BANCA D'ITALIA
EUROSISTEMA

Questioni di Economia e Finanza

(Occasional Papers)

The new framework for the taxation of venture capital in Italy

by Antonella Magliocco and Giacomo Ricotti

June 2013

Number 167

Questioni di Economia e Finanza

(Occasional papers)

The new framework for the taxation of venture capital in Italy

by Antonella Magliocco and Giacomo Ricotti

Number 167 – June 2013

The series Occasional Papers *presents studies and documents on issues pertaining to the institutional tasks of the Bank of Italy and the Eurosystem. The* Occasional Papers *appear alongside the* Working Papers *series which are specifically aimed at providing original contributions to economic research.*

The Occasional Papers *include studies conducted within the Bank of Italy, sometimes in cooperation with the Eurosystem or other institutions. The views expressed in the studies are those of the authors and do not involve the responsibility of the institutions to which they belong.*

The series is available online at www.bancaditalia.it .

ISSN 1972-6627 (print)
ISSN 1972-6643 (online)

Printed by the Printing and Publishing Division of the Bank of Italy

THE NEW FRAMEWORK FOR THE TAXATION OF VENTURE CAPITAL IN ITALY

by Antonella Magliocco * and Giacomo Ricotti *

Abstract

This paper examines the current tax policy on venture capital (VC) in Italy, and compares it with the tax incentives adopted by France, Germany, Spain and the UK. The authors analyze ongoing European initiatives to remove tax obstacles to VC in Europe. Focusing on the taxation of VC funds, they also assess whether the requirements for the new Italian tax incentives are consistent with the uniform regulatory standards designated by the 2011 proposal for an EU Regulation on European VC Funds. Finally, in a quantitative analysis, the tax burden on VC investments in Italy is compared with that in other European countries. The results show that the most favourable schemes are in the UK and in France; the effects of the new Italian VC tax incentives are in line with the British and the French schemes. As regards the design of tax incentives, the authors found that as the duration of investment increases, upfront incentives become less effective than capital gains exemptions.

JEL Classification: G24, H25.
Keywords: venture capital, taxation.

Contents

1. Introduction 5
2. The Italian tax scenario 7
    2.1 The law framework 8
    2.2 The 2012 “VC tax package” 10
        2.2.1 The definition of “innovative start-up” 11
        2.2.2 The new set of tax incentives 14
3. The European initiatives vs. the Italian tax measures 18
4. Tax incentives in other European countries 21
    4.1 France 23
    4.2 Germany 24
    4.3 Spain 24
    4.4 United Kingdom 25
5. The tax burden on VC investments 26
6. Conclusions 29
References 31
Annex 1 France 33
Annex 2 Germany 35
Annex 3 Spain 36
Annex 4 United Kingdom 37

* Bank of Italy, Tax Department.

1. Introduction

Taxation is traditionally mentioned in the literature among the determinants that affect the demand and supply of venture capital (VC). Tailored tax policies can boost growth in the VC industry and act as a catalyst to attract private investment flows [Jeng L. E., Wells P. C., 2000]. In the past, some scholars focused on the effect of capital gains taxation on VC [Poterba P., 1989; Gompers P., Lerners J, 1998]: a decrease in the corporate capital gains tax can favour the VC sector either on the demand side (encouraging people to create new innovative firms] or on the supply side, since it affects the return requirements of the fund providers.

Poterba [1989] was a pioneer in analyzing the inverse correlation between the capital gains tax rate and the supply of VC financing in the US after the 1976-78 and 1982-84 tax reforms, even though his findings underlined a broader role of taxation (capital gains tax rate) on the demand side.

Given that few non-resident venture investors face individual capital gains tax liabilities on their gains from venture investments, the literature does not provide clear suggestions on how tax incentives can really succeed in attracting foreign investment funds to be channeled to start-ups.

Other analyses have shown that an increase in corporate tax rates has a negative effect on VC intensity [Romain A., Van Pottelsberghe B. (2004)]. More generally, taxation has been regarded as being one of the main factors affecting the entrepreneurial environment, although the precise magnitude of tax devices remains unclear.

This paper does not aim to shed light on the general tax domestic framework but is rather a set of considerations on the tax incentives of VC. These incentives can be commonly included in "tax expenditures", and, in this regard, they present the need to avoid inefficient government programmes.[1]

From a methodological perspective, many analyses demonstrate the necessity of separating venture capital into early (seed and start-up) and later (expansion) stages for policy considerations and indicate the early stage investments as being of particular interest to tax policy makers [Keuschiniig C., Nielsen S. B., 2002].

In Europe tax incentives particularly affect the early stage, offering benefits both to investors and to specialized vehicles such as closed investment funds. The rationale is connected to the undisputed idea that venture capital-backed companies have tremendous growth potential. Many incentives are

[1] Tax expenditures are "provisions of tax law, regulation or practices that reduce or postpone revenue for a comparatively narrow population of taxpayers relative to a benchmark tax system" (OECD, Tax expenditures in OECD countries, 2010).

directed to VC financing entrepreneurs involved in the production of "innovative" goods, since this sector is inherently risky and full of informational problems.

This paper examines only the early stage (seed and start-up) but not the later (expansion) financing.[2] As is well known, these kinds of investment are the ones related to the developing phase of the target company. In the later stages (expansion and buyouts) the tax incentives are generally intertwined with the general tax provisions in force under domestic legislation (loss treatment, thin capitalization rules, allowance for corporate equity systems, tax neutrality principles for M&A, etc).

Our qualitative analysis of tax policies does not regard the role of government funds as a catalyst for private sector funding.[3] In recent years, indeed, the role of Government funds has become preeminent in Europe. If we consider the total incremental amount of venture capital funds raised by investors, more than one third has come from Government agencies [EVCA, 2012]. When indirect investments are examined, the paper just focuses on private VC funds, even though in many cases public VC funds should be regarded as very close to other forms of tax expenditures.

According to the specific perspective of tax incentives, different tax issues are especially relevant in the VC industry: tax treatment of investors (which distinguishes between individual/corporate/non-resident investors); tax treatment at the level of vehicles and the tax burden on target companies. With reference to the tax treatment of investors, a common characteristic of VC investments is that they are typically made from the perspective of capital gains on exit, since target companies and VC funds (in the case of indirect investments) do not generally have cash flows to pay dividends on equity.

An accurate screening of tax opportunities requires an analysis of additional tax issues – not covered in this paper – such as: the tax burden on the management company in case of investments through VC funds; the tax treatment of proceeds deriving from securities, such as convertible preferred shares, commonly used in VC financing; and VAT on services offered by management companies to vehicles.

---

[2] In the European Commission' s definition (see *Public consultation paper*, 2012) venture capital includes expansion financing and it is referred to investments in unquoted companies by investment funds (VC funds) only. In this paper venture capital means investment in unquoted companies by individual, institutional or other entities even when not managed by investment funds.

[3] This paper does not consider initiatives – widely tested in Italy – involving the participation of public resources in specialist funds, such as the "Fondo di Finanza di impresa", created by Law No. 269/2006, or the "Italian Investment Fund", a reserved closed-ended fund incorporated in March 2008, operating in the private equity sector and designed to promote the capital growth and aggregations of SMEs through both direct equity investments or indirect investment through the purchase of units of other funds (funds of funds).

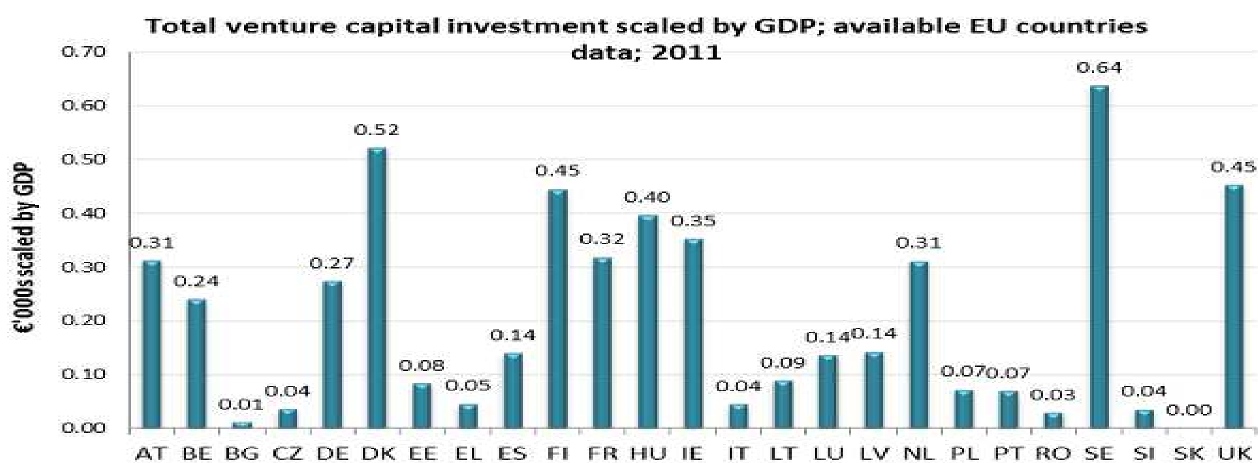
This paper is organized as follows: Section 2 examines the evolution of tax policy in Italy, with particular reference to the "VC tax package" enacted in October 2012 and tailored towards investment in innovative start-ups. Section 3 provides an insight into the on-going initiatives at European level: comparing the new Italian tax model for start-up investments when intermediated by a VC fund with the proposed European regulatory scheme of "panEuropean VC funds". Section 4 describes the current tax incentives in other European countries with a longer tradition in tax policies that foster the VC sector. Section 5 offers a quantitative assessment of the tax burden on VC investments for a business angel in the light of the new Italian tax incentives, in terms of the effective tax rate, simulating the same exercise in other European countries. Section 6 concludes.

2. The Italian tax scenario[4]

There is no doubt about the fact that Italy has never played a significant role in the VC sector. Venture capital intensity is weak.[5]

Compared with other European countries, most notably the UK and France, the Italian venture capital industry is still fragmented and shows a lower growth rate. In 2011 investments in VC capital amounted to just 0.04% of GDP while in the same year they reached 0.45% in the UK, 0.32% in France, 0.27% in Germany, and 0.14% in Spain (see figure 1) [European Commission, EVCA, 2012].[6] In 2011, only €82 million were channelled in new investments in start-ups.[7]

Figure 1



4 This article updates the considerations expressed in Magliocco A., Ricotti G. (2012).

5 European Council, 6 July 2012, http://register.consilium.europa.eu/pdf/en/12/st11/st11259.en12.pdf.

6 http://ec.europa.eu/enterprise/policies/finance/data/enterprise-finance-index/access-to-finance-indicators/venture-capital/index_en.htm

7 Data are taken from AIFI data reported in the Impact Assessment Report on Decree Law No. 179 of 18 October 2012.

As already underlined [Magliocco A., Ricotti G., 2012], unlike other European countries, Italy does not have a long history of tax incentive policies targeted at the VC sector. This public choice may have been influenced by various factors not directly related to the tax system, such as a pervasive and influential banking system, similar to that in Germany, and a delay in the development of investment vehicles and of specialized stock markets.

In comparison with other jurisdictions, what has been missing in Italy is a structural policy able to improve the tax environment as a whole. The tax measures enacted before 2012 were fragmented and aimed solely at fostering a specific segment of the VC industry. However, the extent to which tax incentives are a crucial determinant for VC growth is well known: tax benefits have been recently confirmed as a relevant factor for the growth of start-ups in Italy, second only to the need for capital funds, and behind the need for less red tape) [Ministry of Economic Development, 2012].

2.1 The law framework

For a long time, the taxation of the VC sector came under the tax regime commonly applicable to investors (such as the ordinary capital gains tax rate or the tax provisions generally applicable to other financial proceeds) and to VC funds (subject to the general tax regime applicable to closed-ended funds). No specific rules had been enacted for venture-backed companies or start-ups (with the exception of the loss-carry-forward rule realized in the first three years from incorporation).[8]

A first step towards supporting VC investments through tax incentives was experimented in 2003 when Italy introduced a 5% substitute tax rate (in lieu of the 12.5% rate) for investment vehicles specialized in trading in listed SME shares.[9] In particular, the incentive targeted funds which invest in companies with capitalization of more than €800 million listed on Italian or other European regulated markets. The incentive was aimed at stimulating the listing of small-cap companies, providing a reduction of 7.5 percentage points (from 12.5% to 5%) of the substitute tax on the accrued result of the fund; for the purpose of the incentive, the fund had to prove that at least two thirds of its assets were invested in shares of these companies.

Even though similar provisions have been adopted in other countries (for example, in France), Italy was condemned by the European Commission under the State aid rules. The Commission argued that in this case the tax advantage represented a selective advantage in respect of which there was

---

[8] IT: Articles 84 and 87 of Presidential Decree No. 917 of 22 December 1986 (hereafter the “Consolidated Income Tax Act” or TUIR)). Since 1997 the carry forward regime for tax losses realized within the first three years of activity have no limit (while the general regime of tax losses provided for a five-year limit or, from 2011, allows a maximum of 80 per cent of tax income to be carried forward).

[9] IT: Article 12 of Decree Law No. 269 of 30 September 2003, ratified by IT: Law No. 326 of 24 November 2003.

no justification within the scope of the European Treaty. In particular, the Italian tax regime seemed to cause a distortion of competition, "*because it provides additional liquidity to listed small caps by altering the market value of their stocks and favouring certain undertakings managing the specialised investment vehicles*" (funds and SICAVs).[10]

More recently (2008), in the wake of the French experience, a specific tax incentive was introduced.[11] It provides for a tax exemption for capital gains on the sale of a start-up's undertakings under certain conditions established by law: (1) that the newco started its business activity no longer than seven years ago; (2) that the shares of the newco have been held for a minimum period (three years); and (3) that the capital gains are to be reinvested in other start-up companies (roll-over system). The tax incentive is addressed to individual investors, under the basic assumption that the proceeds deriving from VC investments are primarily capital gains rather than dividends (since venture capital has no special need for dividend returns, and investment returns are harvested primarily in the form of capital gains at the exit).[12] It is hard to say whether the tax benefit has had the expected effects because it started working during the financial crisis and in a stock market which has been facing negative trends.

An important step in Italian tax policy was taken in 2011, when a specific tax incentive with the aim of "*promoting access to VC and supporting the processes of growth of new companies*" was introduced.[13] The incentive covers VC financing in a strict sense: the benefit is related only to fund management and is directly recognized in the hands of fund unit holders. For tax purposes, the law creates a particular category of "venture capital funds", defined as funds investing at least 75% of their capital in unlisted companies, acting in the areas of seed, start-up and expansion financing.

As amended by Decree Law No. 1/2012, VC funds should invest less than €2.5 million annually in each target SME. This condition seems designed to avoid the concentration of investment in a single target company. Indeed, the incentives are granted only if the target company: (1) is not listed; (2) has a fixed business place in Italy; (3) is a small enterprise (with turnover of no more than €50 million before the VC investment); (4) is directly controlled (51%) by individual shareholders

---

10 EU: European Commission, 6 Sept. 2005, Commission Decision 2006/638/EC on the aid scheme implemented by Italy for certain undertakings for collective investment in transferable securities specialized in shares of small and mid-capitalization companies (small and mid-caps) listed on regulated markets, OJ L 268/1 (27 Sept. 2006). For an analysis of the Commission, see Magliocco A., Ricotti G. (2012).

11 IT: Article 3 of Decree Law No. 112 of 25 June 2008, converted with amendments into Law No. 133 of 6 August 2008, now Article 68, par. 6-*bis* and 6-*ter* IT: Article 87 of Presidential Decree No. 917 of 22 December 1986 (TUIR).

12 European Commission (2010).

13 Article 31 of Decree Law No. 98 of 6 July 2011 amended by Article 90 of Decree Law No. 1 of 24 January 2012.

and has been incorporated for no longer than 36 months; (5) is subject to taxation without whole or partial tax exemptions.

The incentive consists of a full tax exemption for individual investors on proceeds (dividends and capital gains) arising from investment in the VC fund (the exemption cannot be applied to capital gains deriving from the sale of fund units at a price higher than the one indicated in the fund's prospectus). Moreover there is no minimum holding period. The tax benefit is addressed to corporate investors as well.

The tax incentives have only recently gone into effect: although the law providing the benefits was passed in 2011, the Decree required for its enforcement was not issued until 2013.[14]

A preliminary quantitative analysis [Magliocco, Ricotti, 2012] has underlined that the 2011 tax incentives would have led to more favourable conditions to invest in VC funds as elective vehicles. For individual investors, the exemption regime would have reduced the effective tax burden by around 17 percentage points considering the new 20% tax rate (since 2012) and the tax deferral effect on the funds. For companies investing in VC funds, instead, the specific tax exemptions for investment in specialized VC funds would have further reduced the effective tax burden for investment in VC funds in comparison with direct investment.

2.2 The 2012 "VC tax package"

In Italy an important turning point occurred in October 2012, with Decree Law No. 179/2012 (the "Growth Decree-2") which introduced a specific and detailed package of measures in support of start-ups. The rationale of the new provisions is clarified in Article 25.1 of the same Decree: to support the development of a new entrepreneurial culture, to create an ecosystem that is more geared towards innovation, and to promote social mobility and the attraction of talent and capital to Italy from abroad.

This was the first time that Italian policy makers addressed the topic in a comprehensive way, examining all the tax issues concerning supply/demand along the VC industry's value chain. In addition to the new tax rules, the decree introduces several measures aimed at speeding up incorporation procedures, simplifying corporate governance and increasing the flexibility of labour rules for temporary employees hired in innovative start-ups in the first four years of activity.

[14] The tax scheme was subject to the authorization of the European Commission under the State aid rules. In September 2012 the EU Commission gave a favourable decision on it, providing a ten-year expiration date (17 September 2022).

However, the new set of tax rules does not cover all the stages of VC investments, since it disregards the exit stage. As a matter of fact, neither have the incentives been enacted, for instance, with reference to management leverage-buy-outs by start-ups or to support the listing expenses; nor does the decree provide for any specific new tax treatment for "carried interest" (the share of profits that venture capitalists receive when an investment is taken public or sold). This political choice may have been influenced by the worldwide debate (especially animated in the US) on the unjustifiable tax breaks for wealthy speculators or rich managers, a debate that has become a leitmotif during the current economic crisis.[15]

Nevertheless, the new tax benefits are specifically addressed to support seed and the early stage of start-ups active in the field of technological innovation. The legislative solution is consistent with the Council Recommendation on the National Reform Programme 2012 of Italy, delivering a Council opinion on the Stability Programme of Italy, 2012-2015: the Council suggests that Italy should "*take further action to address youth unemployment, ..., also through incentives for business start-ups and for hiring employees*".[16] It is worth noting that in the European guidelines no reference is made to a restricted sector of "technological innovation".

2.2.1 The definition of "innovative start-up"

As already mentioned, the tax incentives are triggered only for investments in an "innovative start-up". The Decree Law provides a succinct definition, and sets several conditions.

In particular, the newco:

1) must not be listed: this condition is commonly met by tax incentives aimed at boosting the seed and early stage of start-ups;
2) must be almost 51% controlled by individual shareholders: this condition is the same as the one required for VC fund's tax incentives (2011) and is aimed at preventing avoidance through pyramid structures. The same criteria are adopted by French legislation with reference to the *Jeunne Enterprise Innovante* (JEI) scheme (see section 4 below);
3) must have been incorporated for no longer than 48 months: this "business timing test" is longer than that required in the case of capital gains exemption in investments in VC funds (2011);

---

[15] Obama's tax proposals (originally introduced in the draft of the *American Jobs Act*) would require venture capitalists to pay higher taxes on "carried interest", subject to a 15 per cent tax rate as on other capital gains. The proposal provides that these proceeds be taxed as regular personal income at a 35 per cent tax rate.

[16] http://register.consilium.europa.eu/pdf/en/12/st11/st11259.en12.pdf.

4) must have been incorporated, under Italian law, as a *società di capitali (*'società per azioni' – public limited company, 'società in accomandita per azioni' – partnership limited by shares, or 'società a responsabilità limitata' – private limited company) or a cooperative company: this condition seems to exclude permanent establishments of foreign companies that are not incorporated under the Italian statute as required;
5) must be resident for tax purposes in Italy;
6) must have its head office or main place of business in Italy;
7) must never have distributed dividends during the relevant tax benefit's period: this condition is aimed at increasing equity in the company;
8) must have reached total annual revenues of no more than €5 million from the second year of activity, and this must be confirmed in the last budget approved within six months after the end of the tax year.

In addition to the above mentioned requirements, the Decree Law lays down further conditions which are more specifically related to qualifying the "technological innovative test".

A start-up is eligible as innovative only when its statutory object primarily provides for the production and marketing of innovative products or services of high technological value. In addition, one of the following conditions must be met: a) R&D must not be less than 20% of the higher value between cost and total revenues of the innovative start-up; b) no less than one third of the total labour force of the newco must be composed by employees or associates with a PhD or still attending a PhD course at an Italian or a foreign university, or who have carried out qualified academic research for at least three years; c) the start-up must be the owner, the licensee or the user of an industrial and biotechnological patent or operating in another technological sector. The first of these conditions is similar to the one provided for under the JEI in French legislation while the second condition (b) is aimed at building a bridge between the academic and entrepreneurial environment.

It is easy to see that the definition of start-up is not the same as the one adopted in 2011 for the purposes of the tax exemption on investments in VC funds (Table 1). Since the perimeter of the two sub-sets of tax rules are different, some distortions are likely to happen. It is not already known if the two systems will be coordinated in the future; in any event, at first glance the tax incentive scheme most recently enacted to boost innovative start-ups has a narrower scope of application.

Furthermore, the definition of target company does not correspond with the "compatibility conditions" on State aid to promote risk capital investments in SMEs. Some cases of categorical aid

are not required to be notified to the Commission, as they are excluded in accordance with the criteria laid down in the General Block Exemption Regulation of 2008, amended in 2010, and included in the Community Guidelines on State aid.[17] In this case, due to the more detailed conditions, the set of the new incentives is subject to the approval of the European Commission.

Table 1

Target company requirements	Tax incentives for VC funds D.L. No 98/2011	Tax incentives for innovative start-up D.L. No. 179/2012
No listing	YES	YES
Italian tax residence		YES
Main place of business in Italy	YES	YES headquarter in Italy required
Control by individual shareholders	YES	YES
Liability to corporate income tax	YES	YES
Initial business test	YES NO more than 36 months	YES NO more than 48 months
Yearly revenue/activity turnover	YES revenue under € 50 mln.	YES activity turnover: under € 5 mln. - after the 2nd yr.
Profit distribution's constraint	NO	YES
Specific business objective	NO	YES primarily concerning the development, production and trading of innovative high technological value products and services
Other requirements	NO	YES at least one of the following conditions: - high incidence of R&D costs - PhD personnel employed - industrial patent owned

Surprisingly, while the perimeter of the eligible start-up is strictly delimited by law, the new tax rules include a new model of newco, the "social enterprises" operating exclusively in certain social sectors as defined by law.[18] As explained below, the new tax incentives are more generous in respect of investments in "social start-ups", in accordance with the potentially lower rates of return of social enterprises due to lower demand on the market.

The range of the eligible business sectors for a new social enterprise is wide: these include social assistance, healthcare, education, professional training, environment protection, access to housing, assistance for the elderly or disabled, child care, access to university education, and the promotion of culture.

These measures undoubtedly represent the most original part of the new legislation, since they anticipate the guidelines which are still in progress at the European level. The Italian solution is

[17] European Commission Regulation No. 800/2008 of 6 August 2008 declaring certain categories of aid compatible with the common market in application of Articles 87 and 88 of the Treaty, OJ L 214 (28 Aug. 2008), as amended by EU Communication from the Commission amending the Community guidelines on State aid to promote risk capital investments in small and medium-sized enterprises, No. 2010/ C-329/05. For more details, see Magliocco A., Ricotti G. (2012).

[18] Article 2.1 of Legislative Decree No. 155 of 24 March 2006.

consistent with the European Commission's guidelines on social business initiatives.[19] In particular, the Commission's "Social Business Initiative" suggests supporting social businesses more widely, including via national measures that provide specific incentives, such as tax benefits for individuals or entities investing in social businesses (these would have to be designed in line with State aid rules and the EU Treaty). Furthermore, among the various positive actions, the Commission proposes to promote "*access to venture capital for social enterprises, in accordance with its proposal concerning the European framework for venture capital funds*" (see section 3 below). As is well known, strong synergies exist between social enterprises and venture capital funds, since social businesses can be a sub-set of start-ups. The Italian law has taken a step forward in this respect, but it still has to make further progress.

Some of the new tax incentives are extended to companies acting as "innovative start-up incubators". The Decree Law sets forth a definition of "incubator", based on a detailed list of statements aimed at proving a qualified experience in supporting the seed and early stage of newcos.

2.2.2 The new set of tax incentives

The new tax incentives are addressed to the stakeholders of the "innovative start-up" (shareholders, employees, service providers, etc.) and are specially aimed at supporting newcos' funding and financial management phases (see figure 2 below).

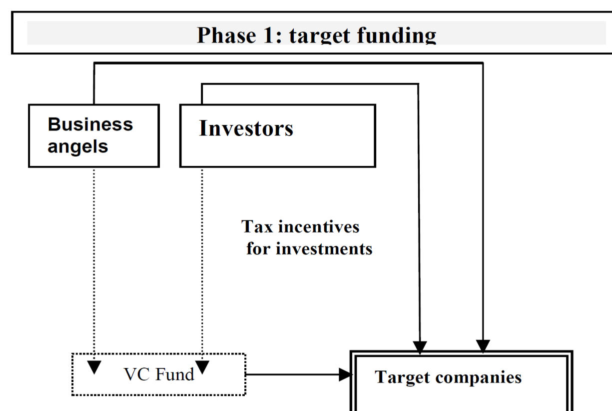
The tax benefits do not regard the corporate tax rate of the start-up. The only tax benefits directly envisaged at the start-up level are the exemption of stamp duty and other fees for the registration of the newco in the register of companies. With reference to corporate income tax an important tax anti-avoidance presumption, aimed in general at preventing the incorporation of "non-operating companies", has been specifically derogated for start-up companies. Even if the newco does not attain a regular income or if it realizes losses over the first three tax years, it is not subject to the minimum presumptive taxation. In the past, this tax presumption represented a major tax obstacle to the growth of newcos since it risked draining their liquidity (in the form of taxes) in the early stage of activity.

[19] European Commission (2011), Communication from the Commission to the European Parliament, *Social Business Initiative, Creating a favourable climate for social enterprises, key stakeholders in the social economy and innovation,* COM (2011) 682 final.

a) The target's funding

The new tax incentives support the target's funding through tax credits or deductions for shareholders investing either directly or indirectly through a vehicle in the newco (figure 2).

Figure 2



It is worth underlining that the new tax benefits regard neither the taxation of capital gains or dividends deriving from direct investments in "innovative start-ups" or indirect investments through VC funds. Therefore, these proceeds remain subject to the general tax treatment or to the specific tax exemption already granted for capital gains (see section 2.1).

Tax benefits in favour of "risk capital investors"

In the case of equity investments in innovative start-ups a specific tax benefit is allowed both for individual and corporate investors. But, notably, this benefit is limited to three years (2013-2015), in accordance with the traditional theses on the efficiency of temporary tax expenditures.[20]

The new tax incentives can be applied either for direct equity investments or undertakings in collective funds that prevalently invest their portfolio in innovative start-ups.

In particular, over the period 2013-2015, individual investors can deduct from the personal income tax due an amount equal to 19% of the undertakings in start-up's shares. The tax credit is allowed on an investment not exceeding €500 million, corresponding to a maximum tax saving of €95,000; a specific three-year carry-forward rule is provided in case of loss. The tax benefit can be applied only if the shares of the newco have been held for a minimum period of two years; the sale of the share, in whole or in part, invalidates the regime and the beneficiary is required to give back the tax credit.

*For corporate entities the deduction from the CIT is equal to 20% of the amount of the investments in the start-up. The threshold for companies amounts to €1.8 million, corresponding to a maximum tax saving of €99,000 [1.8m*20%*27.5% (CIT rate)]. For companies too, there is a two-year holding period for participation, otherwise the benefit has to be recalled and the tax credit has to be refunded.*

A more favourable tax regime is provided for investments in start-ups operating in specific sectors: in fact, the rate of the tax credit/tax deduction is higher for investments in "social start-ups" and "green energy start-ups" (respectively 25% and 27%, instead of 19-20%).

[20] For a review of the literature, see Bronzini R., De Blasio G., Pellegrini G. and Scognamiglio A. (2008).

b) The target's financial management

As is well known, start-ups are used to assign stock options and "performance shares" to their managers and employees, provided that certain business performances are achieved (so-called seeding shares). In order to tackle the financial constraints (the "liquidity trap" of the first stages of newcos), the Decree Law allows the innovative start-up to pay wages in return for work or services by the assignment of own capital shares or other financial instruments issued by the same company.

Under the ordinary tax rules, the equity value of these financial securities is taxed as personal (employee) income at a progressive rate.[21] The Decree Law, instead, introduces a tax exemption on the proceeds of these shares or securities when assigned not only by a newco but also by a "certified incubator".

Tax benefits in favour of employees and other stakeholders

The new tax exemption applies in three cases.

- *The first case refers to corporate "incentive plans" based on the assignment of shares and stock options to managing directors, employees and long-term consultants operating in start-ups or certified incubator companies. The exemption pertaining to personal tax income and social contributions is allowed only if the shares and the stock options are directly issued by start-ups and incubators provided that the issuers (or their controlled companies) do not carry out any buy-back operations. This last condition is aimed at preventing start-ups from abusing untaxed "vested wages" and hence circumventing the real scope of the law, which is the growth of start-ups. If the conditions are met, the tax exemption is extended to the entirety of the shares' value, and the maximum threshold (€2.065,83) ordinarily stated by the tax code for these plans does not apply.[22]*
- *Secondly, an innovative start-up can remunerate its providers by assigning them shares, stock options, convertible notes and in this case (the so-called "work for equity"), the correspondent income is not taxed to the beneficiaries. It is not clear if this tax exemption can be applied both to individuals and companies.*
- *Lastly, the same tax exemption can be applied to creditors of innovative start-ups. In this third case the assignment of shares and securities extinguishes the debts of the companies and payees are not taxed at the level of personal income taxation.*

As detailed below (section 4), incentives for venture capital are present in other European countries, especially in France and the UK. The Italian set of tax rules enacted in 2012 seems mainly modeled on the British one but, unlike in other legislations, the new Italian measures in favour of investors are temporally limited (up to 2015). A limit of three years could be perceived as too short a time horizon also in view of the time required for the practical implementation of the law.

The entry into force of the new tax regime is deferred pending its authorization by the European Commission. Given the uncertainty of any further extension in following years and given the time

---

[21] In accordance with Article 9, § 4 of the Italian TUIR the equity value of shares of unlisted companies – as required for an innovative start-up – shall be determined proportionally to the corporate capital equity and in the case of bonds or other securities in relation to the value of other publicly traded securities with similar financial yields.

[22] IT: Article 51, § 2(g) of the TUIR.

required for implementing the rules, it is reasonable to assume that the expectations in terms of a boost to the seed and early stages are likely to be somewhat disappointed.

If taxation is to be considered among the relevant factors affecting the entrepreneurial environment, an open question is whether tax incentives – such as the new Italian ones – are suitable for charting a new path in Italian tax policy. Some doubts exist on this point, even though the new tax legislation appears to move in the right direction.

Furthermore, in the short term, a closer coordination of the new rule with the other tax incentives previously enacted seems necessary, otherwise some undesired distortions could occur.

Another open question is whether the pattern of "innovative target" eligible for tax incentives can be found in the Italian target companies currently financed by venture capitalists. Focusing only on Italian VC funds and drawing on data from Vacca V. (2013) we know that:

i) the investment from vehicles ranges from €0.6 million on average for private funds, to €4.1 million for banking/finance funds;

ii) more than half of investments are channelled to companies supplying "knowledge intensive" services and high-tech manufacturing;

iii) venture-backed companies are generally middle sized (around €140 million in turnover) and operate for an average of seven years, but there are remarkable differences depending on the fund's ownership (non-financial, banking or public).

The new tax incentives seem to be well tailored to the current Italian venture-backed companies with reference to the threshold for the maximum deduction allowed, as it is not far from the average amount of investments. However, the legal definition of the eligible target (see section 2.2.1) is not currently in line with Italian targets financed by funds as regards the requirements for turnover (€5 million vs. €140 million) and elective business sectors. By reading the Impact Assessment Report to the Decree Law we could assume that a conscious tax policy choice has been made to encourage VC investments toward smaller-sized companies operating in specific sectors.

Finally, some doubts can be expressed about the thesis according to which this set of incentives could help lower tax evasion among small businesses operating in the technology sector by encouraging fiscal transparency (Ministry of Economic Development, 2012). More doubts concern the possibility that the indirect effect of this hypothetical tax disclosure could consist in the reduction of the estimated loss of public revenue deriving from the tax incentives (amounting to around €300 million in the period 2013-2015).

3. The European initiatives *vs.* the Italian tax measures

VC policy in the EU can be examined from two standpoints: on the one side, the policy followed by the European Commission under the State aid legislation aimed at preventing unjustified selective tax advantages in favour of some enterprises to the detriment of other competitors that are not beneficiaries of tax incentives; on the other side, the initiatives taken at the European level to promote the growth of the VC industry. These two areas are only apparently divergent as in fact the on-going European initiatives are moving in tandem.

In this paper we do not focus on State aid legislation even though it has strongly affected national tax policies.[23] Despite the widening of the criteria (since 2006) in the European policy, some tax schemes created by Governments to boost VC investments (for example, in Italy and Germany) have been blocked by European Commission in accordance with the State aid regime (Article 107.3 of the TFEU).[24]

In this section we focus on the other steps taken by the Commission with the same aim of promoting a favorable business climate for risk capital in the EU.

The European Commission has been working for a long time (more than five years) to remove tax obstacles to VC investments. In particular, in 2007 an Expert Group was established to explore possible tax measures aimed at facilitating the VC industry within Europe.[25] Given that VC supply and demand can be allocated in different countries (figure 3), many tax obstacles may easily arise in practice.

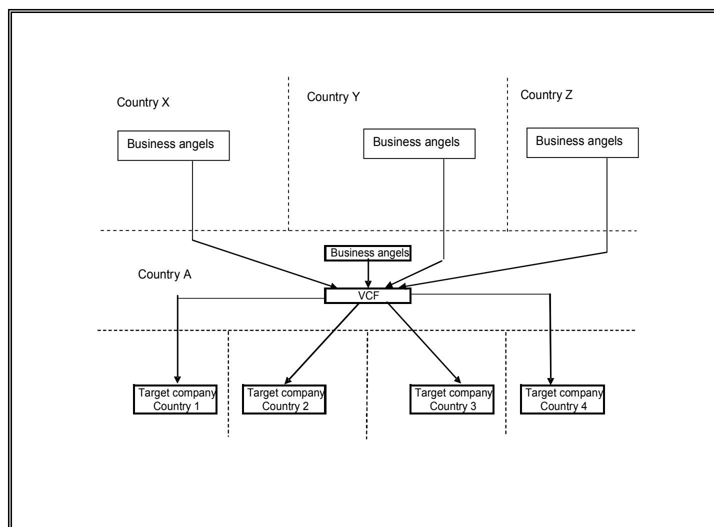
---

[23] For details on the EU guidelines, see Magliocco A., Ricotti G. (2012).

[24] Article 107(3)(c) of the EC Treaty provides that aid to facilitate the development of certain economic activities may be considered to be compatible with the common market where such aid does not adversely affect trading conditions to an extent contrary to the common interest.

[25] European Commission (2010). A public consultation on the "*Problems that arise in direct tax field when venture capital is invested across borders*" was launched on 3 August 2012 and was closed on 5 November 2012.

Figure 3



The lack of coordination among domestic tax legislations in the field of direct taxation may lead to several double taxation cases for cross-border venture capital investors. This issue becomes crucial whenever investors or business angels are tax residents in one EU country while the venture-backed company is incorporated in another one (and eventually, the VC fund is tax resident in a third State) (see figure 3 above). In addition, VC funds face tax treatment uncertainties and tax compliance costs when investing on a cross-border basis.

The Expert Group's main findings

The Expert Group highlighted three main tax obstacles:

a) **the permanent establishment (PE) issues**: *if the VCF is located in a country (A) other than that in which the target companies are established (1-2 ...), the fund manager is generally used to being close to the companies where the investments are made in order to assist in their management. This presence may be regarded – and it frequently occurs – as a business activity in loco. So the fund manager is deemed to be a "permanent establishment" for tax purposes, which means applying income taxation either in the target's country or in the investors' State (and eventually, in the fund manager's country too);*
b) **the entitlement under double tax conventions***: the tax treatment of funds varies among domestic tax jurisdictions. In some countries VCFs are treated as transparent for tax purposes (look-through approach) while in other countries they are subject to tax like other entities (non-transparent approach). These different classifications of VCF do not often allow the application of double taxation treaties (DTT);*
c) **compliance costs for tax relief***: in the case of tax transparent VCFs, the procedures for withholding tax refund claims on investors' proceeds are very complex. Every single investor, as beneficial owner, must request an exemption or reduction of withholding tax on dividends and interest. In only a few legislations are VCFs allowed to claim tax treaty relief on behalf of their investors. High compliance costs can lead investors not to ask for tax refunds; consequently, they determine losses.*

From this perspective, the Italian jurisdiction has not always adopted an approach targeted at attracting risk capital from abroad. On the one hand, the well-known Philip Morris case (2002),[26] even though it did not regard VCFs, stigmatized an unfavorable approach in the Italian criteria used to define a PE (PE issues, sub lett. a); on the other hand, the Italian VCFs are qualified as transparent entities and could be eligible for DTT facilities.[27]

---

[26] The Italian Supreme Court's decision No.3367 of 7 March 2002 in the well-known Philip Morris is considered by the Expert Group to be a landmark one, as it adopted a very wide approach to the interpretation of the cases of "agency" permanent establishment, regarding an Italian company as a multiple permanent establishment of foreign companies pursuing a common strategy.

[27] IT: Article 73, § 1-c of the TUIR.

The same tax Expert Group (2010) suggested a standard EU VC vehicle from a regulatory point of view. Acting on this suggestion, in December 2011 the European Commission adopted a proposal for a Regulation on European Venture Capital Funds[28] to create an internal market for VC in Europe. The proposal introduces uniform requirements for the managers of collective investment undertakings that will operate under the European Venture Capital Fund (EuVCF).

A common set of rules is seen as a good starting point for solving tax problems too, and consequently, for developing a fully functional market for VC and SMEs in Europe. The rationale is that a European VC fund scheme can be used as a template by those Member States which intend to promote VC investments through tax incentives that would be compatible with State aid rules.

In a nutshell, the proposal on the EuVCF: *a)* introduces a simple registration for managers, as a basis for an EU-wide passport (a sort of "home-State system" commonly used in the banking and financial sectors); *b)* introduces a common notion and designation for EuVCF, which must have assets under management not exceeding €500 million and should be marketed to professional investors or qualified clients only (investing a minimum of €100,000); c) provides that each fund must invest 70% in the equity or quasi-equity of unlisted SMEs, employing fewer than 250 persons and with an annual turnover not exceeding €50 million (or an annual balance sheet total not exceeding €43 million); c) sets some common standards for the conduct of business and organisation of the fund managers; d) sets some common transparency and reporting requirements on the features of the funds; e) requires cooperation among the relevant competent authorities; and f) requires deregistration of VC fund managers when they fail to comply with the legislation.

Broadly speaking, the 2011 Italian tax measures appear consistent with the uniform standard rules of EuVCF with particular reference to the "qualifying portfolio undertaking" of the EuVCF. What is evident, however, is that the EuVCF will be not required to select only innovative start-ups as defined under Italian law.

Some problems emerge from the comparison of the 2012 Italian tax incentives with the proposal of European Social Entrepreneurship Funds (EuSEFs) of December 2011, aimed at supporting the market for social businesses by improving the effectiveness of fundraising by investment funds that target these businesses.[29] The EuVCF proposal is complementary to that on social entrepreneurship funds. Moving on the parallel regulatory track drawn for EuVCF, the EuSEF introduces the same uniform requirements for the EuVCF managers. At first glance, the definitions of social

[28] EU: European Commission Regulation of 7 December 2001, COM (2011) 860 final.

[29] EU: European Commission 7 December 2011, COM (2011) 862 final.

undertakings and social services seem wider than the correspondent notions adopted by Italian law. Furthermore, the range of eligible financing tools contained in the EuSEF Proposal goes beyond equity finance, the typical instrument for start-up enterprises in the technology sector. In addition to equity, social companies usually have recourse to other forms of finance, combining public and private sector financing, debt instruments or small loans.

In the social services sector, more extensive coordination between European legal initiatives and the new Italian law will be required.

4. Tax incentives in other European countries

In Europe there are important examples of tax environments stimulating VC industry.[30]

Literature is used to comment the Portugal case-study, that in the mid 1980s created a new type of corporate structure (the VC corporation) supported by a wide range of tax incentives (such as an exemption from income tax for four years). In just one year (from 1986 to 1987) private equity investments increased dramatically [Jeng L. E., Wells P. C. , 2000].[31]

European countries are traditionally considered as adopting good VC tax policies. According to the Global VCPE Country Attractiveness Index 2012,[32] the UK is ranked 3rd in the world; Germany is ranked 8th and in the first twenty ranks there are ten European countries. As to the most important European countries, France is ranked 15th, Spain 24th and Italy 30th.

As regards the tax environment, Europe is the best place for VC and private equity investments; focusing on the most important countries, France ranks 16th, Germany 19th, Italy 33rd, Spain 23rd and the United Kingdom 34th (see table 2).

---

30 For more details on tax policies on VC in Europe, see Magliocco A., Sanelli A. (2004).

31 Outside Europe a well-known case of favourable tax environment is the Israel legislation at the beginning of the 1990s. In particular, in 1992 the Israeli Government enacted temporary legislation guaranteeing tax-free proceeds to foreign “tax-pass-through” venture capital funds investing in VC funds resident in Israel. The development of the VC sector was fostered by the tax exemption regime for individual investors on capital gains on sales of listed securities.

32 The Global VCPE Index evaluates 116 countries (39 from the EU). For each country it considers economic activity, depth of capital market, taxation, investor protection and corporate governance, human and social environment, entrepreneurial culture and deal opportunities. The Global VCPE index can be divided into a VC index and a private equity index.

Table 2

Country	VCPE ranking	TAX ranking
United States	1	13
Canada	2	9
United Kingdom	3	34
Japan	4	44
Singapore	5	29
Hong Kong	6	26
Australia	7	11
Sweden	8	1
Germany	9	19
Switzerland	10	17
France	15	16
Spain	24	23
Italy	30	33

Source: *Groh et al. (2012).*

In this section we focus on the tax incentives schemes provided for VC investments by the most important EU countries: France, Germany, Spain and the UK. The analysis takes account of both "upfront" and disinvestment incentives, considering the tax treatment of individuals and corporations investing in VC.

Table 3 sums up tax incentives in the above mentioned four countries and in Italy. This qualitative comparison allows us to highlight some main findings:

a) one country (Germany) does not provide any tax incentive considered here;

b) one country (the UK) currently provides tax relief only to individuals;

c) the upfront incentives are very different in magnitude and only in Italy are addressed to corporate investors;

d) capital gains exemptions are provided in all countries for individuals; certain French, Italian and Spanish tax schemes grant capital gains and dividend exemption regimes also to corporate investors. It is worth noting that in these countries a company can apply participation exemption regimes in case of qualifying investment in other companies; as a matter of fact, in many cases it means that the effective rate is equal to 5% of the statutory corporate income tax rate;

e) a holding period and/or a minimum/maximum amount of the participation in the target company are often required.

Table 3

State	France				Italy		Spain		United Kingdom		
Tax schemes	Direct investment	Direct investment in JEI	FCPI-FIP	SCR	Innovative Start-up	VC funds	Innovative start up	VC entities	EIS	VCT	SEIS
Investors	Individual	Individual	Individual/ corporate	Individual/ corporate	Individual/ corporate	Individual/ corporate	Individual	Individual/ corporate	Individual	Individual	Individual
Up front relief	Y	Y	Y	N	Y	N	N	N	Y	Y	Y
- maximum annual amount	€50,000	€50,000	€12,000	-	€500,000/ €1,800,000	-	-	-	£1,000,000	£200,000	£100,000
- rate	18%	18%	18-42%	-	19%/20%	-	-	-	30%	30%	50%
Capital gain exemptions	N	Y	Y/15%	Y/15%	N	Y	Y	N/Y	Y	Y	Y
Minimum holding period (years)	5	5	5	5	2	-	≥3 and ≤10	-	3	5	3
Target company											
- maximum investor's shareholding	-	25%	-	-	-	-	40%	-	≤30%	≤15%	≤30%
- not listed	Y	Y	Y	Y	Y	Y	Y	Y	Y/N	Y/N	Y/N
- number of employees	≥2	<250	-	-	-	-	-	-	<250	<250	<25
- age	≤5	≤8	-	-	≤4	≤3	-	-	-	-	≤2

Key to symbols. **France :** FCPI = *Fonds commun de placement dans l'innovation; FIP = Fonds d'investissement de proximité*; *SCR = Société de capital risqué.* **UK**: EIS = *Enterprise Investment Scheme; VCT= Venture Capital Trusts; SEIS = Seed Enterprise Investment Scheme.*

4.1 France

As is well known, France has been adopting tailored VC tax policies for a long time. A strong boost has come in particular from some targeted tax schemes addressed to undertakings in specialized funds.

Currently, the French system provides for tax incentives aimed at increasing equity investments in SMEs, both directly and through specific vehicles (see annex 1).

The tax advantage provided in France consists of upfront incentives, i.e. tax credits related to the invested amount, and of exemptions on income deriving from investment in VC.

In addition, investments in unlisted companies and in VC funds (FCPR, FCPI and FIP) also benefit from facilities for the purpose of taxation on net wealth: they are not – wholly or partially - subject to the *Impot de solidarité sur la fortune*. The value of participations in VC funds, held by wealth tax payers, is not taken into account in the wealth tax basis.

4.2 Germany

Unlike France, Germany does not have a long experience in promoting the development of the VC industry through tax incentives. In fact, Germany did not adopt tax policies in favour of the VC sector until 2008. One of the reasons is that traditionally Germany has not imposed restrictions on equity holdings by banks, unlike in other countries such as the US, where regulations have prevented banks from holding a large equity stake in any companies and from being direct investors [Jeng L. E., Wells P. C., 2000; Mayer et al., 2005].

A tax-favoured regime for VC was introduced in 2008, with the German Venture Capital Act (*Wagniskapitalbeteiligungsgesetz* – "WKBG"). It did not provide any upfront incentives; there was no capital gains exemptions for investors, but just a reduction of the capital gains tax base.

This law defined venture capital companies (VCC) as companies which are recognized as such by the German regulator BaFin and which are not simultaneously registered as an equity investment company pursuant to the German Act on Equity Investment Companies (*Gesetz über Unternehmensbeteiligungsgesellschaften* - *UBGG*). VCC could be companies or partnerships.

The German VC industry does not seem to have appreciated the WKBG law, mainly due to the restrictions on the investments of Regulated VC Fund Vehicles and to the minimal tax advantages offered by this new law; the regulatory supervision of Regulated VC Fund Vehicles was also considered a problem. Because the scope of the regulatory framework was too limited to work for a venture capital fund, no single venture capital firm elected for the application of the WKBG. In addition, on 30 September 2009 the European Commission decided (Commission Decision 2010/13/EC) that the exemption from the liability for trade tax for venture capital companies, pursuant to the WKBG, is incompatible with the common market and may not be implemented. Therefore, the application of the WKBG has been blocked (see annex 2).

4.3 Spain

In Spain the VC industry started with a public initiative in the early 1970s, when regional entities were established in order to finance and develop industrial activities (Dovalina et al., 2010).

However, tax incentives were introduced only in 2005 with the Spanish law on venture capital entities (*Ley 25/2005, de Entidades de Capital-Riesgo*). Tax incentives for direct investment were introduced only in 2011.

These laws do not provide any upfront incentives for direct or indirect investments, but only a capital gains exemption at the moment of the disinvestment (for further details, see annex 3).

4.4 United Kingdom[33]

From more than 30 years, the British tax system has been characterized by a bias towards equity investment in enterprises.

The first VC tax scheme (VC Loss relief) was introduced in 1980; it allowed individuals and companies to relieve capital losses on unquoted shares of companies against income tax. Reliefs for investment in a new company were introduced in 1981 (the Business Start-Up Scheme) and extended to investment in existing companies in 1983 (the Business Expansion Scheme); subsequently, in 1986, they were extended to grant exemptions from capital gains tax (CGT). Finally, these schemes were replaced by the Enterprise Investment Scheme (EIS) in 1993. In 2000 reliefs for VC investment were made available to companies through the Corporate Venturing Scheme (CVS), which ended on 1 April 2010.

The UK offers a favourable tax environment not only for VC, but also for entrepreneurs and investors in companies. For example, since 2008 individuals have been allowed to claim relief on capital gains made, *inter alia*, on the disposal of shares of a trading company. The relief applies, if the investor holds at least a 5% participation for one year, in a company where he works as manager or employee. The relief provides a 10% reduced tax rate on capital gains, with an annual maximum exemption of £10,600, instead of the 18%-28% standard capital gains tax rate.[34] The tax law provides a maximum lifetime limit on the amount of entrepreneurs' relief equal to £10 million.

In the UK there are currently three tax schemes designed to spur VC: the Enterprise Investment Scheme; Venture Capital Trust; and Seed Enterprise Investment Scheme (see annex 4). All these schemes provide for upfront incentives and capital gains exemptions, but only for individuals: since the CVS scheme ended in 2010,[35] there has not been any tax VC scheme addressed to companies investing in the VC sector. Some items, such as the definition of target companies, are often the same for every scheme.

---

[33] The main source for this sub-section is the HM Revenue and Customs Venture Capital schemes Manual (http://www.hmrc.gov.uk/manuals/vcmmanual/Index.htm).

[34] The rate depends on the total taxable income of the taxpayer. If it is higher than £35,000, the 28% rate applies.

[35] As regards CVS, upfront reliefs are no longer granted, but the capital gains exemption still applies.

5. The tax burden on VC investments

In the previous section we highlighted the different tax incentives provided for the supply of VC by the most important EU Member States. They are aimed at boosting investments in target companies by granting upfront incentives, i.e. tax credits related to the amount invested, and tax exemptions on capital gains realized in the phase of disinvestment. At the same time, together with these tax benefits, low corporate taxation and reduced compliance costs are crucial for the development of a VC market (Groh et al., 2010).

In this section we assess the magnitude of tax incentives granted to investors in the countries explored in the previous section, in order to evaluate which tax system supports the VC industry more and what are the differences among them from a quantitative point of view.

The quantitative analysis is based on the following assumptions:

a) we consider only tax incentives provided for individual investors (business angels);

b) the business angel invests € 500,000 in the first year;

c) the target company is resident in the same State as the business angel; in case of indirect investment through a vehicle, the vehicle is also resident in the same State as the business angel;

d) since we focus only on the supply side of VC, the taxation of the target is assumed (hence, corporate tax rate, indirect taxes and tax incentives for start-ups are omitted); as a matter of fact, this assumption implies the same return on investment after corporate income tax.[36] The yield achieved in this period is set at 10%. Although this assumption is not realistic, it is necessary in order to take account only of the incentives on the supply side;

e) we assume a five-year investment term;

f) at the end of this period, the business angel sells the company shares and realizes a capital gain.

For each country we assess the effect of the several existing tax incentives schemes.

As regards Italy, we consider both a direct investment in a target company and an investment made through a VC fund. In France the present analysis considers a direct investment, a direct investment

[36] In the five countries, target companies are subject to different statutory tax rates (36.1% in France; 29.83% in Germany; 31.4% in Italy; 30% in Spain; 23% in the United Kingdom); the rules for calculating the tax base are also very different. This means that companies with the same characteristics (i.e., with the same profit before tax) would have different net profits.

in a JEI, and an investment through FCPR and SCR. In Germany and Spain[37] we assess only the effects of a direct investment in a target company.[38] As regards the UK, we consider the three existing schemes: EIS, VCT and SEIS (for the VC schemes, see section 4). Table 4 summarizes the results of this exercise.

Table 4

State	**France**				**Germany**	**Italy**		**Spain**	**United Kingdom**		
Tax schemes	Direct investment	Direct investment in Jeune Entreprise Innovante	FCPI-FIP	SCR	Direct investment	Innovative Start-up	VC funds	Direct investment	EIS	VCT	SEIS
After Tax Internal Rate of Return (ATIRR)	6.25%	10.14%	9.02%	8.67%	7.51%	12.14%	14.41%	7.65%	17.42%	12.68%	12.21%
Tax advantage	1.60%	5.49%	4.38%	4.02%	NA	3.86%	6.14%	NA	9.76%	5.01%	4.54%
Tax incentive multiplying factor	1.34	2.18	1.94	1.87	NA	1.47	1.74	NA	2.27	1.65	1.59

Note: the After Tax Internal Rate of Return (ATIRR) is the IRR of an investment with the tax incentives provided for in any State; the Tax advantage is the difference between ATIRR and the ATIRR of the same investment without any incentives (NI-ATIRR); the Tax incentive multiplying factor is equal to the ratio between ATIRR e NI-ATIRR. NA: in Germany and Spain individual investors do not have any VC incentives.

It is worth noting that an after tax internal rate of return (ATIRR) higher than the before tax IRR (BTIRR) means that the tax system is adding value to investments and granting public resources to VC investors. Assessing only the tax incentives on the VC supply side, the best tax scheme is the UK EIS[39] (where the ATIRR is equal to 17.42%) while the worst place to make a VC investment is Germany (where the ATIRR is equal to 7.51%); France has the least attractive scheme (a direct investment with up-front incentives has an ATIRR equal to 6.25%), due to heavy capital gains taxation, but the other schemes allow investors to obtain higher ATIRR.

In relative terms (i.e., how much the tax incentives augment the rate of return of an investment), the presence of tax incentives can double the rate of return of an investment, as happens in France and the UK. Also in relative terms, the best scheme is the UK EIS.

[37] We do not consider the Spanish incentives for direct investment, because these incentives do not apply when the sum invested is higher than € 75,000.

[38] Capital gains realized by individuals are subject: in France, to progressive personal tax and social contributions (effective rate 58.2%); in Italy, to a substitute tax at a 20% rate; in the UK, to a progressive substitute tax, at a 28% marginal rate, with an allowance of £10,600; in Spain, to a progressive substitute tax at a 27% marginal rate. In Germany, capital gains realized by individuals are subject to a 26.38% withholding tax if the individual holds less than 1% of capital of the target company; in other cases, capital gains are subject to progressive personal income tax, but 60% of the capital gains are exempted: the PIT marginal rate is 47.48%. As to Germany, in the analysis we apply the progressive taxation of capital gains, as we assume that a VC investment usually represents more than 1% of a company.

[39] If the invested amount is equal to the maximum allowed, the best scheme is the UK SEIS, with a 23.41% ATIRR.

From the perspective of the tax design of incentive schemes, these results do not answer the question of whether a State has to provide an upfront incentive or a capital gains exemption. We do not get an answer from existing schemes, because this depends on the design of the tax system and on the duration of the investment: e.g., the effective tax rate on capital gains is influenced by the capital gain taxation method (cash or accrual basis) and by the tax rate (progressive or proportional); hence, granting an exemption might not be so important if the capital gains are taxed on a cash basis (there is a tax deferral effect) with a low proportional tax rate and the VC investor holds the shares for a long period.[40]

However, we can evaluate whether the incentives of existing tax schemes in any countries rely more on upfront tax credits or on capital gains exemptions. In order to achieve these results, we compare the ATIRR of any tax scheme to a standard situation, where no incentives are provided and individual investors are subject to the ordinary capital gains tax upon the disposal of the shares; we divide the two effects, assuming upfront tax credits and capital gains exemptions are alternatively provided (see table 5).

The results confirm that in Italy and in the UK upfront incentives are more important than capital gains exemptions: upfront relief accounts for around three quarters of the total advantage. In France, due to the heavy capital gains taxation and the limited upfront incentives, the capital gains exemption accounts for around nine tenths of incentives.

Table 5

State	France	Italy	United Kingdom
Incidence of upfront relief on tax advantage	3%	72%	76%
Incidence of capital gains exemption on tax advantage	97%	28%	24%

Note: the tax advantage is calculated as the difference between the ATIRR of the best tax scheme investment of a State (direct investment in JEI for France; VC fund for Italy; EIS for UK) and the ATIRR of the same investment without any incentives (NI-ATIRR). The split between upfront relief and capital gain exemption is computed with a two step approach: first we compute the advantage due to capital gains exemption as the difference between BTIRR and NI-ATIRR; then we find out the remaining advantage as the difference between ATIRR and BTIRR.

As regards the design of tax incentives, one interesting result is that, all other things being equal, as the duration of the investment increases upfront incentives become less effective compared with capital gains exemptions. In the case of Italy for a five-year or ten-year investment period investors

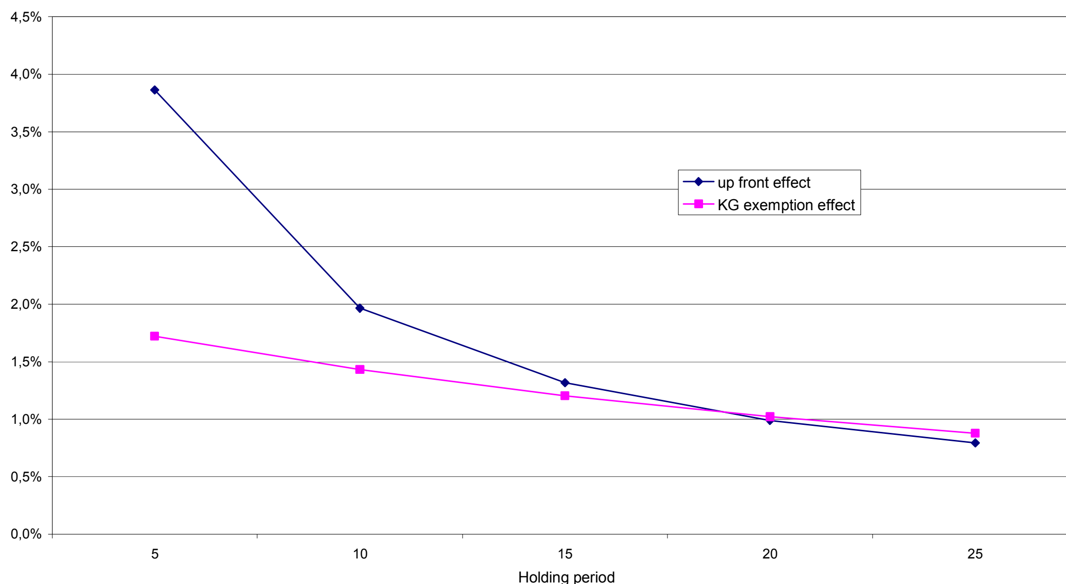
---

[40] Let us consider an investment in a company, with a 10% annual yield: the investor sells the share after ten years and the capital gains tax rate is equal to 12.5%. The ATIIR is 9.1%: a capital gains exemption augments the ATIRR by less than one percentage point. If shares are sold before five years, the ATIRR will be equal to 8.9% because the shorter the holding period, the shorter the tax deferral effect: in this case a capital gains exemption has a greater effect on investment decisions.

will prefer upfront incentives to capital gains incentives. But if the duration of the investment is increased to 20 years, upfront incentives lose importance, hence they prefer capital gains exemptions (see figure 4).

This result can be interpreted as a rationale for the tax design of VC. If lawmakers have to choose between upfront incentives and capital gains exemptions, they will prefer upfront reliefs in order to boost short period investments; if they would rather encourage VC investors to hold shares for a longer term, they have to provide capital gains exemptions.

Figure 4



Note: the up front effect and the KG exemption effect are equal to the differences between an ATIRR which considers, alternatively, the two effects, and the ATIRR calculated without considering any effect.

6. Conclusions

Unlike other European countries, Italy does not have a long history of tax incentive policies targeted at the VC sector. In comparison with other jurisdictions, what has been lacking is a structural policy able to improve the tax environment as a whole. The tax measures enacted before 2012 were fragmented and aimed solely at fostering a specific segment of the VC industry.

With the 2012 tax package for the first time Italian policy makers have dealt with the topic comprehensively, examining all the tax issues concerning supply/demand along the VC industry's value chain.

The Italian set of tax rules enacted in 2012 seems mainly modeled on the British one but, in contrast to other legislations, the Italian measures are temporally limited (up to 2015). A limit of three years could be perceived as too short a time horizon also considering the time required for the practical

implementation of the law. It follows that expectations in terms of a boost to the seed and early stages are likely to be undermined.

The new tax incentives seem to be well tailored to the current Italian venture-backed companies with reference to the threshold for the maximum deduction allowed, as it is not far from the average amount of investments. However, the legal definition of the eligible target is not currently in line with Italian targets financed by funds as regards the requirements for turnover and elective business sectors. We could envisage that a conscious tax policy choice has been made to encourage VC investments toward smaller-sized companies operating in specific sectors.

The new Italian framework requires coordinated action with the other tax incentives previously enacted, otherwise some undesired distortions could occur. As regards the on-going tax policies at the European level, the Italian tax framework is basically consistent with the 2011 European regulatory proposals, respectively on the "European Venture Capital Fund" and the "Social Entrepreneurship Funds". Some adjustments will eventually be needed.

Finally, quantitative comparisons shed light on the importance and magnitude of tax incentives; they can even double the rate of return of a VC investment. In the countries considered (French, Germany, Italy, Spain and the UK) the results of the analysis show that the most favourable schemes are provided for in the United Kingdom; in relative terms, not only the UK, but also France, has a well-functioning VC tax scheme.

As regards the design of tax incentives, the quantitative analysis supports the idea that upfront incentives lose importance compared with capital gains exemptions, when the duration of investment increases. This result implies that the tax lawmaker should prefer upfront reliefs in order to boost short period investments, and capital gains exemptions to encourage long term investments.

References

Anand B. (1996), *Tax effects on venture capital*, Unpublished WP, Yale School of Management.

Bonini S. (2012), *The Development of Venture Capital: Macroeconomic, Political, and Legal Determinants*, in The Oxford Handbook of Venture Capital, Douglas Cumming.

Boxberger L.M. (2008), *Germany Updates Financial Investment Tax Regime,* Tax Notes International.

Bronzini R., G. de Blasio, G. Pellegrini and A. Scognamiglio (2008), *The Effect of Investment Tax Credit: Evidence from an Atypical Programme in Italy*, (in Italian), Rivista di Politica Economica, 98(7-8).

Dovalina M., Avila J., Maldonado M.R., Rojas G. (2010), *An Overview of Spain's Venture Capital Industry*, Tecnologico de Monterrey.

European Commission (2010), *Report of Expert Group on removing tax obstacles to cross-border Venture Capital Investments*.

European Commission (2012), *Public consultation. Problems that arise in the direct tax field when venture capital is invested across borders*, 3 August.

EVCA, Yearbook 2012, www.evca.eu.

Faulconbridge J.R., Ewald E., Hoyler M., Beaverstock J.V. (2007), *Analysing the Changing Landscape of European Financial Centres: The Role of Financial Products and the Case of Amsterdam*, Growth and Change 38(2).

Gompers P., Lerner J. (1998), *What drives Venture Fundraising?*, Brookings Papers on Economic Activity-Microeconomics, pp. 149- 92.,

Groh A., Liechtenstein H. Lieser K. (2012), *The Global Venture Capital and Private Equity Country Attractiveness Index*, IESE Business School, University of Navarra.

ICO (2011), *Venture Capital. Policy lessons from the VICO projects*, September 30.

Jarass L, Obermair G.M. (2007*), Taxation of Private Equity and Hedge Funds in Germany,* Tax Notes International.

Jeng L. E., Wells P. C. (2000), *The determinants of venture capital funding: evidence across countries*, Journal of Corporate Finance, 6.

Keuschiniig C., Nielsen S. B. (2002), *Tax Policy, venture capital and entrepreneurship*, Journal of Public Economics.

Kessler W., Eicke R. (2008), *Germany's New Private Equity Act and 'Business Angels'*, Tax Notes International.

Magliocco A., Sanelli A. (2004), *Taxation and development of venture capital in Europe and the United States: A comparison of tax models, Taxation and Finance in Italy and Europe,* Bancaria (text only in Italian).

Magliocco A., Ricotti G. (2012), V*enture Capital Funds and the New Tax Framework in Italy*, European Taxation, vol. 52, n. 2/3, IBFD.

Mayer C., Schoorsb K., Yafeh Y. (2005), *Sources of funds and investment activities of venture capital funds: evidence from Germany, Israel, Japan and the United Kingdom*, Journal of Corporate Finance, vol. 11.

Ministry of Development (2012), Report task force, *Restart Italia!* (text only in Italian).

Poterba J.M. (1989), *Venture Capital and Capital Gain Taxation,* NBER, Cambridge.

Romain A., Van Pottelsberghe B. (2004), *The determinants of venture capital: a panel data analysis of 16 OECD countries*, Working Papers CEB 04-015.RS, ULB -- Université Libre de Bruxelles.

Vacca V. (2013), *Venture capital and banks. Financing innovation in Italy* (mimeo).

Annex 1

France

Tax incentives

a) Direct VC investments

As regards direct investments, individuals are entitled to a tax credit equal to 18% of the subscribed capital in unlisted small companies that have been incorporated for no longer than five years, with an annual limit of €50,000. The tax credit was equal to 25% of the subscribed capital until 2010 and was lowered to 22% in 2011. If the investment exceeds €50,000, the excess is a tax credit that can be deducted in the next four years, again up to the limit of €50,000. The tax credit must be repaid if the investment is liquidated (or the capital is given back) within five years.

As to the characteristics of target companies, they, inter alia, should: i) be resident in a Member State of the European Union or in Iceland, Norway and Liechtenstein; ii) not be listed; iii) be liable to corporate income tax; iv) employ at least two employees; v) carry on a qualifying trade, i.e. conduct a commercial or industrial activity that does not consist of an "excluded activity" (i.e. banking, etc.); vi) be small or medium enterprises (SMEs) as defined by Commission Regulation (EC) No 800/2008.

In the past, the French tax system also promoted investments in small and medium listed companies: a tax credit was provided for investments in SMEs listed on ALTERNEXT market (Faulconbridge et al., 2007).

At the time of disinvestment, capital gains realized by individuals are included in the income subject to progressive personal income taxation; a 15.5% social security contribution is applied, but a part of this contribution is deductible. A tax base reduction up to 60% is provided for, related to the holding period. Capital gains, therefore, are subject to a 58.21% maximum levy. 60% of dividends are included in the income subject to progressive personal income taxation; a 15.5% social security contribution is applied, but a part of this contribution is deductible. Dividends derived from these investments, therefore, are subject to a 40.21% maximum levy.

If the target company is a Jeune Entreprise Innovante (JEI), capital gains realized from individual investors are not taxed. A company is a JEI if: i) it is a small or a medium enterprise (SME) as defined by Commission Regulation (EC) No 800/2008; ii) it has been incorporated in the last eight years; iii) at least 50% of its shares are held by individuals or FCPI, FCPR, SCR, or other public foundations; iv) 15% of its deductible expenses are R&D expenses; either a manager or partner are qualified researchers (PhD, MA, Professor, etc.).

b) Indirect VC investments

There is a specific form of funds that can be used as VC funds: the Fonds commun de placement à risques (FCPR). The two main types of FCPR, in addition to the standard FCPR, are the Fonds commun de placement dans l'innovation (FCPI) and the Fonds d'investissement de proximité (FIP). There are still other French vehicles for VC investments in France: the société de capital risqué (SCR) and the société unipersonnelle d'investissement à risques/regional (SUIR).

As regards VC funds, the tax incentives depend on the characteristics of both the vehicle and of the target companies. The FCPI must invest at least 60% of its assets in "innovantes" (innovative) target companies; FIP must invest more than 60% of its assets in regional target companies; FCPR must invest at least 50% of its assets in target companies. The characteristics of target companies are the same provided for direct investment. Moreover, the investor should hold no more than 10% of the fund and no more than 25% of any target company in which the fund has invested.

The same incentives granted for direct investment (18% tax credit) are provided in the case of subscriptions for FCPI and FIP, with an annual limit of €12,000. With reference to FIP, the 18% tax credit may be increased up to 42% if the fund invests in certain depressed regions. The tax credit must be repaid if the investment is liquidated (or the capital is given back) within five years. The tax credit can be combined: if investors subscribe shares of FCPI and FIP, they can have 18% tax credit both on the investment in FCPI and on the investment in FIP, up to a maximum amount of €24,000. There are no specific upfront incentives for SCR.

As regards the disinvestment, individuals who invest in FCPR and SCR are exempt from tax on all income (dividends and/or capital gains) arising from the investment, provided that the investment in an SCR/FCPR is held for at least five years and any dividends paid out in the first five years are reinvested in the SCR/FCPR.

The tax exemption does not extend to social security contributions: the income/gains derived from these investments, therefore, are always subject to a 15.5% levy.

Incentives are also provided if the investor is a corporation or a non-resident: for the former, the gains from an SCR/FCPR are subject to corporate income tax at a reduced rate of 15%, compared to the ordinary rate of 33.33%. Foreign investors, due to the transparency of the FCPI and SCR, are not subject to withholding tax on income received.

It is worth noting that SCR and FCPR are exempt from corporate income tax on all income arising from companies in which they invest.

Germany

The German VC Act (Wagniskapitalbeteiligungsgesetz – "WKBG") and VC companies (VCC)

The tax stimulated scheme provided by the WKBC Act - enacted in 2008 and now no longer in force - did not restrict the application of tax incentives to a certain legal form. It simply required that vehicles had as their principal business, the holding, management and sale of venture capital participations. At least 70% of the total assets managed by the VCC had to be equity capital participations in a target company with a maximum holding period of 15 years. The registered office and management had to be established in Germany. The minimum participation in VCC was equal to €50,000.

As regards the characteristics of the target company, it had to be a corporation and it had to have its registered office and its management in a member state of the EEA (not necessarily in the same Member State). The equity capital of the target company had to be no more than €20 million at the time when the participation in the target company was acquired by a VCC. The target was required to have been set up no more than ten years before the time when the participation in the target company was acquired by the VCC. Finally, the target could not be listed on an organized or equivalent market.

With reference to the taxation of the VCC, it could be treated as either transparent (a partnership) or opaque (a corporation) for tax purposes. In general, the VCC would be subject to the same tax rules as ordinary partnerships and ordinary corporate entities. One of the ordinary rules of note is the corporate income tax exemption of 95% on dividends and capital gains, which a corporate entity derives from a corporate target company (the present German corporate income tax rate plus solidarity surcharge is 15.825%). This means that the effective taxation on dividends and capital gains is equal to 0.8%. The 95% exemption also applies to trade tax as far as capital gains are concerned, and to dividends, if the VCC holds at least 15% of the shares in the distributing target company at the beginning of the respective calendar year. Otherwise the dividend would be fully subject to trade tax, the rate of which depends on the municipality in which the VCC is located.

There was, however, some special tax rules which had to be applied to VCC: the main advantage was that a VCC would not have been subject to trade tax, if i) the activity of a VCC which was set up as a partnership had been in principle limited to the administration of shares (which must not include short-term sales) and other permissible assets and ii) the target companies had been solely corporate entities.

As regards investors, no tax incentives were provided for VC fund raising. At the time of disinvestment, a tax-free allowance was provided for on realized capital gains, if the shareholding was between 3% and 25% at the time of disposal or in the preceding five years, and if the participation had not been held for more than ten years. The capital gains were exempted up to €200,000, multiplied by the participation percentage. The tax-exempt amount was reduced, if the capital gains had been in excess of €800,000. The reduction was equal to the difference between the capital gains and €800,000 multiplied by the participation percentage.

VC vehicles in Germany and tax transparency

The VC industry uses other vehicles ("Unregulated VC Fund Vehicles") which were already used before the WKBG was enacted:

– GmbH & Co. KG , the German legal form of limited partnership, whose sole general partner is a GmbH; German VC Fund GmbH & Co. KGs usually have a so-called managing limited partner, i.e. the partnership agreement constituting the VC Fund limited partnership endows one of the limited partners with (co-) management authorities. The purpose of this is to avoid applying the so-called deemed commercial partnership concept. In addition, German VC Fund GmbH & Co. KGs normally strive to comply with the criteria for non-commercial-partnership-classification as described in the decree by the Federal Ministry of Finance dated 16 December 2003. Only in the case of non-commercial partnership classification, the VC Fund GmbH & Co. KG is fully transparent for tax purposes, i.e. the investors are in principle taxed as if they had made the investments directly.

– GbR (Gesellschaft bürgerlichen Rechts), the German legal form of simple partnership. Due to the absence of any limit on the liability of all partners, this legal form is rarely used for VC Fund Vehicles in practice.

- GmbH, the German legal form of company with limited liability. This legal form is used rather rarely, because it does not achieve tax transparency, i.e. there is an additional tax levy and the investors are not taxed as if they had made investments directly.

Annex 3

Spain

Tax incentives

a) Direct VC investments

Capital gains arising from the transfer of shares or participations in start-ups or recently created companies are exempted, provided the following conditions are met: i) the company whose shares or participations are transferred should be an unlisted limited liability company that undertakes a business activity (i.e. no real estate or portfolio companies) with an equity not exceeding €200,000 in the year the individual acquired the shares or participation; ii) the individual, who sells the shares or participations, should have maintained such shares or participations for a period of between three and ten years; and have not held more than 40% of the capital of the company; iii) the acquisition value should not exceed €25,000 (this amount could be increased to €75,000 by acquisition through an increase of capital in the three years after acquisition). This incentive applies to shares bought after 7 July 2011.

b) Indirect VC investments

The 2005 law provides for tax incentives in case of VC investments made through special entities. Venture capital entities (VCEs) are defined as financial institutions whose main purpose consists of taking temporary stakes in the capital of non-financial and non-real-estate companies, not listed at the time of the acquisition of shares on the stock exchange primary market or on any other equivalent regulated market in the European Union or in other OECD member countries.

In Spain there are specific vehicles that enable direct or indirect investments in Venture Capital, namely Venture Capital Companies ("VCCs"- Sociedad de Capital de Riesgo) which have legal personality and Venture Capital Funds ("VCFs"- Fondos de Capital Riesgo) which do not have legal personality. These vehicles may be used both for domestic and cross-border investments in Venture Capital.

A special tax treatment is provided for VCEs income taxation. It includes a total exemption on dividends and a 99% tax relief of the burden attributable to capital gains obtained through the transfer of shares and participations in the capital of target companies, if the transfer, computed from the time of the acquisition, occurs after a year and before 15 years (and exceptionally before 20 years). Given this 99% tax relief, the effective final taxation would be 0.3% of the gains arising from the transfer of the targets by the VCE (1% x 30%, i.e. the standard Corporate Income Tax rate).

This special treatment will apply with certain limitations. VCEs may also apply a tax credit to avoid Spanish double taxation on received dividends and a participation exemption to avoid international double taxation, regardless of the interest and holding period. The rest of the income received by these entities (interest, income derived from profit participating loans, etc.) will be taxed at the standard Corporate Income Tax rate of 30%.

As regards the taxation of the investor in the vehicle, capital gains and dividends are exempted if the investor is a Spanish corporate entity (a full deduction to avoid the Spanish double taxation may be applied, regardless of the interest and holding period). In the case of individuals, dividends and capital gains are considered taxable savings income, generally subject to the marginal rate of 27% for their gross amount, i.e. before deduction of any tax withheld at the source; dividends are exempted up to €1,500 per year.

United Kingdom

Tax incentives

a) Enterprise Investment Scheme (EIS)

The Enterprise Investment Scheme (EIS) was introduced in 1993 and is designed to help small companies to raise equity capital by offering a set of tax reliefs to investors purchasing new shares in those companies. New shares can be purchased directly or through an EIS Fund.

The tax incentive is allowed only for individuals and consists of an income tax relief, equal to 30% of the cost of the shares. The maximum relief is equal to £300,000 per year (€1 million in terms of investment). One year carry-back facility is provided for. The investor must not be "connected" to the target company: inter alia, he cannot hold more than 30% of the company and cannot be a partner, director or an employee of the company; only business angels can be directors of the company, but they must have no remuneration whatsoever. The shares must be held for three years. After this period, the investor who sells the shares is exempted from CGT, but only if they claim income tax relief; capital losses can be set against any income of the year or of the previous year.

The target company must meet certain requirements, among which: i) it must be UK resident, or have a permanent establishment in the UK; ii) it must not be listed on any market when shares are issued, except for the Alternative Investment Market (AIM) and the PLUS Markets; iii) it must not be controlled by another company; iv) the total assets of the company cannot exceed £15 million before any share issue and £16 million after that issue; v) it must have fewer than 250 full-time employees; vi) it must carry on a qualifying trade (e.g., real estate or financial activities are not qualifying trade); vii) it must not raise more than £5 million per year from VC schemes (EIS, VCTs and SEIS). The EIS qualification of a company is not automatic, but is decided by the Small Company Enterprise Centre (SCEC), administered by the HMRC.

b) Venture Capital Trusts (VCTs)

Introduced in 1995, the VCT scheme aim to spur individuals to invest through VCTs in a range of small trading companies whose shares and securities are not listed on an official stock exchange. In contrast to the EIS, investors do not choose the target company and leave this task to the management of a VCT.

In the UK there are three kinds of investment fund: a) unit trusts: open-ended, non-corporate investment funds; b) investment trusts: closed-ended investment companies with fixed share capital (the share must be quoted); c) OEICs: unit trusts in corporate form (like a SICAV). These funds may qualify as UCITS only if authorized by the FSMA. They may be tax-favoured (i.e. they are not subject to UK tax on their capital gains) only if they are approved by Inland Revenue.

Venture Capital trusts (VCTs) are a sub-set of investment trust companies and must be admitted to trading on a regulated market of the EU or EEA. Essentially, all investors in VCTs are retail investors and are UK tax payers, because only UK individual tax payers can claim tax reliefs.

VCTs must be approved by HMRC in order to be exempted from Corporation Tax on any gains arising on the disposal of their investments and to allow investors to get tax incentives.

The VCT tax relief consists in upfront incentives, disposal and dividend reliefs.

As regards upfront incentives, there is an income tax relief at the rate of 30% on the amount invested in new VCT shares. The tax law provides for an annual limit of £200,000 on the total value of the investment. The investors must hold VCT shares for a five-year qualifying period before a disposal takes place.

There are exemptions from Income Tax on dividends from ordinary shares in VCTs and from CGT on any gain made on the disposal of VCT shares.

The granting of tax incentives depends on the characteristics both of the vehicle and of the target companies. Inter alia, the VCT must have more than five investors and must be quoted and approved by HRMC; at least 70% of its investments must be in an unquoted qualifying company; no more than 15% of its investments must be in a single company; at least 85% of the VCT income from shares and securities must be distributed. The characteristics of the target companies are the ones described in the EIS section.

c) Seed Enterprise Investment Scheme (SEIS)

Launched in 2012, SEIS encourages equity investment in new small, early-stage start-ups. It should be seen as a complement of EIS: target companies can use EIS after an initial issue supported by SEIS.

Income tax relief is available to individuals who subscribe for qualifying shares in a company which meets the SEIS requirements. The shares, as in the EIS scheme, must be held for a period of three years. Relief is available at 50% of the cost of the shares, on a maximum annual investment of £100,000. As with the EIS, a one year carry-back facility is provided.

Only in 2012 was a capital gains reinvestment relief (roll-over incentive) granted: a capital gain realized the in 2012-13 tax year is exempted from CGT, if all or part of it is reinvested in shares which also qualify for SEIS income tax relief. The £100,000 investment limit which applies for income tax relief also applies for re-investment relief.

As regards the disposal of shares, if an income tax relief is claimed, any capital gains realized after the holding period is exempted from CGT.

Investors obtain tax relief only if: i) they hold no more than 30% of the company; ii) they are not an employee of the target company. These two conditions must be met only from the date of incorporation of the company to the third anniversary of the date of issue of the shares subscribed by the investor.

As regards the characteristics of the target company, they are the same as those required for the EIS schemes, except that: i) the total assets of the company cannot exceed £200,000; ii) the company must have fewer than 25 full-time employees; iii) the target company must not raise more than £150,000 per year from an SEIS scheme; iv) it must not raise any equity from EIS or VCT schemes; v) the company's business must be no more than two years old.

As in EIS, also the SEIS qualification of a company is not automatic, but it is decided by the Small Company Enterprise Centre (SCEC), administered by the HMRC.