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INSTITUTIONAL DETERMINANTS OF PRIVATE EQUITY MARKET IN CZECH REPUBLIC

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ABSTRACT. A well-functioning private equity and venture capital market is affected by a range of institutional aspects. This study intends to answer the question on what is the current tax and legal environment for private equity and venture capital investments in Czech Republic as previous studies have emphasized that a rather poor scope of resources available. Qualitative data with content analysis proved to be the best way to assess the institutional framework. Data collection methods cover a comparative analysis of scientific literature documents and reports, as well as primary data from interviews with experts in the industry. The results of both secondary and primary data analysis were categorized and serious gaps in the institutional framework were identified and discussed. Our results indicate that the issue of legal and organisational structure suitable for private equity and venture capital funds may be resolved through a national equivalent to a Limited Partnership which has already been adopted into Czech law. However, a tax handicap was identified implying that it is necessary to amend the tax legislation so that the legal regulation extends the tax exemption. Another amendment should then be directed towards eliminating or mitigating the barriers imposed on pension. We believe that our findings provide valuable implications for the government, banks, stock exchanges and venture capital industry while formulating new strategies how to increase the level of investments in this specific environment of Czech Republic.

***JEL Classification*:** B25, G24, K23

Keywords: new institutional economics; private equity; venture capital; tax and legal environment; private equity fund structures

Introduction

In well-developed capital markets private equity and venture capital (PE/VC) is considered to be an important pool of sources that can significantly contribute to developing entrepreneurship and positively impact the growth of national economies. Previous research has proved that PE/VC supports innovations and thus, also the development of entirely new industries (e.g. Lahti, 2008; Mason and Harrison, 2004; Cichy and Gradoń, 2016; Gollay *et al.*, 2016).

Peneder *et al.* (2004) defined a set of prerequisites affecting the development of PE/VC market, namely (1) the existence of suitable legal fund structures for PE/VC investments and their tax treatment, (2) the involvement of competent investors, (3) an environment offering attractive investment opportunities and (4) a functional capital market which ensures the liquidity of individual investments. The study also concludes that institutional framework is essential if a government aims at supporting the PE/VC capital market. In particular, the establishment of suitable legal fund structures and their tax treatment ought to be the priority.

According to the statistics of Invest Europe (2016a), Czech Republic took the last place in CEE countries by the share of PE/VC investments to GDP (Invest Europe, 2016a), although many legislative changes were conducted between 2012 and 2016 so that to support the local PE/VC market. We assume that the development of this market is still adversely affected by a set of institutional drawbacks already highlighted in previous studies (e.g., Zinecker, 2011; Pazour and Marek, 2011), which are, however, essential for a higher level of commitment on the side of both domestic and foreign investors. Therefore, in this paper, we examine the current tax, legal and investment environment for PE/VC development in Czech Republic by trying to answer the question, which elements of the current institutional framework are not comprehensible and competitive from the perspective of both domestic and foreign investors. We believe that the results can contribute to better understanding of investment obstacles in terms of the PE/VC industry. Revealing a gap in institutional factors is a starting-point in formulating new strategies how to take influence on the PE/VC activity. We expect that our findings will be beneficial not only for the PE/VC industry, but also for stock exchanges and macroeconomic policy makers while discussing and designing incentives how to support entrepreneurship and economic growth under the specific conditions of Czech Republic.

The methods employed in this paper include systematic and logical literature analysis, collecting of original data (through structured interviews), content analysis of survey-gained data, and expert interpretations of the same.

The rest of this paper proceeds as follows. First, we review the literature on the role of formal institutions for the PE/VC capital market development. Section 3 provides an overview of the related methodological approaches. Section 4 presents the detailed findings and the last sections discuss and summarise our main conclusions.

1. Literature Review

The new institutional theory proved to be a popular theoretical foundation for exploring a wide range of scientific topics in the entrepreneurial research inclusive of private equity and venture capital (Ahlstrom and Bruton, 2006; Li and Zahra, 2011; Lerner and Tåg, 2013). Bruton *et al.* (2010) reviewed the existing entrepreneurship literature that employs institutional theory and understand the term “institution” as “a set of formal rules, ex ante agreements, less formal shared interaction sequences, and taken-for granted assumptions that organisations and individuals are expected to follow” (Delibasic, 2016). Therefore, the institutional theory is focused on research of regulatory, social and cultural aspects that “promote survival and legitimacy of organisation” (Bruton *et al.*, 2010).

Private equity and venture capital (PE/VC) is one of the most important resources of financing for start-ups and high-growth potential businesses in both well-developed and emerging economies (Ahlstrom and Bruton, 2006). The phenomena of uncertainty and information asymmetry, however, play an essential role in terms of its availability because of transaction problems (Li and Zahra, 2011). Recent academic literature on PE/VC documented that both formal and informal institutions represent the proper incentives supporting investors in reducing transaction problems and thus enhancing their investment activity (Ahlstrom and Bruton, 2006; Li and Zahra, 2011; Lerner and Tåg, 2013; Strelnik, 2016). There are several elements of a stable institutional framework as shown by Ahlstrom and Bruton (2006): a predictable rule of law and enforcement regime to facilitate and safeguard the investments, efficient markets for corporate control and capital and minimal corruption. The concept of quality of institutional system is currently considered as the core of institutional economics (for more details see e. g. Kuder, 2015; Balcerzak and Pietrzak, 2016; Lizińska *et al.*, 2016; Woźniak-Jęchorek, 2016).

Lerner and Tåg (2013) surveyed the literature on PE/VC and institutions and based on a case study compared the development of the PE/VC market in the United States and Sweden. In particular, the legal environment, financial market development, the tax system, labour market regulations, and public spending on research and development represent the corestone of their analysis. The authors conclude that the legal environment in a country affects directly PE/VC activity because it implies "the extent to which efficient contracts between venture capitalists and entrepreneurs can be written and enforced".

Further evidence also suggests that the regulation of legal fund structures ought to be a priority in particular because it affects the exercise of ownership title, the manner and scope of investor liability, the method of profit and loss distribution, the manner and extent to which investors can participate in the management of the PE/VC fund, the liquidity and inheritability of shares, and tax treatment at the levels of both the PE/VC fund and the investors (Peneder *et al.*, 2004). In the international context, the most common legal form of PE/VC funds is the Limited Partnership based on the law of the UK and US, as it conforms to the general requirements of the PE/VC market participants (Peneder *et al.*, 2004).

A well-developed local stock market is crucial for venture capitalists because it represents a channel how the investors can arrange their exit through an initial public offering. There are many additional benefits of going public for both the investors and investee companies (Meluzin & Zineker, 2016, pp. 327-341). The entrepreneur can regain control of the firm and the venture capitalist can signal its quality and thus raise fresh funds from investors for future projects, etc. A local venture capital market also tends to boost if public pension funds receive the opportunity to invest a part of their inflow of funds onto the venture capital market (Lerner and Tåg, 2013).

Capital gain taxes are essential while supporting venture capital market in a country, because taxation affects contracting between venture capitalists and entrepreneurs. The development of the market can be hindered if the capital gains taxation lowers significantly the return on investment and thus incentives for entrepreneurs to expand and venture capitalists to provide support (Lerner and Tåg, 2013). An efficient tax structure for investments into PE/VC is based on the principle of tax transparency. The main idea behind tax transparency is that PE/VC fund investors should not be in a worse position from the perspective of capital gains taxation than investors who invest directly into an investee companies. According to a study published by the European Venture Capital Association in 2006 (hereinafter only as the "EVCA"), three models of tax structures for supporting PE/VC investments can be distinguished in Europe. The first model is represented by countries which adopted such a tax structure into their legislation which is tax-transparent or tax-free. Such structures are relevant for both national and international investors. The second group of countries provides investors with structures which offer favourable taxation treatment in that country under certain conditions. However, such structures are very often not applicable because they are complicated or linked to restrictive conditions. In the last group of countries no transparent structures are established, and thus PE/VC investors usually use foreign structures in low tax areas.

The EVCA states that in 2014, 27% of all European funds invested in private equity originated from pension funds which are the biggest investor in private equity in the USA and Western Europe (EVCA, 2014). According to the 2015 Invest Europe report on European private equity activities (2016b), 29% of PE resources in the UK came from pension funds.

Similarly, in 2012, investments of pension funds in alternative instruments exceeded 19%, compared to 5% 15 years earlier (Boyde, 2013; Wills Towers Watson, 2013). The importance of PE/VC investments to pension funds is also mentioned by Khort (2015). In comparison to the Western Europe the participation of pension funds as a source of capital is at a significantly lower level.

2. Methodological Approach

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

The research approach was developed after an extensive review of recent academic literature on institutional economics and venture capital in well-developed and emerging markets (Ahlstrom and Bruton, 2006; Li and Zahra, 2011; Lerner and Tåg, 2013; Balcerzak and Pietrzak, 2016; Lizińska *et al.*, 2016; Woźniak-Jęchorek, 2016; Caselli, 2009; Cumming, 2010; Gregoriou *et al.*, 2011; Cumming and Johan, 2013).

As the phenomenon under study is complex and explanatory in nature, qualitative data proved to be the best way how to assess institutional framework for PE/VC in the Czech Republic. We used the content analysis as data collection method. Hsieh and Shannon (2005) defined content analysis as a type of qualitative study, "a research method for the subjective interpretation of the content of text data through the systematic classification process of coding and identifying themes and patterns". Moldavska and Welo (2017) give reasons for applying content analysis as a research method. Firstly, content analysis is a tool to provide "new insights and increase the understanding of a specific phenomenon". Next, this method is also appropriate to gain "a broader and more condensed description of the phenomenon, as well as to describe and quantify a phenomenon". As recommended by Moretti *et al.* (2011) we used "inductive content analysis" as no previous study on the topic has dealt with the issue of the PE/VC institutional framework in the Czech Republic and the former knowledge is fragmented. A three-stage scientific approach developed by Moldavska and Welo (2017) was applied: preparation, organization and reporting.

Preparation stage consists of data collection. An essential source of secondary data represents Acts of Collection of Laws of the Czech Republic and their Explanatory Memoranda and Regulations and Directives of the European Parliament and of the Council. The definitions of key terms used herein come from Invest Europe's statistical yearbooks (2016a, b, 2017). Secondary data was also obtained from the studies published by EVCA (2006, 2008, 2010), Austrian Private Equity and Venture Capital Organization (Peneder *et al.*, 2004; Gloden *et al.*, 2006), and Czech Private Equity and Venture Capital Association (2010) (hereinafter only as the "CVCA"). Furthermore, academic papers that include a definition of institutional framework in context with PE/VC have been the object of the research. We used the following databases: Web of Science and Scopus. To limit the number of papers we reviewed and to list the most relevant we defined search criteria as follows: ("private equity") AND ("venture capital") AND ("institutional framework") OR ("legal structures"), AND ("Czech Republic"). The data range includes the years between 2010 and 2016 as substantial legislative amendments in Czech Republic were conducted to support PE/VC industry in this period. We considered papers written in English.

Furthermore, experts from PE/VC industry (in particular institutional investors) were interviewed to gain primary data. The interviews were conducted in the period from December 2016 to February 2017. The main advantage of the survey approach was that we could directly ask questions on issues (variables) that are not publicly available. On the other hand, surveys measure beliefs and not necessary actions of respondents. This is considered to be their drawback (Bancel and Mittoo, 2009). The key topics covered within face-to-face and phone interviews were as follows: tax and legal factors affecting PE/VC funds structures in the Czech Republic and the EU, defining the tax and legal environment for limited partners and fund management companies, available PE/VC fund structures within Europe, the tax and legal environment for PE/VC in the Czech Republic, tax and legal barriers preventing the establishment of a standard PE/VC fund in the Czech Republic, and legislative amendments of corporate law. The questions were open response because of the novel nature of the topic. Eight respondents delivered usable information which could be transcribed, categorized and interpreted.

Both secondary and primary information sources were carefully reviewed. The goal of the qualitative content analysis was to categorize gained data and to define a set of variables to see and discuss core lacks in the Czech institutional framework in context with PE/VC. Finally, reporting stage consists in formulating of proposals for prospective improvements of the institutional framework.

3. Research results

3.1. Private Equity and Venture Capital Fund Structures

On the basis of the literature review, e.g. Jenkinson (2008); Metrick and Yasuda (2010), and the interviews with investors and experts from the PE/VC industry, it may be stated that the legal form which the investors operating in the international context prefer for the purposes of establishing a PE/VC funds in the so-called Limited Liability Partnership (UK) and its variations, such as Société d'investissement à capital variable (SICAV) and Société d'investissement en Capital à Risque (SICAR) in Luxembourg. The most frequently cited reasons include tax transparency, flexible capital rules, the possibility of establishment for a definite term, the possibility of flexible capital calls, the possibility to issue various types of equity securities, and the possibility to restrict the share transferability. Fulfilling these criteria by means of various legal forms established in the Czech legal system is analysed in the following paragraphs, whereas the summary of the qualitative analysis is shown in *Table 1*.

Since 2011, the legislative regulation of the legal forms of investment funds in the Czech Republic has seen substantial amendments. Above all, the completely new Act on Investment Companies and Investment Funds (hereinafter only as the ZISIF) (No. 240/2013 Coll.) became effective in 2013, replacing the unsuitable Collective Investment Act (No. 189/2004 Coll.). Among other things, the ZISIF reflects Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (abbreviated as UCITS) and Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (abbreviated as AIMFD). Apart from that, with the effect from 2014, the Czech Republic has recodified the private law in the form of the new Civil Code (No. 89/2012 Coll.) and Business Corporations Act (No. 90/2012 Coll.).

We will now focus on the analysis of the legal forms of the funds of the SICAV and SICAR types, which were not established in the Czech law until the effect of the Business Corporations Act (No. 90/2012 Coll.).

Within the ZISIF, there has been a fundamental change in certain concepts, in particular the concept of "investment fund" and "collective investment fund". In the previous legal regulation, the concept of "collective investment fund" represented an umbrella term. Collective investment funds were divided into investment funds (with the legal personality, exclusively in the legal form of a joint stock company) and unit trusts (without the legal personality). Another classification divided collective investment funds into standard and special funds including qualified investor funds. The ZISIF completely transformed this classification, when some concepts are still used, yet with completely different meanings. The "investment fund" is now any entity engaged in collective investment, regardless of its legal status and legal personality.

The ZISIF now explicitly divides investment funds into qualified investor funds and collective investment funds, which include 1) standard funds (complying with the requirements of the UCITS Directive) and 2) special funds (not complying with the requirements of the UCITS Directive).

In particular, the qualified investors include professional institutions (e.g. banks) and other investors operating in the mode of the written declaration when meeting the limit of the minimum amount of initial investment corresponding to 125,000 EUR. The amendment to the ZISIF (No. 148/2016 Coll.), becoming effective in June 2016, also allowed the alternative in the form of the minimum amount of 1 million CZK, provided that the "suitability test" demonstrates the suitability of the client's investment profile. The amount of 1 million CZK roughly corresponds to 40,000 EUR, which according to the explanatory memorandum is the amount defined for the qualification of an investor for example in Poland (Explanatory memorandum of Act No. 148/2016 Coll., 2016). At the same time, qualified investor funds and special funds are ranked among the so-called alternative funds, the regulation of which is primarily based on the AIFMD Directive.

According to the ZISIF, investment funds may also be divided into funds with legal personality (a number of options) and funds without legal personality (unit fund and trust). Another classification is based on the fund administration, when, for instance, the autonomous investment fund is managed by itself, unlike other funds.

Whereas the legal regulation in 2011 admitted only the joint stock company or unit trust as the legal form of collective investment funds (currently thus investment funds), the new legislation has substantially extended the options. For PE/VC funds, two newly established structures are important, as they may only be used in the case of an investment fund: a joint stock company with variable registered capital (hereinafter only as the SICAV, according to the Luxembourg model (SICAV) and a limited partnership with investment certificates (hereinafter only as the KSIL), which is the structure corresponding to the Limited Liability Partnership or SICAR. The aim was to make the Czech Republic more attractive for foreign investors (Explanatory memorandum of the Act on Investment Companies and Investment Funds, 2013).

In addition, the ZISIF also newly defined the so-called sub-threshold funds which are subject to the registration principle only, rather than a license issued by the Czech National Bank (the so-called property administration comparable to management). Apart from the closed type fund in the legal form of a common joint stock company, the current options thus include the SICAV fund, as well. It issues two types of shares, i.e. founder shares and investment shares. In its character, it belongs to open-end funds, where as it also maintains the legal personality. It allows flexible, i.e. essentially automatic changes in the amount of the registered capital depending on issuing and purchase of investment shares. The legal form allows the exit in the form of repurchase of investment shares. The internal SICAV structure was originally obligatorily monistic. However, this requirement was eliminated with the ZISIF amendment. The entry in the Companies Register does not include its entire authorized capital, but only a part consisting of the so-called registered capital, which is the amount subscribed by the founders and the corresponding to founder shares. Shares are issued as unit shares, i.e. without the nominal value, and represent an equal share in the registered capital of the SICAV, or the equity of the sub-fund. Investment shares may be issued without voting rights, as well. Investment shares may be subscribed only on the basis of a public call, whereas the subscribers may include only qualified investors. If per-mitted by the statutes, the SICAV may establish flexible sub-funds representing separate accounting and property assets, even without separate capital requirements. Individual sub-funds may be assigned with different investment strategies.

Within the context of the Czech legislation, the closest to the legal form of the SICAR type is the limited partnership company with investment certificates (KSIL). According to the explanatory memorandum, it was for example the SICAR that served as one of the models for the Czech legal regulation of the KSIL. The original legislation suffered some shortcomings, most of which were nevertheless addressed in the ZISIF amendment effective since the beginning of 2015. In the KSIL, one shareholder (unlimited partner) always serves as the general partner with unlimited liability for debt, whereas the shares of limited partners with limited liability are represented by investment certificates, as well as certificated securities to order, which allow easier transfer of shares which may be publicly traded. Unlike the SICAV form, which is available for both collective investment funds (as well as standard funds), and qualified investor funds, the KSIL may be solely used by the qualified investor fund. Unlike the general legal regulation of a limited partnership, KSIL limited partners are not recorded in the Companies Register, and the ZISIF amendment also excluded the accessibility of the limited partners data in the collection of documents to the public. The ZISIF amendment also completely excluded the liability of limited partners, also in the case when they have not yet paid the whole amount of their deposit, and the interpretation may also infer the exclusion of liability after the liquidation of the company. Since 2015, the position of limited partner has seen substantial improvement.

Even though there is thus the legislative basis for the suitable organizational and legal form of the PE/VC funds in the Czech Republic, until now, there has been no investment fund in the KSIL legal form registered in the list kept by the Czech National Bank (Regulated institutions and registered financial market entities lists). It may be assumed that the reason for this consists in the substantially discriminating tax conditions, as specified below.

The qualified investor funds also include the investment fund in the EuVECA regime regulated since 2013 by the regulation of the European Parliament (Regulation on European venture capital funds, 2013). Within the ZISIF, this fund is labelled as the qualified fund of venture capital The EuVECA regime is voluntary, being based on the opt-in principle. Voluntary compliance with this regime brings an advantage in the form of the so-called European passport, which allows the administrator to offer investment in these funds in other EU Member States. In order for an investment fund to comply with the EuVECA definition, it has to invest at least 70% of the deposits or other investment of its members into so-called qualified investments within small and medium enterprises. Several legal forms are admissible, including the KSIL and SICAV. At the same time, it must be an alternative investment fund, i.e. the so-called sub-threshold fund administering the property not exceeding the value of 500 million EUR. At the present time, the CNB records do not contain any such fund under the ZISIF; nevertheless, the CNB records 16 foreign funds comparable to EuVECA (Regulated institutions and registered financial market entities lists).

The issue of the suitable legal and organizational form of PE/VC funds in the Czech Republic may be concluded with a finding that the current legislation (except the area of taxes, as specified further) has already set up acceptable conditions. For details see *Table 1*.

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

PE/VC Fund Structures	Criteria						
	a	b	c	d	e	f	g
Limited partnership with investment certificates	✓		✓	✓	✓	✓	✓
Joint stock company with variable registered capital	✓	✓		✓	✓	✓	✓
Limited partnership			✓	✓	✓	✓	
Joint stock company		✓	✓	✓	✓	✓	
Limited liability company		✓	✓	✓	✓	✓	

Note: a: Flexible capital rules; b: Tax transparency; c: No duty to repurchase the share; d: Possibility of establishing for a definite term; e: Possibility of capital calls; f: Possibility of limiting the share transferability; g: Various types of member securities

Source: own research.

3.2. Taxation of Private Equity and Venture Capital Funds

This part of our analysis focuses on the assessment of tax transparency of the legal and organisational forms anchored in the applicable Czech legislation.

Within the European Union, each Member State has jurisdiction to tax investment funds through its own legislation. Taxation of investment funds and their investors in the Czech Republic is regulated by the Act on Income Taxes (ITA) (1992), which has also undergone a certain evolution since 2011. Already in 2011, i.e. in the time when the terms and conditions of the later ZISIF were not yet known, an amendment to the ZDP was adopted (Act No. 458/2011 Coll.), also containing a part concerning investment funds with a zero tax rate for all investment funds. These changes were supposed to become effective at the beginning of 2015. However, this did not happen in the end, as the regulation was not consistent with the conditions introduced by the ZISIF in the period of vacantia legis of the ZDP amendment. It was necessary to respond to the new conditions, while there occurred the need to adapt the ZDP to recodification changes. Another amendment to the ZDP thus proved necessary. Its changes were supposed to become effective at the beginning of 2014, together with the recodification changes. Within this amendment, the zero income tax rate was put forward again only for selected types of investment funds, while investors were supposed to be consistently subjected to taxation (15% withholding tax in the case of natural persons and 19% in the case of legal entities). Other funds were supposed to be taxed by a common corporate tax rate of 19%, while all the payments should be exempt in order to avoid double taxation (Explanatory memorandum of amending law, 2013).

Since the amendment became effective, the taxpayers of corporate income tax have included not only all the organizational forms of investment funds with legal personality, as the legal personality has also been granted to the closed unit trust and similarly SICAV sub-funds (hereinafter only as the trust fund). The subject to the income tax is the investment fund's income on all activities and disposing of any assets. As for the tax rate, the zero tax rate was dropped by maintaining the exemption (introduced in 2004) for all domestic and some foreign funds consisting in the 5% tax rate; in the Czech Republic since 2010, there has been a general corporate income tax rate, which has also been applied onto the foreign funds not meeting the statutory conditions, at the level of 19%. When this legal regulation became effective the tax rate for investors remained unchanged, keeping the withholding tax of 15% for both natural persons and legal entities. A combination of a reduced tax rate for funds, together with a possible exemption from taxation of investors pursuant to the Dividend

Directive (see below) led in a number of ordinary business corporations to using the fund mechanism and establishing funds solely for the purposes of tax avoidance.

Other important changes were introduced by means of a technical amendment to the ZDP, taking effect at the beginning of 2015. The primary aim of the legislature in the area of taxation of investment funds was preventing harmful tax planning while reaching the tax neutrality. In order to fulfil this purpose, the amendment introduced the institute of the "basic investment fund" The purpose of the selective approach to basic and other investment funds was the effort to reduce the number of entities opting for the legal form of an investment fund solely due to tax avoidance (Explanatory memorandum of amending law, 2014). Since then, only basic investment funds have been subject to the reduced 5% tax rate. Other investment funds have been subject to the general corporate tax rate at the level of 19%. According to the explanatory memorandum, no tax benefits are desirable in this type of investment funds (Explanatory memorandum of amending law, 2014). In principle, these funds then operate in the regime of ordinary business corporations.

At the same time, the definition of the basic investment fund is satisfied in particular by those funds which do not commonly allow establishment with a special purpose, i.e. those whose shares are traded on the European regulated market and open unit trusts. In other cases, investment funds must comply with the statutory limitations in order to satisfy the definition. For PE/VC funds, it is important that the basic investment fund also includes the SICAV investment fund and sub-fund investing in accordance with its statutes more than 90% of the value of its assets in participations in capital companies.

Similarly to domestic funds, foreign funds may benefit the reduced tax rate only for selected types of funds from the European Economic Area (EEA). Upon complying with the statutory conditions, investment funds may benefit the tax exemption applicable to received dividends and the sale of shares in subsidiaries held in the long-term. The tax exemption is based on the so-called Dividend Directive (Directive on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, 2011). It provides for the exemption of paid profit shares paid by subsidiaries to their parent companies from withholding taxes and eliminates double taxation of profits. The exemption applies to income from profit shares paid by a subsidiary which is a Czech tax resident to the parent company, as well as income from transfer of shares of the parent company in the subsidiary onto the company which is a resident of an EEA State. At the same time, if the Czech parent company receives profit shares from a subsidiary of another EEA State, the received profit share is not subject to taxation in the Czech Republic. The exemption also applies to income from profit shares paid by subsidiary which is a tax resident in another EEA State to a permanent establishment of the parent company, which is a Czech tax resident and is located in the Czech Republic. The exemption is also extended upon meeting other conditions onto an EEA concerning the share of profits paid by a business corporation and transfer of shares in the business corporation which is resident of a third country with which the Czech Republic has concluded an effective agreement on avoidance of double taxation. The tax exemption requires meeting the definition of the parent company and subsidiary: a tax resident of an EU Member State, as well as the condition of the legal form (joint stock company, limited liability company, cooperative, European company, or European Cooperative Society), the condition of the minimum amount of registered capital (10%), and the condition of a minimum holding period of the share (12 months; it can also be met subsequently). The amended Directive (implemented in the Czech Republic by Act No. 125/2016 Coll.) adopted a regulation where the Member State in which the parent company is based, no longer subjects to tax the profit of the subsidiary to the extent that such gains are not taxable for the subsidiary (thus eliminating the possibility of so-called double nontaxation). If the exemption to the share of profits cannot be applied, the withholding tax on income from received profit shares in an investment fund amounts to 15%.

If it is impossible to apply the exemption onto the sale of the share under the Dividend Directive, the proceeds from the sale are subject to ordinary taxation. In this case, a fundamental inconvenience for the PE/VC fund consists in the fact that the acquisition price is tax effective only up to the amount of the income from the sale of the share and the sale of every share is assessed separately. In this context, what is of essential importance to PE/VC funds is the fact that the KSIL (and in addition its limited partners in the investor’s role) will not reach the exemption as its very legal form does not comply with then definition of the parental company (or the subsidiary) under the ZPD. In fact, the Dividend Directive defines, as a necessary condition, a set of legal forms, both multinational (European Company or European Cooperative Society), and individual Member States, to which the exemption mandatorily applies (joints stock companies and limited liability companies in the case of the Czech Republic). Member States then may extend this set by means of the national legislation. However, in the case of the Czech Republic, the definition of the parent company and subsidiary extended with a cooperative only. In fact, the received shares in profits and income on sales shares are crucial to PE/VC funds. This is probably the main reason why this legal form of the investment fund has not yet been used in the Czech Republic. An investment fund in the KSIL legal form would have to tax all received shares in (already taxed) profits and any income on the sale of long-term shares in companies, whereas it could not offset the loss of any transaction to profit. Also, shares in profits paid to KSIL corporate investors from previously taxed income could not be exempt from tax.

At the level of investors, the taxation also includes the paid shares in profits and income on the sale of shares.

In the case of domestic investors, the taxation of paid profit shares remained in the form of the 15% withholding tax; when meeting the above statutory conditions, corporate investors may apply the exemption under the Dividend Directive. In the case of foreign investors, unless the treaty on the avoidance of double taxation stipulates otherwise, the withholding tax is fundamentally also 15% and corporate investors may apply, under the above statutory conditions, legal exemption under the Dividend Directive. There is an exception in the case of certain non-residents, when the tax rate is 35% (so-called tax havens).

As for the income on the sale of shares, the legal entity may also apply the tax exemption under the Dividend Directive. If it is impossible, the resident will include it in the general tax base to which the 19% rate applies. In the case of investors – natural persons, the income on the sale of shares is exempt from tax when complying with the statutory conditions upon the completion of the time test in the period of 5 years, unless it is business property. If the tax exemption cannot be applied, the natural person will include the income in the tax base (as other income or possibly income from independent activities if the share was included in the business property).

Apart from the above restriction concerning the legal form, the investors in PE/VC funds may also be affected by the limitation of the tax exemption to EEA tax residents only. As stated in the CVCA, typical investors in PE/VC funds include institutions investing through foreign structures often outside the EEA, although the majority of these structures are transparent in terms of tax, and the final taxation occurs at the final investors in their jurisdiction. In particular, these include investors from countries where capital is available, such as the USA. The CVCA pointed out that discrimination of these investors could significantly affect the attractiveness of the Czech Republic for establishing funds and subsequent investment in the Czech Republic (CVCA comments, 2015).

Another limitation for investors of normally taxed funds could also consist in the condition of at least 10% share in order to meet the definition of the parent company.

For the reasons of completeness, it should be noted that the amendment also introduced changes which affected SICAV funds (or sub-funds), when the originally synthetic approach of the summary assessment (for the whole joint stock company) of the conditions for tax exemption under the Dividend Directive changed into an analytical approach, assessing the compliance with the conditions for every sub-fund separately. In addition, the SICAV sub-fund, which is also a collective investment fund, was removed from the group automatically belonging to basic investment funds (Explanatory memorandum of amending law, 2014).

With respect to the above, the issues of tax conditions of PE/VC funds in the Czech Republic may be assessed as largely unfavorable both on the level of taxation of funds themselves, and their investors. For details see *Table 2*.

Table 2. Fund structures and their taxation

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

Source: Own research.

3.3. Investments of pension funds

In the Czech Republic, there are altogether eight pension companies operating soon-to-expire supplementary pension insurance or supplementary pension savings, replacing the supplementary pension insurance in 2013. These companies thus manage both transformed and participating pension funds. At the end of 2016, the volume of managed assets of participants totalled at 383.033 bn. CZK (Czech Association of Pension Companies Statistics, 2017).

Originally, the statute did not allow pension funds to invest in PE/VC funds. However, in 2013, a pension reform took place in the Czech Republic. The basis of the current pension system, from which state pensions are paid, includes the first pillar, which represents the continuously funded state system mainly from social security contributions with mandatory participation of employees and sole traders.

The second fund pillar consisted of pension savings which could be joined on a voluntary basis with a subsequent duty to remain in the system. Yet, it was discontinued in 2015. The third pillar includes supplementary pension insurance for participants of transformed funds (within the pension reform) and supplementary pension savings (within the reform, the newly defined participating funds). The pillar operates on a voluntary basis with a state contribution.

It is the funds in the third pillar that may partially invest in PE/VC. Transformed funds allow investing 5% of the assets in alternative assets; however, the statute provides for a requirement of ensuring reliable revenue, which tends to lead to more conservative strategies (Act on State-Contributory Supplementary Pension Insurance, 1994). In addition to the mandatory conservative fund, participating funds allow for more dynamic profiles with the possibility of using special funds. These special funds exclude PE/VC investments by means of an exhaustive list, completely ignoring them (Act on Supplementary Pension Savings, 2011).

The current situation is thus not ideal even in the area of pension funds, either.

Table 3. Investment restrictions of pension funds

	Possibility to invest in a PE/VC fund	Duty to make a profit
Transformed funds	Max. 5% of assets	Yes
Participating funds	No	No

Source: own research.

Conclusions

The conducted analysis implies that the issue of the legal and organizational structure suitable for PE/VC funds may be deemed resolved in the Czech Republic. A Czech equivalent to a Limited Partnership (SICAR), i.e. a limited partnership with investment certificates, has already been provided with sufficient support in the legislation in terms of the legal form. If there were any issues, they were eliminated by means of the amendment to the ZISIF; if some of them have remained, they will probably be marginal issues which may be recognized upon practical application, i.e. after using this legal form in practice. The Czech version of SICAV funds, i.e. a joint stock company with variable registered capital, has also been provided with satisfactory legislative conditions of its legal form, and unlike the KSIL, funds of this legal form have already been established in practice.

The current situation thus points to the fact that some of the changes of the conditions for PE/VC capital only make sense if they are performed in interdependence. This is demonstrated as the non-existence of even a single representative of the limited partnership with investment certificates, where the suitable legal regulation concerning the legal form is overshadowed by absolutely unsatisfactory tax conditions. Our analysis has shown that the legal form is a necessary, yet not sufficient condition.

The tax drawback may be summarized as follows. Firstly, it is impossible for the KSIL investment fund (unlike a joint stock company or a limited liability company) to apply the tax exemption concerning the received shares in profits and income on the sale of shares held in the long-term, which is essential to a PE/VC fund. Next, unlike other assets in which funds can generally invest, the acquisition price of the share is tax deductible only up to the amount of the income on the sale of the share, while the sale of every share is assessed separately, which renders impossible to offset the loss of individual investments to the profit. Third, it is impossible for the investors in PE/VC funds to apply the tax exemption concerning the shares in profits and income on the sale of the share held by the fund in the long-term 1) If the fund uses the KSIL legal form (compared to a limited liability company and joint stock company); 2) If it is an investor outside the EEA; 3) If it is an investor with an investment share in the PE/VC fund lower than 10%. The withholding tax for funds investors may in the case of some non-residents amount to 35%.

Our research findings imply the following proposals. Above all, it is necessary to amend the ZDP so that the legal regulation extends the tax exemption. Another amendment to the applicable legislation should then be directed towards eliminating or mitigating the barriers imposed on pension funds when investing in PE/VC funds.

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