MATERIALS AND METHODS

Data required for the analysis was obtained from studies published by the *European Venture Capital Association/EVCA*, *German Private Equity and Venture Capital association e.V.* (*Bundesverband Deutscher Kapitalbeteiligungsgesellschaften/BVK*), *Austrian Private Equity and Venture Capital Organisation/AVCO* and the *Czech Venture Capital Association/CVCA*. With *CVCA Tax and Legislation Committee* members was conducted a qualitative research to identify tax and legislation barriers concerning PE/VC in the Czech Republic. An E-correspondence as well as several phone interviews were held on the basis of semi-structured interviews expressed the attitudes, knowledge and experience with this form of financing. Topics of the asked questions were: tax and legal factors affecting PE/VC funds decision to enter a capital market, defining the tax and legal environment for limited partners and fund management companies, available PE/VC fund structures within Europe, the tax and legal environment for PE/VC in the Czech Republic, tax and legal barriers preventing the establishment of a standard PE/VC fund in the Czech Republic, legislative amendments of corporate law.

The data was processed using the content analysis method, while respecting the fact that according to Bartes (1997, p. 62), the basic task in the analysis of the data obtained is to find answers to the basic questions of Roman law: *Who? What? When? Where? How? By what means? Why?*

Definitions of key terms used herein come from *EVCA*'s statistical yearbooks.

RESULTS

Legal fund structures for PE/VC investments and their importance for the development of the PE/VC market

The *AVCO* study (2004, p. 66) stresses that if a policy is to stimulate the development of the PE/VC market, then legal regulation of legal fund structures for PE/VC investments and their tax treatment ought to be a priority. The PE/VC market terminology also refers to legal regulation of fund structures.

Fund structure represents the cornerstone of the PE/VC market because it affects the exercise of ownership title, the manner and scope of investor liability, the method of profit and loss distribution, the manner and extent to which investors can participate in the management of the PE/VC fund, the liquidity and inheritability of shares, and tax treatment at the levels of both the PE/VC fund and the investors.

If legislation is complicated in terms of concept and incorporates restrictions with regard to PE/VC investments, professional institutional investors in particular are unwilling to invest funds into such structures. In such case, the investors prefer foreign fund structures which are frequently associated with considerable establishment and transaction costs. However, if legislation is based on international usance, domestic PE/VC funds are being established (AVCO 2004, p. 95). The existence of funds in the respective country positively stimulates the development of the PE/VC market, and ultimately the entire economy. In addition to direct effects, such as fundraising and investments, indirect effects also need to be stressed: the establishment and development of infrastructure required for the functioning of PE/VC funds (fund management companies, administrators, depositaries, consultants). The provision of law usually consists of a set of individual legal norms regulating issues of fundraising, investment, portfolio building and tax treatment in the PE/VC context.

Table I contains an overview of basic PE/VC funds structures in selected European countries. *EVCA Tax & Legal Committee* stresses that the appropriate fund structure should always take account of specific conditions in the country in question and the requirements of domestic and foreign investors.

Requirements applicable to legal fund structures for PE/VC investments

Given the international competition in the area of PE/VC investment, the provision of law applicable to fund structures must be viewed as a crucial instrument stimulating the volume of capital invested in the country. Fund structure is a tool of the state economic policy, the effects of which on

I: *Suitable tax/legal structures for PE/VC investments in the legislation of selected countries*

Country	Suitable tax/legal structure from the point of view	
	Local Investors	**Foreign Investors**
Austria	Mittelstandsfinanzierungs-aktiengesellschaft (MFAG), Aktiengesellschaft (AG)	Mittelstandsfinanzierungsaktiengesellschaft, (MFAG), Aktiengesellschaft (AG), foreign structures
Belgium	NV (Participation Privilege), Limited Company, Privak and foreign structures	foreign structures preferable, possibly NV subject to tax treaty
Czech Republic	Qualified Investor Fund as a normal company (Joint Stock Company – a. s.), Qualified Investor Fund as a unit fund	foreign structures preferable
Finland	Limited Partnership	Limited Partnership for investors from tax treaty countries, foreign structures preferable for investors from non-treaty countries
France	FCPR, FCPI, FIP or SCR	FCPR or FCPI or foreign structures
Germany	GmbH, GmbH & Co KG nebo UBG	foreign structures or passive investment partnership
Hungary	Private Equity Fund, Investment Fund	foreign structures preferable
Ireland	Limited Partnership	Limited Partnership
Italy	Fondo Chiuso or foreign structures	foreign structures preferable
Luxembourg	SICAR, SICAV or FCP	SICAR, SICAV or FCP
Netherlands	Commanditaire Vennootschap (CV) as a Limited Partnership	Commanditaire Vennootschap (CV) as a Limited Partnership
Poland	Limited Liability Company	Limited Liability Company
Portugal	Local corporate structure (VCC (SCR) – CRF (FCR))	Foreign structures
Spain	Local corporate structure (SCF-FCR)	Foreign structures
Sweden	Limited Partnership, Qualified Investment Company and Consortium	foreign structures preferable
Switzerland	foreign Limited Partnership structures preferable for tax reasons	foreign Limited Partnership structures preferable for tax reasons
UK	Limited Partnership, Investment Trust, Venture Capital Trust	Limited Partnership & a other structures
USA	Foreign structures or US structures may be appropriate depending on other factors	Foreign structures or US structures may be appropriate depending on other factors

Source: *EVCA* (2006, p. 14); working material of *CVCA* (2010)

the amount of PE/VC investment in the form of legal certainty are shown in particular over the long term.

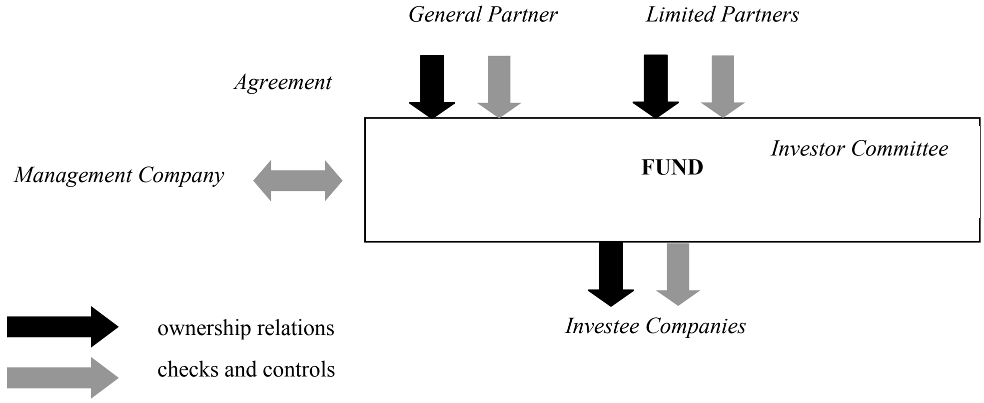
The *AVCO* study (2006, p. 80–83), the *EVCA* study (2010), and further, Horvath (2006, p. 100) and Dvořák/Procházka (1998, p. 32) stress that the economic policy of the state ought to focus on the resolution of the following issues in particular as regards the optimization of fund structures:

1. Provision of law for such structuring of PE/VC funds which is in harmony with the international provision of law for Limited Partnership as a legal form

According to Dvořák/Procházka (1998, p. 30) and Rudolph/Haagen (2004, p. 12), a PE/VC fund is a company established for the specific purpose of raising of funds from investors, which funds are subsequently used to purchase shares in selected business entities (the investee companies). A fund management company needs to be distinguished from a PE/VC fund. A fund management company assesses investment opportunities, selects potentially efficient investment projects, monitors the investments made and carries out the sale of shares in the target companies through its professional managers. However, the final decision on the investment is made by investors' representatives who, together with representatives of the fund management company, sit on the investor committee. The activities of the fund management company are regulated by an agreement on the provision of advisory services.

Generally speaking, an investor prefers such legal PE/VC fund structure which limits its liability for the capital invested clearly allocates powers and liability and is constructed in a way which ensures a transparent flow of information and controlling rights exercise. The legal form of a PE/VC fund further ought to facilitate the most flexible fundraising possible.

The relationship between the investors, the fund, the fund management company and the recipients



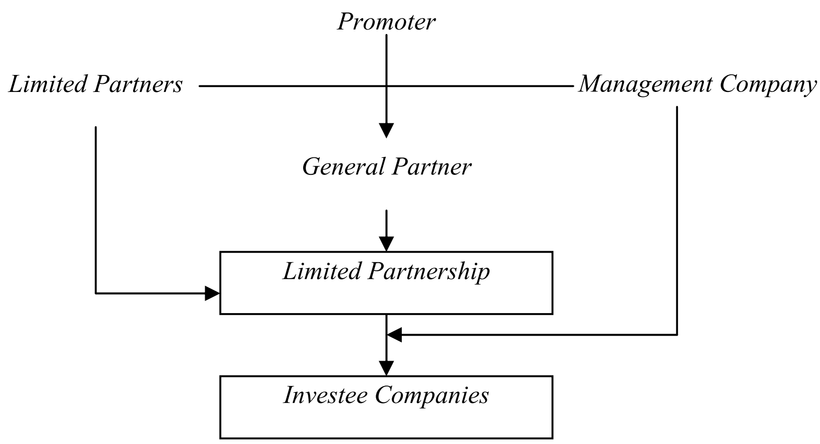
1: *PE/VC market – key elements*
Source: *EVCA* (2006, p. 12), Dvořák/Procházka (1998, p. 31), modified

of the capital (the investee companies) is shown in Fig. 1 below.

On international scale, the most common legal form of PE/VC funds is the *Limited Partnership/LP*. It is modelled on the concept of *Limited Partnership* as provided for in the legislation of the UK and USA, as it conforms to the requirements of the PE/VC market and is used anywhere where a domestic provision of law does not exist (AVCO 2004, p. 95).

LP is frequently translated into Czech as "komanditní společnost" (k. s.); however, the two terms cannot be considered identical. Viewed under the Czech Commercial Code (Act No. 513/1991 Coll., Section 93 (1)), a *LP* is not, unlike a "komanditní společnost", a trading company – a legal entity – but a partnership, which makes a significant difference from a legal point of view. The *LP* is a truly transparent entity (tax and legal transparent), and thus, as compared to a "komanditní společnost", makes a much more flexible input of capital and profit distribution possible. The *LP* may make an immediate capital call to investors for the purpose of investments, while the "komanditní společnost" has to increase its registered capital formally for that purpose, or use other options (issue premium, loans) which may be inconvenient from a tax perspective. Further, profit distribution is simple in the *LP*. Profit from any exit simply "flows through" the *LP* and is distributed to the investors in accordance with agreed rules (after fees and carried interest are deducted). This element of flexibility is very important for both investors and fund management companies for the purpose of cashflow management. The "komanditní společnost" on the other hand has to distribute profit in a formal manner, i.e., after financial statements are approved and the General Meeting resolves on the distribution.

Dvořák/Procházka (1998, p. 32) and Horvath 2006 (p. 100) summarize the reasons for the utilization of this legal form in the case of PE/VC funds. These include its flexibility thanks to the possibility individual regulation of the working mechanics of the company in the partnership agreement, the option of limiting the investors' liability to the amounts of their contributions, and the tax treatment. The legal form of the *LP* is



2: *Common PE/VC fund structure outline*
Source: Dvořák/Procházka (1998, p. 33), modified

comprehensible for the investors, and represents a standard of a sort on the PE/VC market.

The most common form of a PE/VC fund structure is shown in Fig. 2.

If a PE/VC fund has the legal form of *Limited Partnership*, both legal entities and individuals may serve as *Limited Partners*, i.e., investors. The contractual relationship between the investors and a PE/VC fund is set forth by a *Partnership Agreement*. *Limited Partners* are entitled, depending on the amount of funds invested, to a share in the fund's yield. They are only liable for the obligations of the *partnership* to the extent of their contributions, and are not entitled to participate in its management.

The post of *General Partner* is usually held by another company, most frequently with the legal form of a limited liability company. According to literature (Dvořák/Procházka 1998, p. 33), the choice of the legal form of a limited liability company serves a purpose because the *General Partner* is liable for the obligations of the *Partnership* to the extent of its entire property. The legal structure described above, however, somewhat blunts the liability of the *General Partner's* partners. The *General Partner* is the only partner authorized to manage the business of the *Partnership,* and as such serves as the statutory body of the partnership. The statutory body, i.e., the *General Partner,* is de facto the statutory body of the entire fund (*LP*).

The *General Partner*'s shareholders are usually the founding investors, fund promoter, if defined, as well as the fund management company which is able to influence decisions on the fund's investments which it will subsequently manage (Dvořák/Procházka 1998, p. 34). However, it needs to be noted that there are usually close institutional, or sometimes personal, ties between the management company and the *General Partner* of the PE/VC fund (Horvath 2006, p. 101).

The *General Partner* usually has a certain smaller interest in the *LP*'s registered capital. The *General Partner's* participation in the investment is an important element because it sends a signal to the other investors in terms of the quality of the investment and the *General Partner's* motivation concerning the fund's results.

A great number of PE/VC funds is registered in countries referred to as tax havens in order to reduce the tax burden. The most frequently used *off-shore* territories include the Cayman Islands, the Virgin Islands, Bermudas, or Cyprus and Luxembourg in Europe (Dvořák/Procházka 1998, p. 35).

Management companies which take care of the assets of PE/VC funds investors are mainly have the legal form of the limited liability company, followed by the joint stock company in fewer cases. Dvořák/Procházka (1998, p. 32) state that management companies are registered either in jurisdictions of their operation or in countries offering advantageous conditions.

2. Tax transparency of the PE/VC fund structures

An efficient tax structure for investments into PE/VC funds is based on the principle of tax transparency. According to Paštiková (2006), an entity which is not a payer in the tax system pursuant to which it was organized, established, or to which it has close ties, can be deemed to be tax-transparent. This means that taxable income is not taxed at the level of such entities but only at the level of their members/shareholders/partners (i.e., investors). Therefore, there is no additional layer of taxation – double charge.

Tax transparency in the context of PE/VC market is based on the thesis that PE/VC fund investors should not be in a position worse than that of investors who invest directly into the investee companies. PE/VC funds established as *Limited Partnerships* are generally considered to be tax-transparent.

According to *EVCA* study (2006, p. 13), three types of tax structures can currently be identified in the EU as regards PE/VC investments. The first group is represented by countries which have specific structures in their legislation to accommodate investors on a transparent or tax-free basis. Such structures are relevant for both national and international investors. The second group of member states comprises countries which have specific structures which accord favourable taxation treatment in that country under certain conditions. However, such structures are frequently not useful in practice because they are complicated or subject to restrictive conditions. The last group of countries are countries which have no transparent structure at all, and PE/VC investors therefore have to use foreign structures in low tax areas. If national structures are used (e.g., limited liability company, limited partnership, joint stock company, collective investment structures, etc.), those are non tax transparent structures.

EVCA Tax & Legal Committee recommends that countries lacking transparent PE/VC fund structures adopt same.

3. Recognition of PE/VC fund structure as a specific form of the management company in order to avoid undesirable tax disadvantages for foreign investors

From a tax perspective, personal trading companies are transparent entities. However, if a trading company is pursuing business in the territory of a certain country, its members (i.e., investors) are frequently obliged to have a permanent establishment within the meaning of tax laws. The member thus becomes obliged to become registered, to file annual returns at stipulated dates and to become a tax payer.

However, this does not apply if the PE/VC fund structure is recognized as a specific form of the management company. No permanent establishment is created in the country in which the investment is made, and as a result, a double taxation treaty between the country of investment and country in which the investor has tax domicile can also be applied.

4. *No undue restrictions on funds' investment activities with respect to geographic distribution of investments (domestic, foreign), business areas, investment size, etc.*

If no legislative restrictions apply to investment strategies of PE/VC funds, techniques enhancing the performance of PE/VC investments can be used actively. However, this parameter is insignificant. Geographic and other restrictions are generally not imposed by legislation, save for funds subject to financial regulation (see para 6).

5. *VAT exemption of management services provided by the PE/VC fund management company*

The PE/VC fund management is usually institutionalized by way of a separate management company providing services to the PE/VC fund under a management contract. Such institutional separation represents an institutional usance because it ensures that the processes between the fund and the management are transparent, and affords the management team its own business identity. The management company receives a management fee for services provided, which fee is usually determined as a percentage of the volume of assets managed. The management company usually further requires a certain share in the appreciation of the fund's capital, up to 20% of the carried interest generated above and beyond the threshold agreed with the investors ("hurdle"). Services related to the management of PE/VC funds by fund management companies ought to constitute VAT-exempt performance. Otherwise, the price of services provided by the management company is increased by the tax (the fund cannot claim a refund) due to the institutional separation of the PE/VC fund and its manager.

6. *No financial regulation for PE/VC funds which approach institutional investors*

The primary objective of financial regulation as a set of rules and norms regulating the operation of

II: *Typical structure of funds in selected countries from the perspective of tax and other legal conditions*

Country	Structure	Tax transparent for domestic investors?	Ability to avoid permanent establishment for international investors from treaty or non-treaty countries?	Ability to avoid paying VAT on management charges?	Ability to avoid paying VAT on carried interest?	Freedom from undue restrictions on investments?
Austria	Mittelstands-finanzierungs-aktienge-sellschaft (MFAG)	Yes	Yes	Yes	Yes	Yes
Belgium	Limited Company, Privak	No	N/A	No	Yes	Yes
Czech Republic	Fund of qualified investors as an investment fund (joint stock company)	No	Yes	Yes	Yes	Yes
Finland	Limited Partnership	Yes	Yes	Yes	Yes	Yes
France	FCPR	Yes	Yes	No	Yes	No
Germany	GmbH & Co KG	Yes	Yes	No	Yes	Yes
Hungary	Private Equity Fund or Investment Fund	Yes	Yes	Yes	Yes	Yes
Ireland	Limited Partnership	Yes	Yes	Yes	Yes	Yes
Italy	Fondo Chiuso	No	Yes	Yes	Yes	Yes
Luxembourg	SICAR	Yes	Yes	Yes	Yes	Yes
Netherlands	CV as a Limited Partnership	Yes	No	Yes	Yes	Yes
Poland	Limited Liability Company	Yes	Yes	Yes	Yes	Yes
Portugal	VCC (SCR)-CRF FCR)	No	N/A	Yes	No	No
Spain	SCF-FCR	No	N/A	Yes	No	No
Sweden	Limited Partnership	No	No	Yes	Yes	Yes
Switzerland	Limited Partnership	No	Yes	No	No	Yes
UK	Limited Partnership	Yes	Yes	Yes	Yes	Yes
USA	Limited Partnership	Yes	Yes	Yes	Yes	Yes

Source: *EVCA* (2010, p. 6); *CVCA*'s internal document (2010))
Note: In each case the most appropriate structure available in each country has been taken.

financial institutions is to increase financial stability and to protect the sector of retail (non-qualified) investors. Financial regulation thus applies to the activities of both commercial banks and other financial institutions and to the asset management segment where the manager takes care of another party's capital on a fiduciary basis. However, this concept of regulation is not suitable for the purposes of the PE/VC market because PE/VC funds focus on institutional investors who manage highly valuable assets, are managed by professional management, and have completely different requirements than retail investors. Therefore, the regulation of activities of PE/VC funds cannot be put on the same level as that of other (collective) investments because PE/VC investments are not intended for the general, non-qualified public. In the case of PE/VC funds, equity rather than third party capital is invested, and the requirement of appreciation reflecting the business risk involved is required. Investors provide funds for the direct purpose of investment with a view to the PE/VC fund's investment strategy, and not, as is the case in bank transactions, on terms and conditions known beforehand (e.g., as is the case of applicable interest rate), where the investor is unable to influence the application of funds.

In 2010, *Directive on Alternative Investment Fund Managers* was adopted on EU level; starting from 2013, it will also regulate the PE/VC market, hedging and other funds and their managers. Although it provides for certain exemptions, it will probably apply to large PE/VC funds as well. Costs will presumably increase and yields drop for both the funds and their managers.

Table II shows an overview of selected European countries and the extent to which they have structures defined in paras (1)–(5) in their jurisdictions. For each country, a typical legal PE/VC fund structure was selected. The situation in the USA is also shown in the table for comparison.

Legal PE/VC Fund Structures in the Czech Republic

The *Benchmarking European Tax and Legal Environments* study (2008) published by *EVCA* assesses selected European countries with a view to their legislative and tax frameworks and their impact on PE/VC investments. Each country is assessed in three categories, namely: the tax and legal environment for limited partners and fund management companies, the tax and legal environment for investee companies, and the tax and legal environment for retaining talent in investee companies and fund management companies. The composite score of each country is the result of a total of thirty variables on a scale of 1 (the best) to 3 (the worst). The countries were then ranked in terms of attractiveness for PE/VC investment (Tab. III).

Tab. III shows that France, Ireland and Belgium offer the best tax and legal environment with respect to PE/VC investment stimulation potential.

III: *Ranking of countries in terms of PE/VC investment attractiveness in 2008*

Country	Composite Score
France	1.23
Ireland	1.32
Belgium	1.33
UK	1.45
Greece	1.46
Spain	1.58
Netherlands	1.63
Portugal	1.63
Luxembourg	1.65
Lithuania	1.75
Switzerland	1.76
Denmark	1.77
Hungary	1.84
Average	**1.85**
Austria	1.87
Latvia	1.88
Finland	1.92
Poland	1.95
Italy	1.96
Sweden	2.02
Norway	2.03
Estonia	2.06
Germany	2.18
Cyprus	2.24
Romania	2.27
Slovenia	2.30
Slovakia	2.33
CR	2.40

Source: EVCA (2008, p. 11)

Interestingly, even countries such as Germany, Sweden and Italy ranked below the European average, although their national markets are among the largest in Europe in terms of both fundraising and the volume of investment made.

In the "tax and legal environment for *Limited Partners* and management companies" category, the existing legal PE/VC fund structures are also assessed (EVCA 2008, p. 186). The assessment is based on six variables: the existence of a dedicated or suitable domestic fund structure or investment vehicle for PE/VC investments (CR's score: 1), tax transparency of legal PE/VC fund structures for domestic Limited Partners (CR's score: 3), tax transparency of legal PE/VC fund structures for non-domestic Limited Partners (CR's score: 3), ability of non-domestic limited partners to avoid having a permanent establishment in the country (CR's score: 1), exemption of PE/VC fund management companies from VAT on management fees (CR's score: 1) and freedom from undue restrictions on PE/VC funds on investment strategy and instruments (CR's score: 1).

The Czech Republic scored 1.67 on average in the "tax and legal environment for *Limited Partners* and management companies" category. It thus came below the European average in said category (EU25 score – 1.5).

According to *CVCA* (2010), legal barriers bar the establishment of a standard PE/VC fund in the territory of the Czech Republic. A great number of PE/VC funds operating in the Czech Republic is therefore domiciled in other jurisdictions and was organized pursuant to foreign laws – foreign offshore fund structures are normally used. The importance of appropriate legal fund structures for the development of the PE/VC market has already been mentioned.

Generally speaking, the following options for investment into a business entity are available in the Czech Republic (EVCA 2006, pp. 42–44):

1. The investor makes a direct investment, i.e., purchases a share in the registered capital of the target trading company, and becomes its shareholder/member. Trading companies, and the rights and obligations of shareholders/members, are governed by Act No. 513/1991 Coll. (the Commercial Code) in the Czech Republic.
2. The investor takes part in collective investment, i.e., entrusts its money to a fund which raises funds from investors and creates an investment portfolio.

Entities involved in the collective investment sector in the Czech Republic were mostly organized pursuant to laws of foreign jurisdictions, and pursue their business in accordance with such respective foreign laws. Act No. 189/2004 Coll., on Collective Investment, defines the legal form of *Qualified Investor Fund/QIF* (as of 2006) which can be used as a structure for collective investment in the form of PE/VC. Topinka (2007) states that *QIF*'s may have the legal form of an investment fund (as a regulated joint stock company with fixed capital), or an open-end or closed-end mutual fund (*QIF* as a unit fund). If the *QIF* is established as a unit fund, its establishment and management requires the existence of a regulated investment company (again with the legal form of a joint stock company). Unlike unit funds, investment funds have legal personality or may use third parties for the performance of defined activities.

Only qualified investors may invest into *QIF*'s; these are enumerated in full in the law (e.g., banks, insurance companies, pension funds and experienced qualified investors who make a representation to that effect). A *QIF* may be established solely without a public offering, i.e., its shares (units) as an investment instrument are not intended for the general public.

The advantage of *QIF* as compared to other collective investment funds lies in the fact that the law places no restrictions on *QIF* in terms of investment strategy and investment instruments. Therefore, *QIF*'s are not subject to undue restrictions on investment. The rules governing the activities of the fund are set forth in its statute, and its formation and commencement of business operations are subject to the grant of a license by the Czech National Bank. Where applicable, the fund's assets are in custody or other care of a depositary bank which may also monitor the fund's activities in greater detail if so agreed with the fund. Following the amendment to the Collective Investment Act in 2009, the originally strict conditions applicable to depositaries have become less stringent, and the depositary now no longer has to monitor and check, and merely keeps assets in custody.

From the investors' perspective, *QIF*'s are, as compared to trading companies organized pursuant to the Commercial Code, attractive in particular thanks to the tax rules applied: *QIF*'s are subject to a preferential tax regime – a 5% corporate income tax (Act No. 586/1992 Coll., on Income Tax). According to literature (Vlčková, Suchý, Šandera, 2010), due to difficulties arising in the application of certain provisions of tax laws, practical utilization of a *QIF* in the form of a unit fund is limited. Investors therefore prefer investment funds subject to tax conditions similar to those applicable to regular trading companies. Another advantage is the possibility of exemption of investment fund profit distributions from income tax if the investor is a trading company (tax resident of the Czech Republic or other EU member state) holding a minimum of 10% of the investment fund's registered capital for at least 12 months. However, a *QIF* in the form of an investment fund is not a tax transparent entity because profit at the fund level is subject to tax, although at only 5%.

Foreign investors' investment through *QIF* is not associated with the creation of a permanent establishment, i.e., foreign investors are not obliged to register in the Czech Republic, and are thus not subject to other regular obligations (e.g., the obligation to file annual returns).

The *EVCA* study (2006, p. 44) states that PE/VC funds established and operated in the Czech Republic pursuant to foreign laws are not subject to any separate tax rules. If a PE/VC fund pursues its business through a domestic permanent establishment, such entity is fully subject to taxation in the Czech Republic, same as other legal entities resident/domiciled in the territory of the Czech Republic. If a foreign fund invests in the Czech Republic without establishing a permanent establishment, its income generated in this country is taxed at the source in accordance with the applicable double taxation treaty. If the jurisdiction of the fund's incorporation considers the fund tax transparent, Czech tax authorities should theoretically respect this fact.

DISCUSSION

Despite the advantages outlined above, QIF is not a structure which would be in harmony with international standards. From the point of view of international investors, the one of the most comprehensible legal fund structures is the *Limited Partnership*. While the Czech Commercial Code does define the legal form of *komanditní společnost* (Section 93 of the Commercial Code), it cannot be currently used for the purposes of collective investment pursuant to the Collective Investment Act (for the public) in its current form. The legal form of *komanditní společnost* theoretically is an option for investment through PE/VC, not available to the public, but there is no practical experience available as yet.

If the PE/VC market in the Czech Republic is to be positively stimulated, legislative amendments are required in order to provide for the legal form of *Limited Partnership* in a manner comprehensible to international investors, whether in the Commercial Code, or by means of a new act on business corporations which is to supersede the Commercial Code as of 2012, or in the Collective Investment Act. The following in particular needs to be stressed in the next paragraphs.

The *QIF* as a joint stock company is governed by the applicable provisions of the Commercial Code. Compared to other legal forms of trading companies, its establishment and activities are complicated. Prior to its incorporation, the company must obtain a license from the Czech National Bank. On the other hand, structures such as a *Limited Partnership* are established by virtue of a *Partnership Agreement* in which all pertinent matters, as outlined above (management authority, profit and loss distribution, etc.), can be regulated in a flexible manner. In the United Kingdom, the Netherlands or Luxembourg, the establishment of a *Limited Partnership* is not even subject to any prior consent of the competent financial services authority.

The *QIF* is a regulated joint stock company with a stipulated minimum registered capital requirement (CZK 2 million given the fact that a QIF may be established solely without a public offering). The QIF must raise a minimum of CZK 50 million within one year of its incorporation, otherwise, its license may be revoked by the Czech National Bank. Where the *Limited Partnership* is concerned, the law does not stipulate any minimum registered capital. This is more in line with the "*capital call and return on exit*" concept which is typical precisely of PE/VC investment where funds are only raised when required and distributed to the investors upon exit.

The *QIF* needs a license from the Czech National Bank to be able to commence its operations. The supervisory authority examines in particular the source of the fund's capital, its business plan, suitability of founders and experience and qualifications of the fund's management. The Czech National Bank further reviews the fund's statute to ascertain whether it meets the statutory requirements and whether it contains all the requisite information. The *QIF*'s assets are held in custody or other care by a depositary bank. Countries with developed PE/VC markets either do not apply any financial regulation at all (the United Kingdom or the Netherlands can serve as an example of this approach), or apply only a "mild" form of regulation is applied by the regulatory authority. However, it needs to be noted that the *Directive on Alternative Investment Fund Managers* (*AIFMD*) may lead to a marked change of this situation.

The advantage of *QIF* is that its investment goals and policy (i.e., asset types, limits, risk spread) can be defined in its statute. In this regard, QIF is a sufficiently flexible structure which is in full harmony with the requirement of no restrictions on investment activities of PE/VC funds (the issue of risk diversification). Any restrictions in this area prevent a full utilization of the potential of investment opportunities, and are contrary to the spirit of PE/VC investments.

In the context of a *Limited Partnership*, there are active and passive investors. The *General Partner* who manages the company and has unlimited liability for its obligations is an active investor. *Limited Partners* have no management authority and are liable only up to their contributions. A *QIF* in the form of a joint stock company does not permit the distinction of investors – shareholders – as passive and active; however, mutual relations can be regulated by shareholders agreements. *A QIF* in the form of a unit fund makes such distinction possible.

QIF can be established for a definite period of time or in perpetuity; this is in line with international standards.

In a *QIF*, the investor exits by a sale of shares or the distribution of liquidation proceeds, as the case may be. The law does not define transferability of an interest in the case of an *LP*, and this is left to contractual arrangements.

In the case of a *QIF*, the fund is exited by means of the dissolution and liquidation of the joint stock company. In the case of a *Limited Partnership*, the general option also is to wind up and liquidate the business entity upon the elapse of the agreed period, and to distribute the proceeds from the sale of assets subsequently.

The legal form of a *Limited Partnership* is a partnership, which makes it a tax transparent structure. If the *LP* has the status of an "asset manager," investment into the fund does not involve the creation of a permanent establishment for foreign investors. That is the only way to ensure that investors will be tax payers in jurisdictions whose tax residents they are. Specific tax rules applicable to investors depend on their respective domiciles. *QIF*'s are subject to corporate income tax at a reduced rate (5%). If the investor is a trading company (tax resident of the Czech Republic or other EU member state), profit distributions from the investment fund may be subject to exemption, as mentioned above. A *QIF* in the form of an investment fund then becomes a tax transparent entity.

The management services provided by the regulated management company to the investment or unit fund are VAT exempt (Act No. 235/2004 Sb., on VAT). This provision is in harmony with international standards which view PE/VC funds as property values which ought to be VAT exempt pursuant to the EU Directive. Otherwise, an additional tax burden arises which has a negative impact on the performance of the fund and which results solely from the separate organization of the PE/VC fund and the management company.

In summary, the main barriers preventing the establishment of a standard PE/VC fund in the Czech Republic are the inflexibility of corporate law (fixed capital level requirements, non-existence of share classes, etc.), tax obstructions and non-transparency of the existing structures.

CONCLUSIONS

A stronger capital position of domestic companies can be deemed to be a prerequisite for a stronger competitive position in world markets. This is particularly true for young, technology-oriented businesses which cannot be expected to launch an IPO in the foreseeable future.

National legislation ought to respect the requirements of such companies and introduce appropriate legal PE/VC fund structures for the purpose of investment. Otherwise, the current status will remain in place where PE/VC funds, as well as management companies, mainly operate pursuant to foreign laws, and where "smart" private equity can only be purchased outside the Czech Republic.

If the above recommendations concerning legal PE/VC fund structures are successfully incorporated into national legislation, the Czech Republic will have a modern investment tool required for the successful development of the PE/VC market.

SUMMARY

This article strives to assess how the current Czech legislation provides for the legal PE/VC fund structures and their tax treatment. Data required for the analysis was obtained from studies published by the *European Venture Capital Association/EVCA, German Private Equity and Venture Capital association e.V. (Bundesverband Deutscher Kapitalbeteiligungsgesellschaften/BVK), Austrian Private Equity and Venture Capital Organisation/AVCO* and the *Czech Venture Capital Association/CVCA*. The introduction defines the prerequisites for the correct operation of the PE/VC market. The legal regulation of suitable legal fund structures for PE/VC investments and their tax treatment can be seen as a key factor. The "Results" section analyses key area to be focused on by the economic policy of the state in terms of optimization of fund structures, and assesses the current situation in the Czech Republic. The development of the PE/VC market in the Czech Republic is obviously adversely affected by the following factors: inflexibility of corporate law (fixed capital level requirements, non-existence of share classes, etc.), tax obstructions and non-transparency of the existing structures. If the PE/VC market in the Czech Republic is to be positively stimulated, it appears necessary to make legislative amendments addressing the problem areas outlined. In "Discussion", proposals for improvement of the current status are formulated.

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