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Private Equity Fund Structures in Czech Republic within the Framework of the New Institutional Economics

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**Private Equity Fund Structures in Czech Republic
within the Framework of the New Institutional Eco-
nomics**

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Private Equity Fund Structures in Czech Republic within the Framework of the New Institutional Economics

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Abstract

Research background: Institutional aspects of a well-functioning private equity and venture capital market are emphasized in the recent academic literature. In particular, a favourable tax and legal environment is essential, since formal institutions enable the industry to attract a larger volume of investors and thus to contribute more efficiently to the growth of GDP. In the Czech Republic, however, legal barriers represent an essential obstacle affecting a rather poor scope of resources available to domestic private equity and venture capital funds.

Purpose of the article: This paper examines the current tax and legal environment for private equity and venture capital investments in the Czech/ Republic. Proposals for prospective improvements of legal and tax framework are made in the empirical part of the study.

Methodology/methods: As the phenomenon under study is complex and explanatory in nature, qualitative data with content analysis proved to be the best way how to assess institutional framework for PE/VC in the Czech Republic. Data collection methods cover a comparative analysis of scientific literature documents and reports, as well as primary data from interviews with experts in the industry. The results of both secondary and primary data analysis were categorized and core lacks in the institutional framework were identified and discussed. Finally, proposals for prospective improvements of the institutional framework are made.

Findings & Value added: The conducted analysis implies that the issue of the legal and organisational structure suitable for PE/VC funds may be deemed resolved in the Czech Republic. A Czech equivalent to a Limited Partnership (SIC-AR), i.e. a limited partnership with investment certificates, has already with provided with sufficient support in the legislation in terms of the legal form. The legal form is a necessary, yet not sufficient condition. A tax handicap was identified implying that it is necessary to amend the tax law so that the legal regulation extends the tax exemption. Another amendment to the applicable legislation should

then be directed towards eliminating or mitigating the barriers imposed on pension funds when investing in PE/VC funds.

Introduction

The new institutional theory proved to be a popular theoretical foundation for exploring a wide range of scientific topics in the entrepreneurial research inclusive of private equity and venture capital (Bruton *et al.*, 2010, pp. 421-440; Almstorm & Bruton, 2006, pp. 299-320; Li & Zahra, 2011, pp. 95-111; Lerner & Tåg, 2013, pp. 153-182; Balcerzak, 2009, 711-739). Private equity and venture capital (PE/VC) is one of the most important sources of financing for start-ups and high-growth potential businesses in both well-developed and emerging economies (Almstorm & Bruton, 2006, p. 299). The phenomena of uncertainty and information asymmetry, however, play an essential role in terms of its availability because of transaction problems (Li & Zahra, 2011, p. 95).

Recent academic literature on PE/VC documented that both formal and informal institutions represent the proper incentives supporting investors in reducing transaction problems and thus enhancing their investment activity (Almstorm & Bruton, 2006, p. 299; Li & Zahra, 2011, p. 95; Lerner & Tåg, 2013, p. 153). There are several elements of a stable institutional framework as shown by Almstorm & Bruton (2006, p. 300): a predictable rule of law and enforcement regime to facilitate and safeguard the investments, efficient markets for corporate control and capital and minimal corruption. The concept of quality of institutional system is currently considered as the core of institutional economics (for more details see e. g. Balcerzak & Pietrzak, 2016, p. 68; Lizińska *et al.*, 2016, p. 286; Woźniak-Jęchorek, 2016, p. 130).

According to the statistics of *Invest Europe* (2016a), the Czech Republic took the last place in CEE countries in terms of the share of PE/VC investments to GDP (Invest Europe, 2016a, p. 18). Based on a comprehensive review of empirical research in the area, we assume that the development of the PE/VC market in the Czech Republic is adversely affected by the following set of institutional drawbacks, which are, however, essential for a higher level of commitment of both domestic and foreign investors: inflexibility of corporate law, tax obstructions and non-transparency of fund structures (see Zinecker, 2011, pp. 541-551; Pazour & Marek, 2011, pp. 30-33).

Therefore, in this paper, we examine the current tax and legal environment for PE/VC investments in the Czech Republic to answer the question whether the institutional framework after incorporating legislative changes

between 2012 and 2016 is comprehensible and competitive from the perspective of both domestic and foreign investors. In the empirical part of the study proposals for prospective improvements of the institutional framework are made.

Research Methodology

This research assesses formal institutional environment for PE/VC investments in the Czech Republic from the perspective of legal structures, tax transparency and investment obstacles. The analysis is founded on the assumption that Czech Republic as an emerging economy has less-developed formal institutional structures and many institutional differences compared to well-developed countries (see also Almstorm & Bruton, 2006, p. 303).

The research approach was developed after an extensive review of recent academic literature on institutional economics and venture capital in well-developed and emerging markets (Almstorm & Bruton, 2006, pp. 299-320; Li & Zahra, 2011, pp. 95-111; Lerner & Tåg, 2013, pp. 153-182; Balcerzak & Pietrzak, 2016, pp. 66-81; Lizińska *et al.*, 2016, pp. 285-296; Woźniak-Jęchorek, 2016, pp. 129-151; Caselli, 2009; Cumming, 2010; Gregoriou *et al.*, 2011; Cumming & Johan, 2013).

As the phenomenon under study is complex and explanatory in nature, qualitative data with content analysis proved to be the best way how to assess institutional framework for PE/VC in the Czech Republic. Data collection methods cover a comparative analysis of scientific literature documents and reports, as well as primary data. Experts from PE/VC industry (investors as well as CVCA Tax and Legislation Committee members) were interviewed to gain primary data. The key topics covered within face-to-face and phone interviews were as follows: tax and legal factors affecting PE/VC funds structures in the Czech Republic and the EU, defining the tax and legal environment for limited partners and fund management companies, available PE/VC fund structures within Europe, the tax and legal environment for PE/VC in the Czech Republic, tax and legal barriers preventing the establishment of a standard PE/VC fund in the Czech Republic, and legislative amendments of corporate law. The questions were open response because the novel nature of the topic. The interviews were conducted and transcribed. The results of both secondary and primary data analysis were categorized, a set of variables was defined, and core lacks in the institutional framework were identified and discussed. Finally, proposals for prospective improvements of the institutional framework are made.

Private Equity and Venture Capital Fund Structures and Taxation of Capital Gains

The first part of the analysis focuses on the research question: Does the current Czech regulation allow establishing legal and organisational form of the PE/VC fund which is competitive in the European context in terms of domestic and foreign investors?

On the basis of the literature review, e.g. Jenkinson (2008); Metrick & Yasuda, (2010, pp. 2303-2341), and the interviews with investors and experts from the PE/VC industry, it may be stated that the legal form which the investors prefer is the *Limited (Liability) Partnership* (in United Kingdom) and its variations, such as *Société d'investissement en Capital à Risque* (SICAR) in Luxembourg. The most frequently cited reasons and fulfilling these criteria by means of various legal forms established in the Czech legal system is analysed in the following paragraphs, whereas the summary of the qualitative analysis is shown in Table 1.

Investment funds are now regulated by *Act on Investment Companies and Investment Funds* (No. 240/2013 Coll.). Two structures are important for PE/VC funds: a joint stock company with variable registered capital (hereinafter only as the SICAV, according to the Luxembourg *Société d'investissement à capital variable*) and a limited partnership with investment certificates (hereinafter only as the KSIL) The aim of these legislative changes was to make the Czech Republic more attractive for foreign investors (*Explanatory memorandum of the Act on Investment Companies and Investment Funds*, 2013).

SICAV fund issues two types of shares, i.e. founder shares and investment shares. It belongs to open-end funds, whereas it also maintains the legal personality and it may establish sub-funds with different investment strategies.

The closest to the SICAR type is the KSIL, with the general partner with unlimited liability for debt, whereas the shares of limited partners are represented by investment certificates.

It may be concluded that the current legislation (except the area of taxes, as specified further) has already set up acceptable conditions. For details see Table 1.

Table 1. Content Analysis Results - PE/VC fund structures in the Czech Republic from the perspective of legal conditions

	Criteria						
	Flexi-ble capital rules	Tax trans-parency	No duty to repur-chase the share	Possibility of estab-lishing for a definite term	Possibil-ity of capital calls	Possibility of limiting the share transferabil-ity	Various types of member securi-ties
Limited partnership with invest-ment certifi-cates	✓		✓	✓	✓	✓	✓
Joint stock company with variable registered capital	✓	✓		✓	✓	✓	✓
Limited partner-ship			✓	✓	✓	✓	
Joint stock company		✓	✓	✓	✓	✓	
Limited liability company		✓	✓	✓	✓	✓	

Source: Own elaboration on the basis of the literature research (secondary data) and inter-views (primary data).

But there has been no investment fund in the KSIL legal form registered in the list kept by the Czech National Bank (*Regulated institutions and registered financial market entities lists*). It may be assumed that the reason for this consists in the substantially discriminating tax conditions, as specified below.

Taxation is in the Czech Republic regulated by the Act on Income Taxes (ITA) (1992). The tax conditions of PE/VC funds in the Czech Republic are largely unfavourable both on the level of taxation of funds themselves, and their investors (for details see Table 2). Firstly, it is impossible for the KSIL to apply the tax exemption concerning the received shares in profits and income on the sale of shares held in the long-term, which is essential to a PE/VC fund. Next, it is impossible to offset the loss of individual investments to the profit. Third, it is impossible for the investors in PE/VC funds to apply the tax exemption:

- If the fund uses the KSIL legal form;

- If it is an investor outside the EEA;
- If it is an investor with an investment share in the PE/VC fund lower than 10%;

Last, the withholding tax for funds investors may in the case of some non-residents amount to 35%.

Table 2. Content Analysis Results - Differences between individual types of fund structures established in the Czech legislation from the perspective of taxation

Criteria	Yes	No
Tax transparency for the fund (according to the fund's legal form)	Upon meeting other conditions: Joint stock company, SICAV, limited liability company, cooperative, (European Company, European Cooperative Society)	Limited liability partnership, KSIL
Tax transparency for the investor (according to the fund's legal form)	Upon meeting other conditions: Joint stock company, SICAV, limited liability company, cooperative, (European Company, European Cooperative Society)	Limited liability partnership, KSIL
Tax transparency for the fund (according to the share size)	Upon meeting other conditions: At least 10%	Less than 10%
Tax transparency for the investor (according to the share size)	Upon meeting other conditions: At least 10%	Less than 10%
Tax transparency for the investor (according to the tax domicile)	Upon meeting other conditions: EEA Member States	Countries outside the EEA
Reduced income tax rate for the fund	Basic investment fund under the ITA	Other investment funds
Increased tax rate for the investor (according to the tax domicile)	So-called tax havens	Others
Tax-deductible loss of investment for the fund (according to the assets in which the fund invests)	For example, shares for trading or real property	Significant shares in companies

Source: Own elaboration on the basis of the literature research (secondary data) and interviews (primary data).

Discussion and Conclusions

The conducted analysis implies that the issue of the legal and organisational structure suitable for PE/VC funds may be deemed resolved in the Czech Republic. A Czech equivalent to a Limited Partnership (SICAR), i.e. a limited partnership with investment certificates and the Czech version of SICAV funds, i.e. a joint stock company with variable registered capital, have been provided with satisfactory legislative conditions of their legal forms. Unlike the KSIL, funds of this legal form have already been established in practice.

The current situation, however, points to the fact that some of the changes of the conditions for PE/VC capital only make sense if they are performed in interdependence. This is demonstrated as the non-existence of

even a single representative of the limited partnership with investment certificates, where the suitable legal regulation concerning the legal form is overshadowed by absolutely unsatisfactory tax conditions. Our analysis has shown that the legal form is a necessary, yet not sufficient condition.

Our research results imply the following proposals. Above all, it is necessary to amend the IAT so that the legal regulation extends the tax exemption.

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