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Obstacles to Nordic Venture Capital Funds

Promoting a common Nordic venture capital market

Updated version 2011



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1. Executive summary

This is a new version of the “Obstacles to Nordic Venture Capital Funds” report first published in November 2006 and updated in 2007 and 2009. Since publication of the original report, discussions regarding these issues have been ongoing in various forms in the Nordic countries. Although positive changes have been made in several of the countries, new obstacles in different forms have also emerged.

The overall recommendations from the original report are therefore to a large extent still valid and with the Nordic venture capital market currently under severe pressure, the discussion about the conditions and regulations for venture capital has become even more important.

The number of venture capital funds in the Nordic region and the amount of capital managed by them have decreased substantially over recent years due to several factors.

A well functioning venture capital market is an important engine for economic growth and the creation of new industries, companies and employment in the Nordic countries. Furthermore, a venture capital market helps to attract international capital to the region.

Today, these facts has been acknowledged by all the Nordic countries and efforts have been made to improve the regulations for the venture capital market in the Nordic countries as well as on a European level. An important part of the regulations for venture capital relates to legal and taxation issues pertaining to transnational investments into venture capital funds.

There is today broad European consensus that there would be far more cross border investment in funds if the funds encountered fewer obstacles to cross border capital raising. This is a significant problem, especially for smaller growing venture capital funds.

In the Nordic countries there are different kinds of obstacles to venture capital funds receiving transnational investments. The purpose of this report is to describe the status in each country and thereby also function as a Nordic best practice study.

In addition to transnational obstacles, other regulations also pose a threat to the market. In several of the Nordic countries the profit of venture capital firms, often called carried interest, is now being taxed or under the risk of being taxed as salary instead of as capital income. This strongly affects the attractiveness of the venture capital model.

Implications of new EU regulations for the private equity industry, the directive on Alternative Investment Fund Managers (“AIFM”), are also mentioned in the report. These are critical issues for the progress of the Nordic private equity market and will have to be addressed by all Nordic administrations.

The first part of the report contains overall common Nordic recommendations and provides an overview of the importance of as well as the present status of the Nordic venture capital market. The second part of the report contains detailed updated status reports and national recommendations regarding obstacles in each Nordic country.

Since the report is part of the Nordic Council of Ministers' efforts to promote a common and well functioning Nordic venture capital market, the term venture capital is used throughout the report. The legal aspects valid for venture capital equally apply to the buyout segment or other parts of the private equity asset class¹.

2. Recommendations

2.1 Overall Nordic recommendation

Since the publication of this report in 2007, some positive steps or at least attempts have been taken in Finland towards removing obstacles to operating venture capital funds on-shore. However, no actual changes in legislation have yet occurred, and therefore the proposed actions remain uncertain. As to the other Nordic countries, very few, if any, positive reforms have taken place. Consequently, the overall Nordic recommendation for removal of tax obstacles to venture capital investments remains fundamentally the same as before. However, the developments relating to the AIFM Directive and taxation of carried interest as salary require new, additional actions.

Venture capital funds organized as limited partnerships should be truly and fully transparent in terms taxation. This means that no income tax should be imposed in the country where the fund is established or where the management carries on the investment activities. The guiding principle should be that investors are only taxed in their country of residence, i.e. taxation should be imposed at the level of investors, not at the level of the partnership. All the countries should look through the venture capital vehicle to the end investor to ensure that tax is only imposed in the home state of the investor.

1. *Venture capital funds organized as limited partnerships should be truly and fully transparent in terms of taxation. This means that no income tax should be imposed in the country where the fund is established or where the management carries on the investment activities. The guiding principle should be that investors are only taxed in their country of residence, i.e. taxation should be imposed at the level of investors, not at the level of the partnership. All the countries should look through the venture capital vehicle to the end investor to ensure that tax is only imposed in the home state of the investor.*
2. *No VAT should be imposed on management services of the venture capital fund. Since venture capital funds do not carry out any activities subject to VAT, the VAT charged on management services is non-recoverable and therefore an additional cost paid by the investors or management team. Although it is possible to avoid VAT in certain situations, some uncertainty remains and therefore local VAT regulations should clearly state that no VAT should be imposed on management services for venture capital funds.*
3. *In situations where local related advisors are used or decision-making takes place locally it is possible that foreign venture capital funds can be considered to have permanent establishments in target countries. The risk of taxing foreign funds on the basis of such permanent establishment should be abolished by explicit regulations.*

¹ Private equity is often defined as investments in non-listed companies. Venture capital, as a segment of private equity, refers to investments in new and early stage companies and buyout refers to investments in more mature companies.

4. *The developments relating to the AIFM Directive on the EU level as well as on national level should be carefully monitored to prevent new, potentially significant obstacles arising. The technical and implementation rules are currently being developed and might still be affected in attempt to suit the needs of the private equity industry as far as possible.*
5. *The profit generated in successful venture capital funds is usually called “carried interest”. In several Nordic countries carried interest is now either taxed as or at risk of being taxed as salary instead of capital income. To avoid making venture capital much less attractive, the legislators should make it clear that carried interest should be taxed as income from capital.*

2.2 Recommended actions

The Project Group recommends the Nordic Council of Ministers to support each Nordic Country to:

1. *continue the important work of removing obstacles to Nordic based venture capital funds in order to enhance the conditions of the common Nordic venture capital market and*
2. *move from the fact finding and benchmarking phase into that of presenting tangible proposals for the removal of existing obstacles.*

The Project Group further recommends the Nordic Council of Ministers to commission the Project Group to:

1. *continue to function as a Nordic reference group with legal expertise as well as with Nordic coordination and a Nordic market overview,*
2. *continue to support the efforts to implement changes in each Nordic country, and*
3. *report back to the Nordic Council of Ministers about the status of each country in 12 months time, to ensure follow up.*

3. Introduction

3.1 Project background

The Nordic Council of Ministers has acknowledged the importance of venture capital and commissioned several projects aimed at promoting a highly functional common Nordic venture capital market. The removal of cross border obstacles is one of the key objectives.

The present report is a new version of the “Obstacles to Nordic Venture Capital Funds” report, first published in November 2006 and updated in 2007 and 2009. It describes the main obstacles for transnational investments into Nordic venture capital funds.

There are several reasons for considering these issues on a Nordic level. The private venture capital market has become Nordic and the private venture capital firms often cover several Nordic countries. Thus, there has been an increase in Nordic cross border investments into funds, which highlights the need to remove the existing obstacles. Cross border investments into these funds from their investor have therefore become more common and made obstacles

for those investments a greater obstacle. Furthermore, by comparing the obstacles, the Nordic countries can learn from each other, despite the fact that their tax and legal systems differ.

On the European level, the European Commission has taken steps to remove obstacles to the cross-border provision of venture capital. However, these changes on a European level will however take time and the Nordic countries have an obvious opportunity to create a competitive advantage by more quickly improve venture capital market regulations. This would strengthen the Nordic region, making it a potential leader within European venture capital.

Since the original report was published, several improvements have been made in Iceland, Sweden and above all in Finland. However, as described in this updated report obstacles remain in most Nordic countries and new ones have emerged. These obstacles lead to less capital investment in promising young Nordic companies that contribute to Nordic innovation and growth.

3.2 The Nordic legal project

After recommendation by a project group of professionals from the Nordic national Ministries and the market, a “Nordic Legal Project” was commissioned in the spring of 2006. This resulted in the original report as well as the updated versions in 2007 and 2009. In 2011 Nordic Innovation, the institution under the Nordic Council of Ministers, commissioned the members of the Nordic Legal project to revisit the issue in order to describe any changes that may have taken place since the last report and to update the overall Nordic recommendations.

The mandate for the project is, as previously, to investigate the main problems encountered by international investors who consider investing in Nordic venture capital funds and to suggest solutions for problems identified.

In this new edition the format of the report has been changed. In addition to the joint Nordic recommendations, the report is divided into two main sections. The first broadly outlines the importance of the Nordic venture capital market and the serious challenges it is currently facing as well as the problems resulting from the existing obstacles to international investors. The second describes the actual obstacles in each Nordic country in a more detailed manner.

The Project group includes legal experts from the five Nordic countries as well as a Nordic private equity advisory firm.

Owner of the project:

Johan Englund, Nordic Innovation

Coordinators of the project:

Erik Johansson and Carl-Peter Mattsson, Nordic Investment Solutions

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As part of their broad efforts within venture capital, Nordic Innovation established a “Nordic Venture Capital Forum” composed of leading public and private market players in the Nordic and Baltic regions. The Forum functioned as a reference group for various projects as well as an advisor for potential projects. The input and feedback from the Forum were important during the execution of the Nordic Legal project and the Forum functioned as an active reference group for the original report published in November 2006 and for its recommendations, which for the most part remain valid in this updated version.

The members of the Nordic Venture Capital Forum were:

Anki Forsberg, Partner HealthCap, Sweden
 Cecilia Gross Friberger, Portfolio Manager, Sixth AP-fund, Sweden
 Christian Motzfeldt, CEO Vækstfonden, Denmark
 Claes de Neergaard, CEO Industrifonden, Sweden
 Petri Niemi, Senior Partner CapMan, Finland
 Peeter Saks, Managing Partner BaltCap, Estonia
 Tellef Thorleifsson, General Partner Northzone Ventures, Norway
 Jón Steindór Valdimarsson, Chairman New Business Venture Fond, Iceland

This report describes the updated findings and suggestions of the Nordic Legal Project and will be presented at the Nordic-European Public Investor Summit on November 24 in Stockholm.

4. Nordic overview – background and problem description

4.1 Why should policy makers care about venture capital?

The importance of a dynamic venture capital industry is to a large extent self-evident. A well functioning venture capital market, that provides equity financing to small growing companies is an important driver of a competitive, entrepreneurial, innovative and dynamic economy.

The venture capital model combines financing with active ownership and incentives to develop young companies and has produced many successful companies worldwide.

The venture capital market is an important engine for economic growth and the creation of new industries, companies and employment in the Nordic countries. Furthermore, it helps to attract international capital to the region.

Today, all the Nordic countries have acknowledged these facts and efforts have been made to improve the regulations for the venture capital market in the Nordic countries as well as on a European level.

However, the Nordic venture capital market is however under severe pressure, with fewer funds and less capital to invest in promising companies. This will be described further in more detail below.

The basis of the importance of venture capital can be traced back to the importance of young innovative companies' contribution to innovation and growth. Many studies have confirmed the role of young companies, so called start-ups, in regards to innovation, especially in new and emerging industries. For example, Professor Josh Lerner at Harvard University, a world leader within venture capital research, has concluded that growth is clearly linked to innovation and innovation is clearly linked to young companies.²

As to the importance of financing young companies, Peter Norman, the Swedish Minister for the Financial Markets, claims that risk capital is central for all companies, but sufficient equity is especially important for small companies in the start-up phase.³

The general view among academics and market players is that governments often place too much focus on providing additional capital to the market. Stage setting such as suitable tax regimes and ensuring that entrepreneurship is attractive, is more important.

Failure to create favourable conditions and regulations for the venture capital market means lower level of investments. This report focuses on a specific part of these regulations, the regulations for establishing Nordic venture capital fund structures of international standard.

Today, there is a broad European consensus that there would be far more cross border investment in funds if there were fewer obstacles to cross border raising of capital. This is a significant problem, especially for small but growing venture capital funds. In order to attract foreign capital to funds, it is even more important for smaller jurisdictions to have as few obstacles for cross-border investments as possible.

4.2 The Nordic venture capital market under pressure

The Nordic venture capital market has been under pressure in recent years. Several factors have combined to make it very difficult for venture capital funds to attract and raise capital in new funds:

- *Lack of attractive returns. Many of the Nordic venture capital funds have not delivered returns at the levels expected by their investors.*
- *Financial uncertainty. The financial crisis of 2008 and the present financial uncertainty have made investors more risk adverse and less willing to invest in venture capital.*
- *More capital aggregated in fewer hands. Today, more capital is managed by a smaller number of asset managers. These managers like to invest large amounts of capital in each fund, making it difficult for them to invest in venture capital funds, which by design are relatively small.*
- *European venture capital out of favour. Over the last few years, the trend within asset management has not favoured the European venture capital market.*

In 2010 only a few funds were successfully raised in the Nordic countries, such as Northzone Ventures headquartered in Norway and Conor Venture Partners in Finland.

Statistics reveal that Norway is the Nordic country with the highest level of fund raising in recent years, where funds such as Northzone Ventures, Energy Ventures and Verdane Capital.

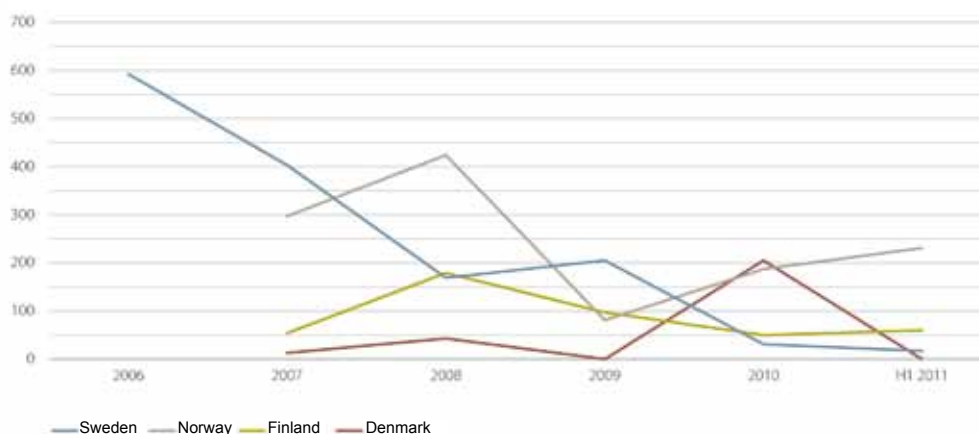
² Professor Josh Lerner, *Boulevard of Broken Dreams*, 2009, Princeton University Press

³ Riskkapital - För välfärd och svensk ekonomi, SVCA

The graphs below visualize the development of venture capital in the larger Nordic countries in recent years. The first graph shows the level of new funds attracted by the venture capital firms and the second the level of investments in portfolio companies from the venture capital firms.

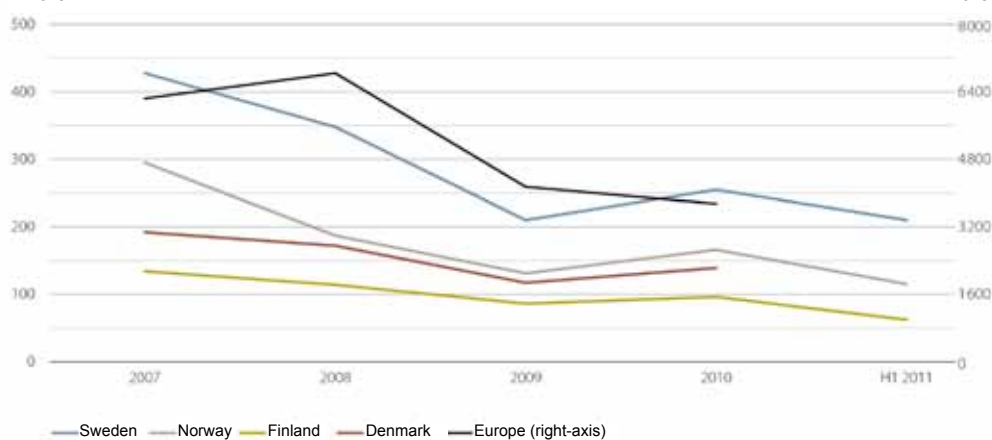
Fund raising by Nordic venture capital funds

MEuro



Investments by venture capital firms in the Nordics and Europe

MEuro



Source: Swedish Private Equity & Venture Capital Association

The decline of the private venture capital market has made public investors more important on the overall market, and also made the public investors make up a larger portion of the market. For example, in Sweden public investors represented 60% of investments in new portfolio companies in the growth segment.

However, it's important to bear in mind that the venture capital market is cyclical and that successful exits and funds could once again make it more attractive to private investors again. Therefore, favourable regulations are important for the Nordic venture capital market.

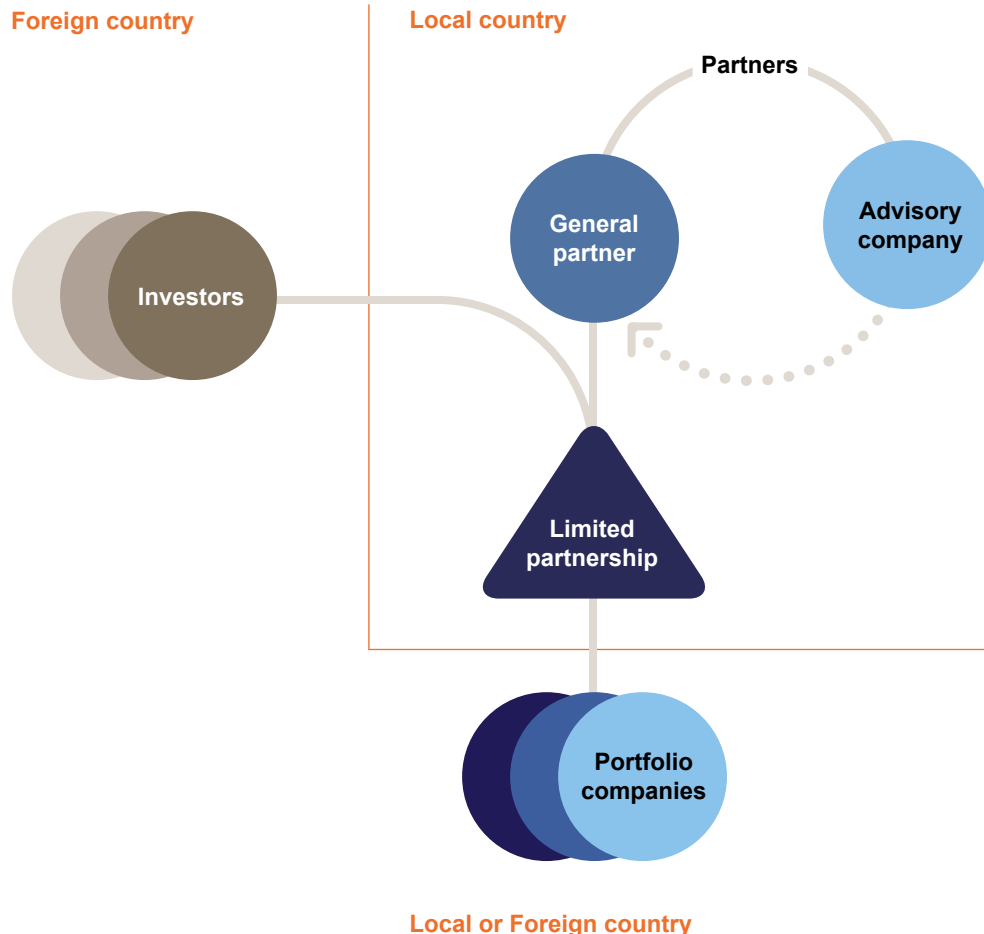
4.3 Overview of obstacles for venture capital funds

In the Nordic countries there are different kinds of obstacles to venture capital funds receiving transnational investments. As mentioned above, the purpose of this report is to describe the status in each country and thereby also function as a Nordic best practice study. Detailed descriptions of the obstacles in each Nordic country can be found in the national sections below, written by the participating law firms.

In this section, a brief overview of the obstacles and their implications will be presented.

The picture below presents the structure of a normal venture capital fund of international standard. The fund is formed as a limited partnership, invested in by both national and international investors. The limited partnership then invests in portfolio companies, which again can be both national and international.

The investors are called limited partners since they are only responsible for the capital they have invested. Full responsibility for the limited partnership rests on the general partner, controlled by the firm managing the fund. The actual management services are carried out by an advisory company (the venture capital firm) that can function as an advisor to several funds.



Obstacles can emerge on different levels of the structure. Obstacles can pertain to the foreign investors tax situation when investing in the fund, VAT on advisory services, unfavourable tax treatment of the management share of the profits and problems regarding the fund investing in portfolio companies abroad.

In the Nordic region as in Europe today, most venture capital firms operate in several countries, which makes the cross-border problems more complex.

The obstacles in the various Nordic countries differ from problems with laws on Limited Partnerships, to uncertainty on taxes on so called carried interest and problems for investors from countries without bilateral tax treaties.

Since publication of the original report, discussions regarding these issues have been ongoing in the Nordic countries. Although positive changes have been made in Sweden, Iceland and above all Finland, obstacles remain in most countries and new obstacles have emerged.

It is worth emphasizing the importance of removing obstacles as well as the need to ensure considerate policy making so as not create new ones by changing laws and regulations for other reasons/to avoid creating new ones when laws and regulations are changed for other reasons.

The European Private Equity and Venture Capital Association (EVCA) have also looked into the issue of obstacles to venture capital funds. EVCA concluded: "Most member states and their governments have some distance to go if their investment environments are to be conducive to single-market use."⁴ Changes on the European level will, however, take time and the Nordic countries have an opportunity to move more rapidly than their European neighbours to create suitable conditions for the venture capital market.

The table below presents a comparison of different aspects and obstacles in the Nordic countries. It is followed by a brief introduction to the obstacles in each Nordic country. A more detailed description with recommendations can be found in each national section.

At the end of this section the Directive on Alternative Investment Fund Managers from the European Commission is briefly described. The regulation directive has to be implemented by all countries and coordination on how the directive is interpreted in the Nordic countries is very important for the market.

⁴ Private Equity Fund Structures in Europe, An EVCA Tax & Legal Committee Special Paper – June, 2010

Comparison table of obstacles to Nordic venture capital funds

1. *Are institutional investors in a fund taxed in the same way as if they had owned the shares directly?*

	Sweden	Denmark	Finland	Norway	Iceland
High level answer	Yes, but only if the investor is a company in the EU/EEA area and holds the shares as a capital asset.	Yes, however a Danish Limited Partnership may in some cases lose its transparency for tax purposes if a majority of the investors for local tax purposes treat the Limited Partnership as a tax subject.	Yes, but only for investors resident in tax treaty countries and assuming they are tax subjects under the treaty.	Yes, with respect to Norwegian portfolio companies. No, with respect to foreign portfolio companies, as ownership in a Norwegian partnership creates a tax liability to Norway.	Income deriving from shareholding in Iceland is regarded as taxable income in Iceland, and as such taxed in Iceland. However, if a Tax treaty states that the relevant income is only to be taxed in the home country of the investor, the investor has to apply for a special exemption from taxation.
Obstacle	Investors outside the EU/EEA area or investors that hold the shares as a trading asset (which includes banks and insurance companies) are taxed in Sweden.	None.	Investors from other than tax treaty countries or investors from tax treaty countries that are not tax subjects under the treaty could be treated as having a permanent establishment in Finland.	Investors outside Norway may be subject to a higher tax and a tax reporting obligation.	It is up to the relevant tax treaty if the income deriving from shareholding in investment funds is taxed in Iceland. If it is not taxed in Iceland, investors have to apply for a special exemption on the grounds of authorization in a tax treaty.
Effect	It is difficult to have a Swedish structure with non-Swedish investors.	None.	Difficulties to attract “non-qualifying” investors, in particular funds of funds, to Finnish funds.	Difficult to set up Norwegian structures where foreign investors are invited.	May hinder investors from countries that do not have a tax treaty with Iceland. The need to file for an exemption based on a tax treaty may also be a hindrance. Noncompliance can lead to the investors being subject to taxation according to Icelandic tax legislation. Taxes paid in these instances can be refunded if an application is submitted to the tax authorities.
Recommendation	Swedish law should be changed so that investors in tax transparent partnerships are always taxed as if they had owned the shares directly.	None.	Finnish exemption should be extended to non-tax treaty investors and e.g. fund of funds.	Norwegian law should be changed to have full transparency for partnerships.	We recommend that Iceland concludes tax treaties with more countries. We also recommend that the procedure of submitting a special application for exemption according to authorization in a tax treaty should be abolished.

2. Is the fund managers part of the profit, the so called carried interest, received by the partners of the fund manager taxed as capital income?

	Sweden	Denmark	Finland	Norway	Iceland
High level answer	Yes, carried interest should be taxed as capital income at 25%.	Since 2010 carried interest has been taxed as salary income, provided that the fund partner is a tax resident of Denmark.	Carried interest may be structured as business income of a corporate entity and taxed at corporate income tax rate.	Yes.	Yes, carried interests are taxed as capital income. If the receiver is an individual the income is taxed at the 20% rate. If a company (non resident), then taxed at the 18% rate, (20% if resident) - hence the income is taxed as capital gains, not as salaries. (According to a proposed bill before the Icelandic parliament, the tax for individuals and companies may be reduced to 10%).
Obstacle	The Swedish Tax Agency has recently taken the position that carried interest should be taxed as salary at ~57% + social security fees at 31.42%.	The applicable salary tax rate is up to 56 % compared to capital income taxation at 42 %.	(Taxation of carried interest received by the partners directly remains unclear. However, Finnish structures do not typically distribute carried interest directly to individuals.)	The taxation will depend on whether the management holds sufficient ownership in the fund, to which the carried interest can be referred to.	None.
Effect	If the Tax Agency is right, there is a considerable risk that the private equity industry will be forced to move to other countries.	Private equity fund partners who are tax resident in Denmark have an (additional) incentive to leave Denmark.	None.	If no, or only insignificant ownership, the carried interest will be taxed as salary, with the effect that management must move out of Norway.	None.
Recommendation	Swedish law should be changed so that it is confirmed that carried interest is taxed as capital income.	The Danish taxation of carried interest is out of line with the legislation in the other Nordic countries - and the EU member states - and should be changed.	None.	No clear answer today. This should be further clarified by law or statements from the tax authorities.	None.

3. Is the advisory fee subject to VAT?

	Sweden	Denmark	Finland	Norway	Iceland
High level answer	Yes, at 25%.	No, the management services will most likely be considered a VAT exempt financial service.	No.	No, provided it is considered a financial service.	Yes, at 25,5%.
Obstacle	Advisory services rendered to a Swedish fund are 25% more expensive than services rendered to e.g. a Jersey or Cayman fund.	None.	Lack of guidance and published court cases concerning the concept of financing services.	The term "financial service" is unclear, and some of the advisory fee may fall outside the exemption and be subject to 25 % VAT.	Advisory services rendered to an Icelandic fund are 25,5% more expensive than services rendered to e.g. a Jersey or Cayman fund
Effect	It is less advantageous to establish a Swedish fund structure.	None.	Some uncertainty among funds concerning some services relating to funds.	It is less advantageous to establish a Norwegian fund and management structure.	Less advantageous to establish an Icelandic based fund.
Recommendation	Swedish law should be changed so that investment advice rendered to private equity funds are VAT exempt.	None.	VAT treatment could be clarified by legislation or administrative guidance.	Norwegian law should be changed so that investment advice rendered to private equity funds are fully VAT exempt.	The Icelandic VAT law should be changed so that service rendered to Iceland based funds (inside Iceland) is VAT exempt.

4. Are investments in local portfolio companies taxed differently just because the owner is a private equity fund?

	Sweden	Denmark	Finland	Norway	Iceland
High level answer	No.	No.	Yes, in certain situations	No.	No.
Obstacle	None.	None.	A private equity investor is subject to tax on capital gains on shares while an industrial investor may benefit from participation exemption if the investment is made directly to the target company.	None.	None.
Effect	None.	None.	Private equity funds are less attractive to certain investors.	None.	None.
Recommendation	None.	None.	Participation exemption on capital gains should be extended to private equity funds.	None.	None.

Sweden

Swedish partnerships can starting from 1 January 2010 indirectly benefit from the tax-free treatment under Sweden's rules on participation exemption. This means that Swedish limited partnerships are now able to receive capital gains and dividends tax free as long as the capital gains and dividends would have been tax free if they had been received by the investor directly. This has opened up possibilities to organize private equity funds as Swedish limited partnerships (Sw. kommanditbolag) instead of limited liability companies (Sw. aktiebolag).

The changes in relation to the enlarged applicability of the participation exemption rules to limited partnerships are positive but will not alone suffice to revitalize the Swedish venture capital industry.

From an overall industry perspective, recent years have been very tough for the Swedish venture capital industry. As compared to a decade ago, there are very few Swedish based private funds that are making investments in early stage opportunities. The reason for the shortage of capital is that a great number of the private funds that have been active in the Swedish venture capital market for many years have not succeeded in raising successor funds.

A few years ago, the Swedish Tax Agency launched a project with the aim of scrutinizing the Swedish private equity industry. During the last years, it has become clear that the Swedish Tax Agency's main focus is on the taxation of "carried interest". Carried interest refers to the profits generated in a successful private equity fund that are usually received by the management of the fund, and which typically amount to 20% of the net profits in the fund provided that certain thresholds are met. Up till recently, it has been commonly believed that carried interest should be taxed as income from capital, just as any other income from

investments. The Tax Agency has, however, taken the position that carried interest should be taxed as employment income, arguing that carried interest is not a split of profits since it is usually not received pro rata to the invested capital but a compensation for services rendered by the management team of the fund.

The collective opinion in the community of tax lawyers and scholars is that the Tax Agency's position is wrong and that it lacks legal support and it is now a question for the Swedish tax courts to decide on. Until then, the uncertainty following from the Tax Agency's position will likely negatively affect the entire Swedish private equity industry.

The Swedish member of the project, Mannheimer Swartling, states that it seems to be generally acknowledged that the government must take measures to actively support the Swedish venture capital market. Apart from increasing the effectiveness of the governmental financing to newly started and growing companies and the establishment of a fund-of-funds that shall invest in Swedish venture capital funds, it should also be considered to remove certain taxes applicable both to the fund entities and their investors that are harmful for the revitalization of the industry. It is important to combine all these different measures so that companies in all stages of their lifecycles can obtain the necessary financing for their developments.

In order not to risk paralyzing the entire Swedish private equity industry for many years given the uncertainty regarding taxation of carried interest, the legislator should make it clear that carried interest should be taxed as income from capital.

Finland

Both legal and tax legislation applicable to Finnish venture capital funds can be regarded as satisfactory for the most part. From a legal point of view, Finnish limited partnerships are generally speaking suitable for venture capital activities, as there e.g. are no restrictions on how profits can be allocated among and distributed to the partners or on how the business of the limited partnership is organized. The limited partnership form also offers the flexibility that needed in venture capital activities. However, the legislation is mostly general and not always optimally suitable for the specific features of the venture capital business, or in part leaving certain issues as a matter of interpretation. This means that in practice fund documentation may need to address certain considerations resulting from mandatory provisions of law in a way that is less than ideal, but the Finnish Partnerships Act does not set any hard obstacles for using a partnership as a fund vehicle.

However, some issues still remain obstacles particularly in relation to taxation. Application of the tax regulations to venture capital funds and especially to non-Finnish investors has presented certain open issues.

After the Income Tax Act amendment entered in force in 2006, a Finnish limited partnership carrying on venture capital investment activities no longer constituted a permanent establishment for investors resident in tax treaty countries (assuming they are tax subjects under the treaty), and also foreign investors began to participate in Finnish funds. Although it was previously thought that international investors often just lack trust in Finnish fund structures, recent developments indicate that this may not be necessarily the case.

Obtaining optimal tax treatment still requires some administrative work by the fund and in some cases legal assistance. The important issues remaining include the fact that the changes

made in 2006 only apply to investors from a tax treaty country and only provided that such investors are tax subjects under the treaty. For some funds of funds (which, even if organised in a tax treaty jurisdiction, may not be tax treaty subjects), this may constitute an obstacle for investing in a Finnish fund, or at least require investing through holding structures. The tax treatment discriminates investments through Finnish funds as the capital gains from shares in portfolio companies would not be taxable in Finland if the investor makes the investments directly (or through a foreign fund) to portfolio companies.

Although in practice management fees from funds have not been subject to VAT, ideally this would be more clearly confirmed in tax laws and praxis.

In addition, tax considerations pose an obstacle for investments by charitable associations in venture capital funds and in non-listed companies.

Although the remaining obstacles to venture capital funds have been acknowledged in public discussions, no concrete actions towards eliminating them have taken place in Finland.

Norway

Under Norwegian corporate law there are, in practice, three available structures for a venture capital fund. The fund can be incorporated as either a private limited liability company (Nw: *aksjeselskap (AS)*), a limited partnership (Nw: *kommandittselskap (KS)*) or a silent partnership (Nw: *indre selskap (IS)*), of which the silent partnership has the most similarities with an offshore limited partnership, and is therefore the preferred Norwegian structure (both IS and KS are hereinafter referred to as limited partnerships).

According to Norwegian tax law, limited partnerships are tax transparent entities, as opposed to limited liability companies which are taxed at company level. The tax exemption under the participation exemption provides, as a starting point, a relatively investor-friendly tax regime, both with respect to fund level and portfolio level taxation.

When the fund vehicle is a limited partnership, it is assumed that the limited partnership will most likely be deemed to constitute a Permanent Establishment for foreign investors. As a result, foreign investors in a Norwegian limited partnership become liable for tax to Norway on the income of the limited partnership, according to internal tax law. However, the Norwegian participation exemption will, under the current regime, in many cases effectively exempt foreign investors from Norwegian taxation. Foreign corporate investors are obliged to file tax returns with the Norwegian tax authorities as a result of their investments in a Norwegian limited partnership.

Even though there is limited taxation due to the participation exemption, the filing obligation and the perception of the Norwegian tax regime as being unpredictable in certain sectors are considered obstacles for foreign investors when considering investing in Norwegian limited partnerships. Although not creating a Permanent Establishment, Norwegian limited liability companies are subjected to more cumbersome distribution regulations which in themselves are considered an obstacle.

As a consequence, most venture capital funds initiated by Norwegian venture capital firms, with the aim of attracting foreign investors, are organized as tax transparent limited partnerships

in foreign offshore jurisdictions, in particular the Channel Islands. These jurisdictions are generally internationally-accepted and thus, preferred by international investors. However, if the targeted investor base is purely Norwegian entities, a Norwegian structure is more likely to be chosen.

Financial services, as defined in the Norwegian Trading Securities Act, are exempted from VAT. Services rendered by a management company to a venture capital fund in a typical structure are, in relation to VAT, deemed as financial services provided that such services relate to “genuine” investment activities. Services that are not connected with the investment activities, such as typical funds administration services, are not comprised by the exemption and are consequently subject to VAT. In practice, the determination of whether or not a service should be subject to VAT is in certain cases proving to be difficult, and is subject to an increased focus by the tax authorities. These uncertainties should be avoided by a more precise exemption from VAT for management companies of venture capital funds.

The taxation of the management’s carried interest has, to some extent, been uncertain in Norway. However, it is normally assumed that as long as the carried interest is based on an ownership in the fund, it should be considered as a capital gain. However, there is no clear rule of thumb on how large the ownership should be in order for the whole carried interest to be considered as a capital gain.

The Norwegian member of the project, Wikborg Rein, recommends that it is clarified, either in Norwegian law or by the Norwegian tax authorities, that foreign investors’ investment in a limited partnership is not deemed as a permanent establishment and that the corporate legislation is amended to be as flexible with regard to distribution in and out of the fund vehicle as in competing offshore jurisdictions. Furthermore, it is recommended to abolish the 3 % tax (effectively 0.84%) on dividends for corporate entities.

Wikborg Rein further recommends that the NVCA continues its close dialogue with Norwegian political and regulatory authorities in the process of translating and implementing the AIFM directive. It is important to focus on ensuring that the implementation of the AIFM directive is in line with that of the other European countries and in particular the Nordic countries. We further recommend that the Norwegian authorities enter into co-operation agreements with regulators in recognized offshore jurisdictions outside the EU (for example Guernsey and Jersey) to enable funds based in these jurisdictions to be marketed in Norway.

Denmark

Denmark has so far been the Nordic country with the least obstacles for venture capital funds. Danish Limited Partnerships (kommanditselskaber) can be used as vehicles for venture capital funds, since neither Danish nor foreign investors will be taxed on the income derived from the Limited Partnership in Denmark. The Danish Limited Partnership structure is also very similar to the structure that foreign investors are used to from Anglo-Saxon based funds, which further implies that the legal documentation is normally drafted along the same lines as the Anglo-Saxon funds and thereby known by foreign investors.

In the past couple of years, certain negative developments have, however, surfaced. The Danish government has introduced salary taxation of carried interest paid to fund partners. Obviously this will not help Denmark attract and retain the best fund partners.

Additionally, in recent years the Danish tax authorities have launched an attack on dividend and interest payments to, primarily, foreign holding companies owned by private equity funds - claiming that the holding companies are not the beneficial owners of the payments and thus the Danish paying companies should have withheld taxes on such payments.

These cases have contributed to legal uncertainty for cross-border investments into Denmark, especially with respect to the private equity business, since they, in many structures, effectively prohibit shareholder loans into Denmark as well as it making exits, “recaps” and other cash withdrawals very difficult.

However, the conclusion still remains that no major legal issues are impeding *foreign investors* from investing in private equity/venture capital funds in Denmark, but the conditions have become less attractive for the *fund partners*.

Additionally, Plesner recommends for example that the Danish tax authorities explain the administrative tax practice more explicitly and set it out in the Tax Assessment Guidelines to avoid uncertainty.

Iceland

During recent years, Icelandic partnership legislation has undergone substantial improvement. The concept of Public Limited Partnerships (PLP) was introduced in 2006 and the Partnership act in 2007.

It should be noted that despite the lack of a dedicated partnership act, partnership has been an accepted form of business in Iceland for many years. The reason for the implementation of the PLP structure was to provide an appropriate option suitable for investment funds that could attract local and foreign investors as well as facilitate their cooperation.

Substantial changes have been made to the Icelandic tax law and the government has indicated that more will be forthcoming. At present, no information is available as to whether will be systematic changes or just increases in tax rates. These changes might result in higher taxation on companies.

The Icelandic member Deloitte recommends that full emphasis be placed on the stability of the Icelandic tax regime so as to attract foreign investors to invest in Icelandic venture capital funds. Corporate income tax and tax on capital gains have been raised considerably over the past two years, making Icelandic venture capital funds less attractive for foreign investors.

Deloitte further recommend that transparency of the Icelandic tax system be focused upon, with the full cooperation of the Icelandic tax authorities. In particular, access to binding rulings could be improved. It is also important that more conventions for the avoidance of double taxation are concluded.

Despite the above-mentioned short-comings, Icelandic tax law is presently not considered an obstacle to the establishment of venture capital funds in Iceland

4.4 Directive on Alternative Investment Fund Managers

On 27 May 2011 the Council of the European Union (the “Council”) adopted the directive on Alternative Investment Fund Managers (“AIFM”). The main features of the AIFM directive are authorization requirements for AIFMs, regulation of marketing and third country provisions, depositary requirements, remuneration policies requirements, general principles for conducting the AIFMs business activities and reporting/disclosure requirements relating to capital, valuation, use of leverage and asset stripping provisions.

The AIFM directive entered into force on 21 July 2011, and the member states (including Norway through the EEA agreement) have to implement the Directive in national law by 22 July 2013. Today the full effect of certain elements of the directive remains unclear. It is expected that the full effect of the directive will become clearer during the implementation process, where the European Commission and the European Securities and Markets Authority (“ESMA”, formerly CESR) will have a leading role. In November 2011, ESMA is to publish its advice to the European Commission on the Level 2 provisions.

The AIFM directive encompasses managers of all funds, which are not UCITS funds, including venture capital funds, save for certain smaller funds, namely funds with managed assets below: (i) 100 Million EUR (for leveraged funds) or (ii) 500 Million EUR (if the fund itself is not leveraged, which is the case for most venture capital funds, and has no redemption rights in the five year period following the constitution of fund).

In order to strengthen venture capital funds’ competitive position in terms of access to sources of funding, the European Commission launched on 15 June 2011 a consultation on special rules for venture capital funds, which considers a voluntary regime for managers of venture capital funds where such managers may register for an EU-wide marketing passport whilst only being required to comply with certain provisions of the AIFM directive. The new regime is proposed to apply only to venture capital funds, i.e. buy-out funds will be regulated by the AIFM directive.

We recommend that the respective Nordic venture capital associations conduct a close dialogue with political and regulatory authorities in the process of translating and implementing the AIFM directive. It is important to focus on ensuring that the implementation of the AIFM directive is aligned among the Nordic countries and in line with that of the other European countries. We further recommend that the Nordic authorities enter into co-operation agreements with regulators in recognized offshore jurisdictions outside the EU (for example Guernsey and Jersey) to enable funds based in these jurisdictions to be marketed in the Nordic countries without any unnecessary burden that might restrict the number of funds available for Nordic investors.

5. What do investors look for in terms of legal and tax treatment of a venture capital fund?

5.1 Present status

The majority venture capital funds that make investments predominantly in the Nordic region do not operate out of the Nordic countries. As stated above, some Nordic countries have today no structures that can compete successfully with foreign fund structures as they lack either of two important criteria for venture capital funds, namely favorable tax treatment and trust.

5.2 Legal

From a legal point of view, investors expect a private equity fund to be structured in such a way that there are basically no restrictions on (i) how profits can be allocated among and immediately distributed to the partners, or (ii) how the business of the limited partnership is organized. The freedom to create tailor made solutions has thus over a very long period, generated a general feeling of trust in the limited partnership structure as the only appropriate vehicle for venture capital funds, among both investors and management teams.

5.3 Tax

From a tax standpoint, investors in a venture capital fund expect that a venture capital fund should have the following characteristics:

- *The fund should be fully tax transparent. This means that no income tax should be imposed in the country where the fund is established or where the management carries on the investment activities. Tax, if any, should only be paid in the country in which the investor is based. Tax transparency has two main advantages for an investor: Firstly, the investor only has to consider the tax laws in his/her own country. Secondly, many investors, such as pension funds, are tax exempt, which in the case of full tax transparency means that they neither pay tax in the country where the fund is established and/or carries on its business (because it is tax transparent), nor in the country where the investor is based (because the investor is tax exempt). If the fund does not meet this criterion, it involves additional costs compared to direct investments, which are often not feasible, practical or possible.*
- *No VAT should be imposed on management's services to the fund. The fund pays a management fee to the company that manages the fund. As a general rule, all supplies of goods and services, such as management services, are subject to VAT. Since venture capital funds are generally not registered for VAT (as they do not carry on any activities subject to VAT), any VAT charged on the management fee will be non-recoverable. This means that any VAT paid on the management fee may be an additional cost that in the end will be paid either by the investors or the management team.*
- *Absence of other significant taxes or charges such as transfer, stamp or wealth taxes.*

6. Obstacles to Swedish based venture capital funds

6.1 Recent developments and present status

6.1.1 Recent developments

From an overall perspective, recent years have been very tough for the Swedish venture capital industry. Compared to a decade ago, there are very few Swedish-based private funds making investments in early stage opportunities. The reason for the shortage of capital is that a great number of the private funds that have been active in the Swedish venture capital market for many years have not succeeded in raising successor funds.

The lack of capital in the venture capital segment and the negative effects thereof have recently been acknowledged by the Swedish Government. In the budget proposal presented to the Swedish Parliament in September 2011, the Government took an initiative to restructure the different public entities that currently provide funds to primarily early stage but also later stage investments. The aim of the restructuring is to make the Government's involvement in the industry more visible and effective. Further details of the proposal will be presented in 2012. The Government is also investigating the possibility of establishing a fund-of-funds for investment in Swedish venture capital funds in parallel with private institutions.

In relation to the effectiveness of Swedish fund structures, since 1st January 2010 Swedish partnerships can indirectly benefit from Sweden's rules on participation tax exemption. This means that Swedish limited partnerships are now able to receive tax free capital gains and dividends as long as these would have been tax free had they been directly received by the investor. This has opened up possibilities to organize private equity funds as Swedish limited partnerships (Sw. kommanditbolag) instead of limited liability companies (Sw. aktiebolag). The changes in relation to the greater applicability of the participation exemption rules to limited partnerships are positive but will not alone suffice to revitalize the Swedish venture capital industry.

A few years ago, the Swedish Tax Agency launched a project with the aim of scrutinizing the Swedish private equity industry. During recent years, it has become clear that the Swedish Tax Agency's main focus is on the taxation of "carried interest". Carried interest refers to the profits generated in a successful private equity fund that are usually received by the management of the fund and which typically amount to 20% of the net profits in the fund provided that certain thresholds are met. Until recently, it was commonly believed that carried interest should be taxed as income from capital, in the same way as any other income from investments. The Tax Agency has, however, taken the position that carried interest should be taxed as employment income, arguing that it is not a split of profits since it is usually not received pro rata to the invested capital but a compensation for services rendered by the management team of the fund. The collective opinion of the community of tax lawyers and scholars is that the Tax Agency's position is wrong and lacks legal support, thus it is now a question for the Swedish tax courts to decide. Until then, the uncertainty due to from the Tax Agency's position is likely to negatively affect the entire Swedish private equity industry.

6.1.2 Present status

The Swedish venture capital industry is currently facing considerable problems. Few Swedish institutional investors are prepared to invest in Swedish based venture capital funds and many funds that have operated on the Swedish market for many years hold portfolios that require a longer time than expected before they are ready to be exited. Several funds experience a vicious circle where they have to show successful developments and divestments of their portfolio companies before they will have a chance to establish successor funds and thereby be able to make investments in new opportunities.

Swedish limited liability companies are no longer the only Swedish-based entities that can be used as fund vehicles in Sweden. Since 2010, Swedish limited partnerships can be structured so that in most situations investors can avoid taxation, similar to the tax environment for Swedish limited liability companies. A main benefit of a partnership compared to a limited liability company is that there are basically no restrictions to withdraw funds from a limited partnership to its investors. In comparison, a limited liability company in which investors invest in shares or other equity based instruments has to comply with the statutory restrictions on value transfers that may delay payments from the fund to its investors.

Swedish limited liability companies have been used for the purpose of establishing buy-out, debt and real property funds and in some instances in venture capital funds. While we have recently seen buy-out, debt and real property funds being established in the form of Swedish limited liability companies, the establishment of venture capital funds based on Swedish structures does not seem to be as common. Despite the fact that Swedish-based structures have become more frequent and attracted foreign investors, especially in the buy-out and real estate segments, it is still fair to say that most foreign investors remain unwilling or unable to invest in structures other than non-Swedish limited partnerships. Consequently, venture capital funds of some size having Sweden or the Nordic countries as their home market have in reality been compelled to go abroad and use foreign limited partnership structures that are acceptable by both their domestic and foreign investors.

The Swedish Tax Agency has taken the position that carried interest should be taxed as employment income. Top date the Agency has mainly focused on larger buy-out funds but has now begun auditing venture capital funds. In general, the tax issues are similar irrespective of where the fund is established or the type of investment. The Tax Agency's position is likely to negatively affect the entire Swedish private equity industry and a final decision from the Swedish tax courts will probably take several years.

6.2 Recommendation

It seems to be generally acknowledged that the government must take measures to actively support the Swedish venture capital market. Apart from increasing the effectiveness of the governmental financing to newly started and growing companies and the establishment of a fund-of-funds to invest in Swedish venture capital funds, consideration should also be given to the elimination of certain taxes applicable both to the fund entities and to their investors, which impede the revitalization of the industry. It is important to combine all these different measures so that companies in all lifecycle stages can obtain the necessary financing for their development.

Although participation exemption applies where shares are held through limited partnerships, venture capital funds organised as Swedish limited partnerships should preferably be truly and fully tax transparent. This means that no income tax should be imposed in Sweden, even if the management carries on the investment activities in Sweden. The guiding principle should be that investors are only taxed in their home countries, not in Sweden. Sweden should look through the venture capital vehicle and identify the end investor to ensure that tax is only applied only in the latter's home state.

When a Swedish management team manages a fund in another Nordic country, its activities should generally not lead to the fund being considered a taxable permanent establishment in Sweden.

In cases where a Swedish management team manages a fund in Sweden, its services should always be exempt from VAT, not only when the management company is also the general partner of the fund.

In order to avoid the risk of paralyzing the entire Swedish private equity industry for many years due to uncertainty regarding the taxation of carried interest, the legislator should clarify that carried interest should be taxed as income from capital.

6.3 Legal

In Swedish law there are no significant restrictions that would prevent Swedish or foreign investors from investing in Swedish limited partnerships. Swedish law contains only a few provisions relating to limited partnerships, and basically all statutory provisions that concern the relationship between the partners can be set aside by agreement. The few provisions that concern the relationship between the limited partnership and third parties do not constitute an obstacle to a flexible fund structure.

With regard to Swedish limited liability companies, investors can be offered the possibility to invest in the fund by means of either equity (in particular preference shares in addition to shareholder contributions) and shareholder loans with fixed interest or participating debentures. Due to the flexibility in creating tailor-made capital structures, investors do not generally have to pay tax in Sweden irrespective of their country of origin.

6.4 Tax

6.4.1 Income tax

The income of a Swedish limited partnership is presently taxed as follows. First, the taxable income is calculated at partnership level as if the partnership was a taxable entity (which it is not). The taxable income thus calculated is then taxed in Sweden in the hands of the investors. The reason why the investors are taxed in Sweden even if they are resident abroad is that the income is considered to be derived from a permanent establishment in Sweden because the fund management conducts its investment activities in there.

However, as mentioned above, since 1 January 2010, it is possible for partnerships held by companies to receive tax exempt share dividends on shares if the dividends would have been exempt had the company that holds the partnership have received the dividends directly. The

same rule applies to capital gains on shares held by partnerships. This is an improvement, as it has opened up the possibility to organize private equity funds as Swedish limited partnerships. For many foreign investors in a partnership, this also solves the permanent establishment issue, as income considered derived from a permanent establishment is not an issue as long as the permanent establishment only generates income that is tax exempt in accordance with participation exemption.

However, participation exemption only applies with respect to foreign companies that are equivalent to certain Swedish legal entities and that domiciled within the EEA. Furthermore, the participation exemption rules are only applicable provided that the shares, had they been held by the foreign investor directly, would have been regarded as capital assets. As many private equity investors are established in countries outside the EEA and as an important investor category is comprised of institutional investors such as pension funds, insurance companies and large foundations, these requirements may not always be met. Such investors thus have to pay tax in Sweden on income from the fund, even if they are tax exempt in the country where they are established. Generally, it should be acceptable from a Swedish tax policy standpoint to extend any tax exemption to investors outside the EEA, even if the shares are regarded as trading assets and irrespective of the investor's legal form.

With regard to the issue of taxation of carried interest mentioned under 6.1.1 it is vital that anybody who today establishes a new fund is aware of the potential tax issues and the uncertainty surrounding them. Different structures have differing advantages and disadvantages but the current tax environment makes it extremely difficult to provide any advice on which structures that still function well.

6.4.2 VAT

In Swedish case law, services rendered by the management company (i.e. the general partner) to the fund are not considered to constitute supply for VAT purposes if they fall within the scope of the limited partnership agreement. Therefore, no VAT is paid on management fees charged to Swedish venture capital funds. Consequently, VAT is not an obstacle to Swedish venture capital funds today .

However, where a Swedish management team manages or gives advice to a fund in another Nordic country, the services are subject to 25% VAT in Sweden unless the entity that buys the services has a business subject to VAT (which is usually not the case in a traditional private equity set up). Therefore, Swedish VAT is often an issue when the management company is not the general partner of the fund. To solve this problem, Sweden should exempt management services rendered to private equity funds from VAT.

6.4.3 Other taxes

Sweden does not impose any other significant taxes or other charges on the activities of a Swedish venture capital fund. Consequently, other taxes or charges are presently not an obstacle to Swedish venture capital funds.

7. Obstacles to Finnish based venture capital funds

7.1 Recent developments and present status

7.1.1 Recent developments

Although the obstacles to venture capital funds have been acknowledged in public discussions, no concrete actions to remove them have taken place in Finland. No tax initiatives directed to venture capital investments were introduced in the programme of the new government in June 2011. Inter alia, the proposal for extending the current tax exemption in Section 9.5 of the Finnish Income Tax Act to cover also investments from non-tax treaty countries and investors in funds of funds has still not progressed. Similarly, the proposal to allow charitable organisations to make tax-exempt investments in venture capital funds and non-listed companies (as tax exemption only currently concerns investments in listed companies) is still under discussion. The possibility of using a Finnish advisory company has been proposed to be improved by eliminating the risk of constituting a permanent establishment in taxation of a foreign fund or its investors. Also the mutual recognition of fund structures and the elimination of PE risks concerning a Finnish fund investing in foreign target assets are intended to be advanced in the future. However, it should be noted that no actual changes in legislation have yet occurred, and it is not even clear whether the planned actions will be realized as proposed.

Nevertheless, new case law has evolved regarding the taxation of venture capital funds. The Supreme Administrative Court has published court cases concerning the interpretation of when a limited liability company may be deemed as carrying on venture capital activities. The question has significance for structuring venture capital investments in Finnish targets as well as for deciding upon a feasible exit structure, as companies classified as venture capital companies are not allowed to utilize the general tax exemption in respect of share sales (participation exemption). This issue also plays a role when combining the activities of different companies within the target group. In the published court cases, the Supreme Administrative Court focused on the purpose of the acquiring company in the fund structure and its role in the business activities of the target company.

After the implementation of the MiFID, the Finnish Financial Supervision Authority (FIN-FSA) issued an interpretation regarding the impact of MiFID on advisory relationships between private equity funds and their managers/advisors, as “provision of investment advice” basically requires authorisation by the FIN-FSA. The interpretation seems to have clarified the situation in most cases (i.e. provision of advisory services within the same group of companies does not require authorisation), although additional and more detailed guidance on special circumstances could still be necessary in some cases.

Previously, certain amendments were enacted in the Finnish Mutual Funds Act and the Investment Firms Act, which changes could basically enable a special mutual fund (a Finnish non-UCITS fund) to invest in closed-end funds. A mutual fund could in theory be used as a feeder fund or as an evergreen fund of funds. There are, however, a number of restrictions that will still need to be considered, and the use of mutual funds as a new type of fund-raising

vehicle also depends on what kind of mutual fund rules will be approved by the Finnish Financial Supervision Authority. In this respect, we have not seen any actual changes or progress in the legal environment or in practice.

The AIFM directive contains several new obligations that are also generally applicable to managers of venture capital funds. Depending on the EU legislative process and on national implementation, the Directive will most likely significantly affect also the Finnish practices. At this stage it is impossible to estimate the actual effect of the Directive on the position of Finnish venture capital funds and fund managers, but it is fairly clear that the industry (or at least some of the management companies) will be burdened by various new non-desirable requirements.

7.1.2 Present status

Both legal and tax legislation applicable to Finnish venture capital funds can be regarded as satisfactory for the most part. From a legal point of view, Finnish limited partnerships are generally speaking suitable for venture capital activities, e.g. since there are no restrictions on how profits can be allocated among and distributed to partners or to how the business of the limited partnership is organized (however, see 7.3 for further details). The limited partnership form offers the flexibility needed for venture capital activities.

However the legislation is mostly general and not always optimally suitable for the specific features of the venture capital business, or in part leaving certain issues as a matter of interpretation. This means that in practice fund documentation may need to address certain considerations resulting from mandatory provisions of law in a way that is less than ideal, but the Finnish Partnerships Act does not set any hard obstacles for using a partnership as a fund vehicle (see section 7.3 for some key factors).

However, some issues still remain obstacles particularly in relation to taxation. After the Income Tax Act was amended in 2006, a Finnish limited partnership carrying on venture capital investment activities no longer constituted a permanent establishment for investors resident in tax treaty countries (assuming they are tax subject under the treaty), foreign investors also began to participate in Finnish funds. Obtaining the optimal tax treatment still requires some administrative work by the fund and sometimes legal assistance. Although it was previously believed that international investors often just lack trust in Finnish fund structures, recent developments indicate that this may not necessarily be the case, as more foreign investors have been attracted to Finnish limited partnerships. For non-Finnish investors that do not fulfil the relevant criteria, Finnish fund structures may still be non-favourable as it may be more beneficial to make the investment directly to the portfolio company instead of investing in a Finnish fund.

In addition, tax considerations pose an obstacle for investments by charitable associations in venture capital funds and in non-listed companies.

7.2 Recommendations

The following issues related to taxation in Finland should be resolved in order to promote venture capital investments:

1. *The provision regarding the maximum binding fund term should be amended or abolished;*
2. *The matters to be filed in the trade register should be minimised (so that e.g. partners, commitments and changes therein no longer need to be filed).*
3. *The participation exemption on share sales should be extended to venture capital companies;*
4. *Venture capital funds should not be obliged to levy withholding taxes on dividends distributed by target companies;*
5. *Due to the lack of tailored tax rules, specific guidance from the tax administration covering the relevant tax aspects of venture capital fund activities should be prepared to minimize the open issues;*
6. *The tax administration should provide a full range of documents, information and services in English;*
7. *The risk of taxing foreign venture capital funds or their investors (based on investment decisions made or permanent advice given in Finland) should be eliminated by explicit regulations;*
8. *Section 9.5 of the Finnish Income Tax Act should be amended to also cover the investors resident in countries with which Finland has not concluded a double tax treaty (or at least an agreement on exchange of information) and to equally apply in situations with funds of funds;*
9. *Investments made by associations for the public good through venture capital funds should be taxed in a similar way as corresponding direct investments and investments in investment funds.*

7.3 Legal

In the majority of cases, Finnish venture capital funds are structured as limited partnerships in accordance with the Finnish Partnerships Act. No special legislation applies to venture capital activities, but venture capital funds are subject to general contract and corporate law. The Act entered into force on 1 January 1989 and has been subject to only a few amendments. Although a majority of the provisions in the Act are non-mandatory and as such enable the partners in the limited partnership to arrange their contractual relationship, some mandatory provisions exist, which mandatory provisions also apply to Finnish venture capital funds.

Taking into account the special nature and features of venture capital funds, the following issues may be seen as obstacles to venture capital funds activities:

7.3.1 Termination of the partnership agreement

According to Chapter 5, Section 2, of the Partnerships Act, if the agreement has been entered into for a period exceeding 10 years, each partner in a limited partnership has the right to terminate the partnership agreement after the agreement has been in force for over 10 years. A provision in the partnership agreement restricting this right is invalid. Accordingly, the provision enables limited partners (and even the general partner) to terminate the partnership agreement even if the fund's investments have not yet been realized. This provision should be amended or abolished, e.g. by making the provision non-mandatory in relation to venture capital funds, at least if the general partner is a legal person. Such changes have been under discussion.

7.3.2 Registration procedures

Venture capital funds are subject to rather stringent rules relating to trade register registrations. Although these rules may not affect Finnish venture capital funds' possibility to raise foreign capital, they unnecessarily increase the workload of the general partner (and in certain cases also of the limited partners). The registration requirements also have a negative impact on the transferability of partnership interest. Among other things, the following matters shall be filed in the trade register:

1. *establishment of the limited partnership (i.e. registration of partnership agreement);*
2. *the capital contributions of each partner;*
3. *amendments to the partnership agreement; and*
4. *all changes relating to the partners and their capital contributions.*

One solution to this problem could be to establish a similar - articles of association - mechanism for limited partnerships as for limited companies. Accordingly, limited partnerships would register their partnership agreements in the trade register and be responsible for maintaining and updating partnership-specific registers of partners and their interests in the limited partnership. Should such a mechanism be applied, changes in the partners and their interest would not require notification to the trade register, and the names of individual partners would not have to be publicly available. Such a mechanism would be more logical and would better suit the realities of the venture capital market. More importantly, it could significantly help enabling more flexible transferability of partnership interests and accordingly result in the development of new fund products. These changes have also been discussed.

7.4 Tax

7.4.1 General remarks

Finnish venture capital funds are usually established in the limited partnership form, the investors acting as limited partners and the management company as the general partner. A partnership is not treated as a separate tax subject but only as an accounting unit for Finnish tax purposes. The total income of a partnership is allocated to the partners to be taxed as their income deriving from the partnership. Special provisions apply to the dividends received by a partnership. Such dividends are taxed in the hands of partners in the same way as they would have been taxed in the case of direct ownership of the shares.

According to current legislation (Section 9.5 of the Income Tax Act), also the share of profit of a non-resident partner (residing in a country with which Finland has concluded a tax treaty) in a Finnish limited partnership carrying on venture capital activities is taxed in a similar way to such an investor's direct investment in a target company would have been taxed. For instance, a non-resident partner is not taxed in Finland on the capital gain derived from the sale of shares in target companies (with the exception of real estate companies, as allowed in the applicable tax treaty). In practice, only dividends from Finnish target companies and possible real estate related income remain taxable in Finland (if not restricted in the tax treaty). After the Finnish Supreme Administrative Court rulings (KHO 2007:10 and KHO 2007:11) the relief also applies to partnerships considered as real estate funds and funds of funds. Thus, with the exceptions mentioned in section 6.4.5, Finnish venture capital funds fulfil the basic requirement of being treated as flow-through entities for both domestic and foreign investors. No income or wealth tax is imposed at the level of a Finnish venture capital fund in a limited partnership form. No transfer tax is due on the sale of partnership interest, although acquisition of shares in target companies is subject to transfer tax.

Management fees paid by a venture capital fund to its management company should be interpreted as a VAT exempt sale of financial services based on the Finnish Central Tax Board ruling on 12 December 2007 (number 57/2007). The preliminary ruling is generally applicable to the activities of Finnish private equity funds and it amended the previous legal praxis. The practical implication of the new ruling is the possibility of not having to register VAT groups merely in order to avoid VAT on management fees. In accordance with the EC VAT Directive, the member states should exempt from taxation inter alia “the management of special investment funds as defined by Member States”. Based on the above mentioned ruling, it can be interpreted that management of customary private equity funds (at least if the management company is responsible for the overall management) should be treated as “a separate entity constituting a special and integral part of the VAT exempt activities of the fund”. Therefore, the management fees paid by a private equity fund to its management company should be interpreted as a VAT exempt sale of financial services.

It is possible that in situations where actual decision making on investments takes place in Finland, or a foreign investor permanently uses a related Finnish advisor, a foreign venture capital fund could be considered to have a permanent establishment in Finland. This calls for legislative actions or at least administrative guidance to avoid constitution of a permanent establishment.

There are also certain other tax-related issues that need to be clarified for venture capital fund purposes. The tax rules applicable to limited partnerships mostly relate to activities not associated with venture capital. The tax authorities are still often unfamiliar with the special features of venture capital arrangements. Thus, there is a lack of clear guidance on how the general tax rules should be applied to venture capital funds and their investors.

The most significant issues still requiring legislative or other actions are presented below in greater detail.

7.4.2 Participation exemption

A significant problem in Finnish legislation concerning venture capital funds relates to the Finnish legislation on taxation of capital gains derived from shareholdings. According to the law, the capital gains on fixed asset shares are exempt from taxation in certain situations. The general rule is that such capital gains are tax-free for corporations if the seller has owned at least 10% of the share capital of the company in question for a period of at least one year.

The exemption does not, however, apply to the sale of shares by companies where the main activity consists of venture capital (private equity) investments. This leads to a situation where capital gains from the sale of shares received by venture capital funds (if established as Finnish limited liability companies or if the sale is made by a Finnish holding company owned by the fund) are always subject to taxation.

On the other hand, lack of participation exemption may be utilized in certain situations as conversely the liquidation loss of a private equity company is generally tax deductible.

Furthermore, the participation exemption described above is not applicable to the sale of real estate companies. This means that the sale of shares of a Finnish real estate company creates taxable income in Finland. It is, however, open to interpretation whether Finnish or foreign companies owning shares in real estate companies are regarded as real estate companies for Finnish tax purposes.

7.4.3 Practical tax issues

Withholding taxation presents certain practical problems for venture capital funds. According to Finnish legislation, venture capital funds are obliged to withhold tax on dividends distributed by target companies. This means an administrative burden for the general partner, which may lead to a situation where Finnish investors/funds are unwilling to accept foreign investors in Finnish venture capital funds. In addition, if a limited partnership is in a loss making position, it is questionable whether withholding tax is justifiable at all. Such a situation may lead to double taxation of dividends, since Finnish withholding tax might not be credited in the investor's country of residence. The amended Finnish legislation on dividend withholding taxation can, however, restrict the Finnish tax burden in cases where the investor is resident in an EU/EEC member country.

Even though a flow-through treatment of funds is desirable, it also causes problems since the tax treaty between Finland and each investor's country of residence (when applicable) may be applied. When the fund receives income from various countries and includes investors from several countries it is in practice difficult to keep track of the taxation applicable to each investor and plan tax efficient fund investments. The situation is even more complex in fund of fund structures. There is e.g. a risk that the investor will pay too much tax if their status as exempted non-residents is not appropriately notified and evidenced to the tax authorities.

The tax rules applicable to limited partnerships are mostly enacted for activities other than those of venture capital, and sufficient lower level guidance on the relevant interpretations concerning venture capital funds is lacking. The tax authorities are often unfamiliar with the special features of venture capital arrangements. Thus, there is not always clear guidance on how general tax rules should be applied to venture capital funds and their investors. Furthermore, only a limited amount of information and documents from the tax authorities are available in English.

7.4.4 Permanent establishment

Foreign investors investing in Finnish target companies through a foreign venture capital fund are not usually subject to taxation in Finland. However, it is possible that in situations where the actual investment decisions are made in Finland or a foreign investor permanently uses a related Finnish advisor, a foreign venture capital fund or its investor could be considered to have a permanent establishment in Finland, which could lead to taxation of investment income in Finland. The risk of taxing foreign funds or their investors should be eliminated by explicit regulations or extensive administrative guidance.

Another problem is related to foreign parallel funds. If a foreign parallel fund of a Finnish fund is considered to be effectively managed from Finland, the parallel fund could be regarded as a Finnish partnership for Finnish tax purposes. In such cases, foreign investors could become tax liable in Finland.

7.4.5 Extending the applicability of the relief for non-resident investors

Another necessary amendment concerns extending the relief provided to non-resident investors to cover also the investors resident in non-treaty countries. In order to avoid constituting a permanent establishment for the fund investor, Section 9.5 of the Income Tax Act currently requires that the investor resides in a country with which Finland has concluded a tax treaty.

As a general rule, the capital gains or interest income received from an investment in a Finnish target (either directly or through a foreign fund) is not subject to withholding tax in Finland, but when investing through a Finnish fund, these types of income would become taxable in Finland for the investors resident in non-treaty countries. Thus, the outcome is not neutral. Therefore, Section 9.5 of the Income Tax Act should be amended to apply to all fund investors, including those resident in non-treaty countries (or at least to investors resident in countries with which Finland has concluded an agreement on exchange of information in tax matters). Relief is also problematic with regard to investors in funds of funds. For that reason, relief provision should be amended so that it equally applies in situations with funds of funds. In addition, investors could be assumed resident in a non-treaty country unless evidence of the applicable tax treaty is presented.

Finnish tax revenue should not decrease as a result of such an amendment, since at present the investors in the non-treaty countries avoid investing through Finnish funds. On the contrary, by abolishing the discriminatory taxation, Finland could even increase its tax revenue, because Finnish funds would become more attractive to investors resident in non-treaty countries, and the dividends from Finnish companies paid through Finnish funds to the non-treaty resident investors would be subject to withholding tax at 28 % (NB: withholding tax rates are expected to increase as of 1 January 2012). Ultimately the amendment would neutralize the taxation of direct investments compared to investments through Finnish funds with regard to non-treaty resident investors.

7.4.6 Associations for the public good

Associations for the public good (non-profit associations, charitable organisations) are tax exempt (with certain exceptions). For example, associations for the public good may invest directly in companies or investment funds and receive the proceeds tax exempt.

However, when an association for the public good makes an investment in a venture capital fund (which is generally taxed pursuant to the Business Income Tax Act), the investment is usually not considered exempt from taxation. Therefore, in practice associations for the public good - which on aggregate have a significant investment asset base - have not been willing to make investments in venture capital funds.

In order to promote the financing of Finnish growth companies, investments through venture capital funds should be taxed in a similar way to direct investments of such associations. This aim should be affirmed with explicit tax exemption regulations.

7.4.7 Taxation of carried interest

Finnish tax legislation does not contain any provisions on taxation of carried interest. The Tax Administration has not published any guidance either.

If received by directly by an individual carried interest could be taxed as earned income of the partner and the tax burden may increase to more than 50%. However, in practice carried interest is distributed to a general partner company, and then often as dividends to holding companies of the partners of the VC firm and therefore the carried interest is taxed at the corporate tax rate. The dividends paid to partners from the holding company are taxed similarly to any other dividend from privately held limited liability company.

8. Obstacles to Norwegian based venture capital funds

8.1 Recent developments and present status

Under Norwegian corporate law there are, in practice, three available structures for a venture capital fund, which can be incorporated as either a private limited liability company (Nw: *aksjeselskap (AS)*), a limited partnership (Nw: *kommandittselskap (KS)*) or a silent partnership (Nw: *indre selskap (IS)*). The silent partnership has the most similarities with an offshore limited partnership and is therefore the preferred Norwegian structure (both IS and KS are hereinafter referred to as limited partnerships).

According to Norwegian tax law, limited partnerships are tax transparent entities, as opposed to limited liability companies, which are taxed at company level. The tax exemption under the participation exemption provides, as a starting point, a relatively investor-friendly tax regime both with respect to fund level and portfolio level taxation.

When the fund vehicle is a limited partnership, it is assumed that the limited partnership will most likely be deemed to constitute a Permanent Establishment for foreign investors. As a result, foreign investors in a Norwegian limited partnership become tax liable to Norway on the income of the limited partnership according to Norwegian tax law. However, the Norwegian participation exemption will, under the current regime, in many cases effectively exempt foreign investors from Norwegian taxation. Foreign corporate investors are obliged to file tax returns with the Norwegian tax authorities as a result of their investments in a Norwegian limited partnership.

Even though there is limited taxation due to the participation exemption, the filing obligation and the perception of the Norwegian tax regime as being unpredictable in certain sectors, are considered obstacles for foreign investors when considering investing in Norwegian limited partnerships. Although not creating a Permanent Establishment, Norwegian limited liability companies are subject to more cumbersome distribution regulations which in themselves are considered an obstacle.

As a consequence, most venture capital funds initiated by Norwegian venture capital firms with the aim of attracting foreign investors are organized as tax transparent limited partnerships in foreign offshore jurisdictions, in particular the Channel Islands. These jurisdictions are generally internationally accepted and thus, preferred by international investors. If the targeted investor base is purely Norwegian entities, a Norwegian structure is more likely to be chosen.

Financial services as defined in the Norwegian Trading Securities Act are exempted from VAT. Services rendered by a management company to a venture capital fund in a typical structure are, in relation to VAT, deemed as financial services provided that such services relate to “genuine” investment activities. Services that are not connected with the investment activities, such as typical funds administration services, are not included in the exemption and are

consequently subject to VAT. In practice, the determination of whether or not a service should be subject to VAT is in some cases proving to be difficult, and is subject to an increased focus by the tax authorities. These uncertainties should be avoided by a more precise exemption from VAT for management of venture capital/venture capital funds.

The taxation of the management's carried interest has to some extent been uncertain in Norway. However, it is normally assumed that as long as the carried interest is based on an ownership in the fund, the carried interest should be considered as a capital gain. However, there is not a clear rule of thumb on how large the ownership should be in order for the whole carried interest to be considered as a capital gain.

At the end of 2008, Norway introduced a taxation for corporate entities of 3 % on gains and dividends. Thus, the exemption method no longer implies a full exemption from taxation for Norwegian investors. This has a negative tax effect for Norwegian investors in foreign companies, and also for the taxation of a fund established in Norway. However, the government has recently proposed that this taxation should be abolished with respect to gains from 2012. On the other hand, it has also been proposed to introduce this taxation for distributions from partnerships, which until now has been exempted. This will have an effect on the taxation of the investors in several of the fund structures.

Most of the Norwegian managers of venture capital funds are expected to fall under the *de minimis* exemptions pursuant to the AIFM directive, see chapter 4.4 above. Such smaller funds will however be subject to registration with the competent authorities and minimum reporting requirements. Furthermore, an exempted AIFM which wishes to benefit from the marketing and passport regime when attracting foreign investors will have to comply with the full set of obligations and requirements of the AIFM directive.

8.2 Recommendation

We recommend that it is clarified in Norwegian law, or by the Norwegian tax authorities, that an investment in a limited partnership by a foreign investor is not deemed to be a permanent establishment. In order to further attract foreign investors it is also important that more emphasis is put on the stability of the tax regime than in the past in Norway. Since this is a perceived risk, it is not only a matter of refraining from amendments to the tax legislation but also of communicating stability over time.

Furthermore, it is recommended to abolish the 3 % tax (effectively 0.84%) on dividends for corporate entities.

It is our recommendation that the Norwegian Partnership Act of 1985 be amended to make the limited partnership as flexible as in competing jurisdictions, especially with respect to more flexible arrangements for distributions (which is relevant for limited partnerships organised as a KS).

We encourage the NVCA to continue its close dialogue with Norwegian political and regulatory authorities in the process of translating and implementing the AIFM directive. It is important to focus on ensuring that the implementation of the AIFM directive is in line with that of other European countries and, in particular, the Nordic countries. We further recommend that the Norwegian authorities enter into co-operation agreements with regulators in recognized

offshore jurisdictions outside the EU (e. g. Guernsey and Jersey) to enable funds based in these jurisdictions to be marketed in Norway.

8.3 Legal

8.3.1 Regulatory

As regards the AIFM directive, we refer to the description in 8.1, 8.2 and 4.4 above. The AIFM directive is in addition to the current licence requirements under the Securities Trading Act, see below.

Investment advisory services (Nw: investeringsrådgivning) relating to financial instruments became a regulated activity in Norway with the implementation of the MiFID in 2007. However, investment advisory services provided to venture capital funds are generally deemed to fall outside the licence requirements and, to the best of our knowledge, no management company has yet been required by the NFSA to obtain a licence to provide advisory services to venture capital funds.

In addition to investment advisory services, both (i) active management of an investor's portfolio of financial instruments on a client-by-client basis in accordance with the investor's mandate and (ii) the reception and transmission of orders in relation to financial instruments, on behalf of clients require a licence from the NFSA.

The investment service related to active management is usually not applicable to Norwegian venture capital fund structures, as the investment decision is normally made by the fund/general partner.

The licence requirements for the reception and transmission of orders, particularly in relation to fundraising, have until recently only been relevant for structures where the fund is a limited company, as shares in limited partnerships have not been deemed financial instruments. However, in April 2009 the NFSA proposed that investment services provided in relation to shares in limited partnerships shall be subject to licensing requirements, unless such services are rendered solely towards professional investors as defined in the Securities Trading Act, in which case an exemption from the licensing requirements should apply. The proposal still remains to be adopted by the Ministry of Finance, and it is uncertain when the new rules will gain legal force. However, if and when adopted, the new rules are unlikely to have any significant impact on the Norwegian venture capital business due, among other things, to the fact that investors in most Norwegian venture capital funds are expected to qualify as professional investors.

8.3.2 Company Law

A Norwegian limited partnership is regulated by the Norwegian Partnership Act of 1985 and its partnership agreement. A Norwegian limited company is regulated by the Norwegian Private Limited Companies Act of 1997 and its articles of association. In addition, the investors always enter into a shareholders' agreement when the venture capital fund is structured as a limited company.

Investors expect a venture capital fund to be structured in line with international market practice. Important features in this respect are, *inter alia*, that (i) capital commitments from investors are paid to the venture capital fund on an "as needed" basis, (ii) profits may be

distributed to the investors without delay, (iii) there are no undue restrictions on investments or investment activities and (iv) customary decision-making bodies will be constituted in the fund.

There is no regulation that prohibits the implementation of customary market terms in Norwegian venture capital funds. However, both the Private Limited Companies Act of 1997 and the Norwegian Partnership Act of 1985 contain certain limitations, which are deemed obstacles to fund managers and investors.

An example of an obvious obstacle under the Private Limited Companies Act is the rule that a limited company may only distribute dividends from annual profits in accordance with the adopted income statement for the last financial year as well as retained earnings after certain deductions. The restrictions on the funds that can be distributed as well as the delay in the distribution itself (profits may only be distributed in the following financial year), make the limited company less attractive than other vehicles. A proposal of 2011 will, if adopted, remove some but not all concerns.

Obstacles contained in the Norwegian Partnership Act of 1985⁵ are, *inter alia*:

1. *at least 20 % of the limited partnership's equity must be paid in at closing and 40 % of the equity within two years after closing. This requirement will normally result in the investors paying in capital commitments to the venture capital fund earlier than needed, which could have a detrimental effect on the fund's IRR performance;*
2. *at least 40 % of the equity is restricted capital which may delay distributions from the fund and thus also reduce the fund's IRR performance;*
3. *the general partner (Nw: komplementaren) of a limited partnership must invest, and at all times own at least 10 % of the partnership's total equity and have the right to receive at least 10 % of the profits. As in most international funds, the general partner can have sole responsibility for the operation of the fund, including decisions relating to investment and realizations on behalf of the fund. However, due to the funding requirement of the general partner, fund managers do not usually have the financial means to be the owner of the general partner. The most common solution is that the investors invest in the general partner as well as in the fund. Whilst possible, this makes the structure more complex in respect of, inter alia, distribution of the fund's profits (including carried interest) and the establishment of customary decision-making bodies;*
4. *the investors in a silent partnership are not entitled to participate at the partnership meeting. The general partner is the sole member for the purposes of the partnership meeting; and*
5. *it is not possible to establish a pledge of shares in a silent partnership, unlike a limited partnership (KS) (where a pledge of shares can be established by the issue of physical share certificates) and a limited liability company (where notification to the company is sufficient to establish a pledge of shares).*

⁵ Unless otherwise stated, the below-mentioned limitations of the Norwegian Partnership Act do not apply to silent partnerships. Thus, structuring a venture capital fund as a silent partnership will be more in line with international market practice.

8.4 Tax

8.4.1 Income tax

According to Norwegian tax law, a limited partnership is not a taxable entity. However, the taxable income of the limited partnership is calculated at the partnership level as if it was a taxable entity. The income is then divided among the partners and taxed at partner level in Norway, subject to the regulations of the Norwegian tax code.

A foreign investor becomes tax liable to Norway for business carried out in Norway, and will thus become tax liable to Norway due to the investment activities of the limited partnership carried out in Norway. Norwegian taxation is dependent on the limited partnership being deemed to constitute a Permanent Establishment. This is the general presumption. As a result, foreign investors in a Norwegian limited partnership become tax liable to Norway for the income of the limited partnership in accordance with Norwegian tax law. No venture capital fund has yet been set up with the aim of not creating a Permanent Establishment and thereby challenging the general assumption that participation in a limited partnership constitutes a Permanent Establishment. It is therefore uncertain whether a limited partnership structure could be effectively implemented without creating a Permanent Establishment.

However, even if a limited partnership is deemed to constitute a Permanent Establishment, the Norwegian exemption method will, under the current system, in many cases effectively exempt foreign investors from Norwegian taxation, cf. below.

Corporate investors - the Norwegian Exemption method

The Norwegian exemption method applies to corporate investors irrespective of a corporate investor's tax residency.

According to the Norwegian exemption method, Norwegian corporate limited partnership investors, as well as foreign corporate limited partnership investors, are not tax liable in Norway on income from shares in companies that are tax resident within the EEA, held through a limited partnership. For investments within the EEA in companies that are genuinely established and perform real economic activities, the Norwegian exemption method has no minimum shareholding threshold nor any holding period requirements whatsoever. However, the exemption method was amended in late 2008, whereby 3 % of the exempted income will be subject to tax at the ordinary tax rate of 28 %. This gives an effective tax rate of 0.84 % on exempted income. The reason for the amendment was that the costs of investments (administration, etc.) are deductible, and this deduction should be off-set by a minor tax liability, which is in line with some other EU/EEA countries. The calculation of the tax is based on the investor's net exempted income during a fiscal year. A net loss will not be deductible. As mentioned above, the government has recently proposed that this taxation should be abolished with respect to gains, while it is proposed that the tax should include distributions from partnerships. These proposals will most likely be approved by the Parliament later in 2011, and will affect the taxation of investors in several of the fund structures.

Income on shares in companies that are tax resident outside the EEA and held through a limited partnership may also be exempt from tax under the Norwegian exemption method (except for the 3 % tax). For investments in companies that are tax resident outside the EEA, the Norwegian exemption method requires a shareholding of at least 10 % and a holding period of two years. The Ministry of Finance has clarified that these requirements apply

to the limited partnership as a whole and not to each investor. Moreover, the exemption is not applicable on investments in companies resident in a low tax country. A company is deemed to be resident in a low tax country if it is subject to less than two-thirds of the income tax it would have been subject to had it been tax resident in Norway. Income from shares not covered by the exemption method will be taxable as general income at a rate of 28 %. Furthermore, a corporate investor, whether foreign or Norwegian, is not taxable in Norway (except for the 3 % tax) on the proceeds arising from the realization of a limited partnership share in a Norwegian limited partnership, provided that the value of shares held by the limited partnership that falls outside the exemption method for a two year period does not exceed 10 % of the total value of shareholdings held by the limited partnership. If the value of shares held by the limited partnership that falls outside the exemption method during the last two years exceeds 10 %, the whole gain will be taxable in Norway as general income at a rate of 28 % for the investor. However, Norway's right to tax foreign investors may be limited by tax treaties.

Foreign corporate investors are obliged to file tax returns with the Norwegian tax authorities as a result of their investments in a limited partnership that constitutes a Permanent Establishment. As foreign investors tend to regard the Norwegian tax regime as highly unpredictable, they are reluctant to invest in a Norwegian limited partnership, even though there is limited taxation under the current regime. As a result, it is generally regarded as difficult to attract foreign investment in a Norwegian limited partnership structure.

Individual investors

Norwegian individual investors are not taxed on income on shares held through a Norwegian limited partnership (except for the 3 % tax), provided that the shares are covered by the Norwegian exemption method as described above. Income on shares not covered by the exemption method is taxable at a rate of 28 %. A distribution of funds from a limited partnership to an individual investor is, however, taxable at a marginal rate of 28 %.

Non-resident individual investors in a Norwegian limited partnership that constitutes a Permanent Establishment are taxed according to the same regulations as resident individual investors.

Furthermore, a Norwegian individual investor is taxed at a rate of 28 % on the proceeds arising from the realization of a partnership share in a Norwegian limited partnership. Norwegian authorities have taken the view that non-resident individual investors should be taxed on proceeds arising from the realization of a partnership share in a Norwegian limited partnership that constitutes a Permanent Establishment. Whether this view is correct in all cases is, however, questionable.

8.4.2 VAT

Financial services, as defined in the Norwegian Trading Securities Act, are exempt from VAT. Services rendered by a management company to a venture capital fund are, in relation to VAT, deemed financial services, provided that such services relate to 'genuine' investment activities. Services not connected with investment activities are not covered by the exemption and consequently subject to VAT. The exemption on financial services applies to fees for financial services, irrespective of whether such a fee is determined as a fixed or success fee. In practice, the determination of whether or not a service should be subject to VAT is difficult, and is increasingly focused upon by the tax authorities. These uncertainties should be eliminated by a more precise VAT exemption for management companies of venture capital funds.

8.4.3 Other taxes

Norway does not impose any other significant taxes on the activities of a Norwegian venture capital fund organized as a limited partnership.

9. Obstacles to Danish based venture capital funds

9.1 Recent developments and present status

Danish Limited Partnerships (kommanditselskaber) can be used as vehicles for venture capital funds, since neither Danish nor foreign investors will be taxed on the income derived from the Limited Partnership in Denmark. Also, the Danish Limited Partnership structure is very similar to the structure that foreign investors are used to from Anglo-Saxon based funds which means that the legal documentation is normally drafted along the same lines and therefore familiar to the foreign investors.

In 2008, the Danish Venture Capital and Private Equity Association (DVCA) issued “Guidelines on Responsible Ownership and Corporate Governance” based on the principle of comply-or-explain and containing various guidelines and principles in regard to inter alia transparency, openness, information and governance. The DVCA guidelines are strongly inspired by the guidelines published by the Walker Working Group. In June 2011, the guidelines were updated and the most notable changes relating to the corporate governance for private equity owned businesses. Thus, the DVCA now recommends that private equity owned businesses adopt CSR policies, establish audit identify and monitor the most significant business and financial reporting risks as well as include information on risk management in the directors’ report in the financial statements. The updated guidelines apply to the accounting year that began on or after 1 January 2011.

In recent years, the Danish tax authorities have launched an attack on dividend and interest payments primarily to foreign holding companies owned by private equity funds - claiming that the holding companies are not the beneficial owners of the payments with the effect that the Danish paying companies should have withheld tax on the payments.

These cases have contributed to legal uncertainty related to cross-border investments into Denmark, especially with respect to the Private Equity business, since in many structures, it effectively prohibits shareholder loans into Denmark as well as making exits, “recaps” and other cash withdrawals very troublesome.

Finally, Denmark introduced a controversial salary taxation of carried interest as of 2010 (section 9.4.1 below).

Despite these recent developments we find it fair to conclude that no major legal issues are impeding foreign investors from investing in private equity/venture capital funds in Denmark, whereas the salary taxation is an obstacle to fund partners who are tax resident in Denmark.

9.2 Recommendation

The Danish Limited Partnership structure is well-known to foreign investors and the Limited Partnership is transparent in terms of tax.

In addition, according to administrative tax case law, a foreign investor in a Danish Limited Partnership is not subject to Danish tax since the investor does not “carry on a business through a permanent establishment”, as the only function of the Limited Partnership is to invest in portfolio shares.

Danish legislation - and its application – is consequently not to be considered an obstacle to the establishment of venture capital funds in Denmark, with the exception of the recently introduced salary income taxation of carried interest as described below. Additionally, recent Danish rules on limitation of interest deductions have had the effect of an increased effective tax rate for Danish enterprises owned by venture capital funds. It is, however, highly unlikely that there is political willingness to improve the tax position.

It still seems to be a not entirely unknown perception within the venture business in Denmark that there is a risk of the investment creating a permanent establishment for the foreign investor where the management of the fund is related to the investors or the LP, including the general partner, or if the general partner or management has extensive powers in relation to decision-making on behalf of the LP.

It could, therefore, be a recommendation to the Danish tax authorities that the administrative tax practice be more explicitly explained and set out in the Tax Assessment Guidelines.

9.3 Legal

There are no significant legal restrictions in Denmark to prevent foreign investors from investing in a Danish Limited Partnership. Most Danish Limited Partnerships are governed by common law and not by the Danish Companies Act. Although not an obstacle, this lack of a detailed legal framework regulating Limited Partnerships can result in uncertainty.

The Limited Partnerships governed by the Danish Companies Act have a less flexible capital structure and are therefore not yet used very often when setting up private equity and/or venture capital funds in Denmark.

The general partner in the Limited Partnership shall have a minimum of influence on the Limited Partnership. The management company normally prefers not to be the general partner due to (i) the unlimited liability and (ii) tax complications, but to have a management agreement with the Limited Partnership. Since the actual influence is vested in the management company, the influence granted to the general partner is somewhat diluted and unclear.

9.4 Tax

9.4.1 Income tax

A Danish Limited Partnership is transparent for tax (but not VAT) purposes.

Tax transparency means that a foreign investor

- *is not subject to tax in Denmark on the income of the Limited Partnership, and*
- *is not subject to tax on capital gains on shares.*

It should be added that in some cases a Limited Partnership will be deemed to be controlling a Danish company as if the Limited Partnership were a non-transparent entity. This may have an effect on intra-group trade and thin capitalization among other things.

In addition, Denmark has enacted rules that imply that a Danish Limited Partnership in some cases may lose its tax transparency if a majority of the investors treat the Limited Partnership as a tax subject for local tax purposes. This could, for instance, be the case for US tax purposes. In the event that the majority of investors are resident in non-treaty states, the Limited Partnership may also lose its tax transparency.

Foreign investors are subject to tax on dividends from investments in Danish companies.

This is, however, no different from investments in Danish companies through foreign Limited Partnerships (or directly) and therefore is not regarded an obstacle.

It has been debated whether a venture capital fund in the legal form of a Limited Partnership may constitute a permanent establishment in Denmark because it carries on investment activities in Denmark, cf. the Swedish tax situation.

Pursuant to Danish tax law, which is based on the OECD Model Tax Convention, a permanent establishment requires that a foreign enterprise carries on business in Denmark either through a fixed place of business or through a person acting on behalf of the enterprise with authority to conclude contracts in the name of the foreign enterprise (dependent agent).

In a ruling from 2001 the Danish National Tax Assessment Board held that if the only activity of a venture capital fund in the legal form of a Danish Limited Partnership was to invest in other companies by acquiring shares - which cannot be deemed trading in shares - such activity does not in itself qualify as “carrying on business” and, hence, cannot constitute a permanent establishment.

Since the mere acquisition of shares does not qualify as “carrying on business” there is – in our opinion – no need to consider whether there is a fixed place of business or whether the dependent agent-rule, i.e. Article 5, Paragraph 5, of the OECD Model Tax Convention is applicable.

Pursuant to a change in Danish tax law adopted in June 2007 and aimed primarily at capital funds, the possibility of deducting interest expenses has been significantly reduced, especially for companies with few non-financial assets. This has limited the possibility (i) of making debt pushdowns into the acquired Danish company acquired and (ii) to finance acquisitions outside Denmark. These rules have increased the effective tax rate for Danish enterprises owned by venture capital funds.

With the effect from 2010, the Danish Parliament has introduced rules on the taxation of “carried interest” paid to Danish based partners in capital funds so that for Danish tax purposes “carried interest” in general is taxed as personal income - as opposed to share income. As a result carried interest paid to fund partners who are tax resident in Denmark is taxed at up

to 56 % compared to a 42 % for ordinary share income. Salary taxation of carried interest is, however, limited to the amount which is in excess of the 'standard return', i.e. the return paid to the ordinary investors. To the extent that the carried interest is not in excess of the standard return it will be taxed as share income.

The timing of the carried interest taxation is an additional problem created by the new regulation. Taxation is levied at the time the partner has earned the right to carried interest, which is generally considered as the time the carried interest has been paid in to the fund's/partner's bank account. However, due to claw back clauses often the partner cannot access the funds at that time just as the partner in fact risks having to pay some of it back to the investors. Needless to say, such legislation does not encourage investors and funds to establish management-businesses in Denmark which in itself could be a disadvantage for the Danish venture capital and private equity industry. According to the DVCA the change in taxation has already motivated fund partners in Denmark to relocate.

Finally, in recent years, the Danish tax authorities have launched an attack on dividend and interest payments primarily to foreign holding companies owned by private equity funds - claiming that the holding companies are not the beneficial owners of the payments with the effect that the Danish paying companies should have withheld tax on the payments.

These cases have contributed to legal uncertainty for cross-border investments into Denmark, especially with respect to the Private Equity business, since it, in many structures, effectively prohibits shareholder loans into Denmark, just as it makes exits, "recaps" and other cash extractions very troublesome. The cases are currently pending before the National Tax Tribunal and the ordinary courts.

To conclude, Danish tax law and corporate law, are still not be considered an obstacle for Danish and foreign investors looking to invest in Danish venture capital but pending tax cases on "beneficial ownership" have lead to some legal uncertainty, especially within the venture capital business, just as tightened interest deduction limitation may pose a challenge. However, the most significant negative development does not directly influence the investors but rather the fund partners, namely the newly introduced special rules on salary taxation of carried interest.

9.4.2 VAT

In the context of VAT, the primary issue is whether the supply of management services from a Danish management company to a Danish Limited Partnership is subject to Danish VAT.

Financial services, including negotiations regarding shares and other securities, are exempt from VAT, while advisory services are as a general rule subject to VAT. However, as a general rule advisory services are exempt from VAT if the advisory services are ancillary to a principal VAT exempt financial service. Whether this is the case depends on the circumstances in question.

Pursuant to Danish administrative case law, services consisting of analysing and recommending portfolio companies for equity financing, and negotiating the contracts are VAT exempt financial services. Subsequent administration and disinvestment of the portfolio companies may be ancillary services to the VAT exempt financial service and therefore also VAT exempt.

Accordingly, in our opinion the management services will most likely be considered a VAT exempt financial service.

Therefore, we do not envisage VAT to be an obstacle to Danish venture capital funds.

9.4.3 Other taxes

Denmark does not impose any other significant taxes or other charges on the activities of Danish venture capital funds. Consequently, other taxes or charges are presently not an obstacle to Danish venture capital funds.

10. Obstacles to Icelandic based venture capital funds

10.1 Recent developments and present status

In recent years, Icelandic partnership legislation has improved substantially. The concept of Public Limited Partnerships (PLP) was introduced in 2006 and the Partnership act in 2007.

It should be noted that despite the absence of a dedicated partnership act, this business form has been in Iceland for many years. The reason for the implementation of the PLP form was to introduce a suitable option for investment funds that could attract local and foreign investors and facilitate cooperation. We will therefore focus on PLPs in this chapter.

Substantial changes have been made on the Icelandic tax law. Furthermore, the Icelandic government has indicated that more changes will be made. To date, information on whether there will be systematic changes or just increases in tax percentages is not available. These changes might result in higher corporate tax.

10.2 Recommendation

We recommend focusing on the stability of the Icelandic tax regime in order to attract foreign investors to Icelandic venture capital funds. The corporate income tax and tax on capital gains has been raised considerably the past two years, making it less attractive for foreign investors to invest in Icelandic venture capital funds.

Another aspect that should be addressed is the transparency of the Icelandic tax system with the full cooperation with the Icelandic tax authorities. In particular, the access to binding rulings could be improved. It is also essential that more conventions for the avoidance of double taxation are concluded to avoid any instances of double taxation.

Despite the above mentioned aspects, Icelandic tax law is presently not considered an obstacle to the establishment of venture capital funds in Iceland.

We recommend that attention be given to temporary restrictions on capital outflows from Iceland, according to the Act on Foreign Exchange no. 87/1992

10.3 Legal

In Iceland, there are no significant legal restrictions that would prevent foreign investors from participating in a PLP. Icelandic PLPs are governed by the Icelandic Companies Act, which contains a detailed legal framework regulating Public Limited Partnerships (PLP) that presents an advantage and rules out uncertainty.

However, the majority of the founders of a PLP have to be resident in Iceland, but half of them in case the number of founders is even, unless the Minister of Economic Affairs grant's an exemption therefrom. The condition concerning residence does not, however, apply to citizens of the States being parties to the Agreement on the European Economic Area, provided that the citizens concerned are resident in an EEA State. Neither does the condition concerning residence apply to citizens of States being parties to the Convention Establishing the European Free Trade Association or to the Faroese who are resident in an EEA State, a State being a party to the Convention Establishing the European Free Trade Association or in the Faroe Islands. In such incidents evidence of citizenship and residence must be submitted.

Same rules apply to board members and CEO's.

10.4 Tax

10.4.1 Income tax

PLPs can choose to be a transparent entity for tax purposes. If a PLP is a transparent entity for tax purposes it will be taxed at partner level.

The corporate income tax is 20% for limited liability companies and 36% for partnerships. PLPs are taxed at the 20% rate.

A few major changes have recently been made to the income tax act regarding companies.

First, in 2009 a CFC regime was introduced in Iceland for the first time, applicable in the assessment year 2011 for the income year 2010. Under the new rules, a resident of Iceland who is a shareholder in a nonresident company of any kind will be taxed on the income of the foreign subsidiary. This applies regardless of whether the nonresident's income is distributed to the Icelandic resident, the Icelandic shareholder owns at least 50% of the capital or voting rights of the nonresident entity or the entity is resident in a low tax jurisdiction. The same applies if a resident of Iceland controls a foreign company resident in a low-tax jurisdiction if the Icelandic national benefits directly or indirectly from the company.

In 2010, the Ministry of Finance published a list of jurisdictions that are considered low tax jurisdiction according to the Icelandic CFC regime.

Second, in September 2009 parties bearing limited tax liability in Iceland, that receive income deriving from interests originating in Iceland became subject to income tax. If a party receives income from Iceland in the form of interests derived from a bank balance, securities,

investment funds, bonds or any other claims or financial acts, that income is subject to income tax, unless a convention for the avoidance of double taxation states the contrary. However, if a convention on the avoidance of double taxations states that interests shall not to be subject to withholding tax, parties receiving income derived in the form of interests, have to apply for the exemption by submitting a special form to the Icelandic tax authorities. Withholding tax on interests to individuals is 20%, legal entities are taxed at 18%.

Third, in 2010, capital gains tax was raised from 18% to 20% for individuals. Legal entities are subject to 18% capital gains tax.

10.4.2 VAT

As a general rule, all supplies of goods and services are subject to VAT in Iceland at a rate of 25,5%. A lower rate of 7% applies to food, books, accommodation etc. Venture capital funds generally are not registered for VAT purposes as they do not carry on any activities subject to VAT.

In general, financial activities are exempt from VAT. No specific exemptions apply to management fees. Consequently, every case has to be examined on its own merits.

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Obstacles to Nordic Venture Capital Funds

Promoting a common Nordic venture capital market

Updated version 2011

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