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The Taxation of the Portuguese Venture Capital Industry

This article provides an overview of the taxation of the venture capital industry in Portugal. In particular, the authors describe the origins of the industry, enumerate the types of venture capital vehicles, explain the lifecycle of VCFs, highlight limitations on investment by private equity/venture capital funds, discuss fund incorporation formalities and mechanics, as well as fund governance. In the second part of the article, the authors conduct an exhaustive analysis of the tax regime applicable to such funds and their domestic and foreign investors.

1. Private Equity and Venture Capital under Portuguese Law

Regulation of private equity and venture capital investment in Portugal dates back to 1986 when the venture capital company (*sociedade de capital de risco*), a special type of company under Portuguese law at the time, was created.[1] This regulation predated the appearance of an independent venture capital/alternative asset fund management industry and entered into force during a period in which the public sector still played an important role in financial activity due to the nationalization of several industries in Portugal (especially in the mid-seventies). Moreover, at the time, the venture capital market in Portugal was still dominated by state-run players (using public funds to invest in small and medium-sized enterprises (SMEs) and subsidiaries of Portuguese financial institutions).

Over the years (notably 1991, 1999, 2002 and 2007), the legal regime applicable to venture capital companies was, on the one hand, progressively expanded and made more sophisticated, introducing wider provisions regarding conflicts of interest and supervision (since 2002, private equity vehicles are supervised by the Portuguese Securities Market Commission (*Comissão do Mercado de Valores Mobiliários*, CMVM). Further, it was extended to contemplate the ability of private equity companies to also incorporate and manage private equity funds. On the other hand, minimum capital requirements for managers were lowered over time.

Recently, more precisely in 2015, the private equity regulatory landscape was dramatically changed with the approval of the Legal Regime for Venture Capital, Social Entrepreneurship and Alternative Investment (Venture Capital Legal Regime),[2] transposing the EU Alternative Investment Fund Manager Directive (2011/61) (AIFMD)[3] and the entry into force of the relevant implementing regulations.[4] The AIFMD and "level 2" regulations imposed stricter organizational and compliance requirements and remuneration standards for large private equity funds[5] to operate in Portugal, but also opened up the possibility for the "passporting" of Portuguese fund managers to other European Union Member States and vice versa.

In any event, the legal regime applicable to "small" private equity companies (not exceeding the AIFMD thresholds) and the funds they manage has not suffered material changes since the first comprehensive legal regime on the matter was approved in 2002.

The Portuguese legal system does not distinguish between private equity (meaning "traditional" later stage, buyout, growth or distressed investments)[6] and venture capital

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1. By PT: Decree Law No. 17/86, of 5 Feb. 1986.
2. By PT: Law No. 18/2015, of 4 Mar. 2015.
3. 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) 1060/2009 and (EU) 1095/2010, OJ L 174 (2011), Primary Sources IBFD.
4. Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (Text with EEA relevance), OJ L 83 (2013), Primary Sources IBFD; Commission Implementing Regulation (EU) No 447/2013 of 15 May 2013 establishing the procedure for AIFMs which choose to opt in under Directive 2011/61/EU of the European Parliament and of the Council, OJ L 132 (2013); Commission Implementing Regulation (EU) No 448/2013 of 15 May 2013 establishing a procedure for determining the Member State of reference of a non-EU AIFM pursuant to Directive 2011/61/EU of the European Parliament and of the Council, OJ L 132/3 (2013), Primary Sources IBFD; and Commission Delegated Regulation (EU) No 694/2014 of 17 December 2013 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to regulatory technical standards determining types of alternative investment fund managers (Text with EEA relevance), OJ L 183/18 (2014), Primary Sources IBFD.
5. Meaning those that comply with the thresholds for applicability of the AIFMD, which are EUR 500 million of assets under management if there is no leveraging, or EUR 100 million of assets under management if there is leveraging.
6. According to recent statistics (CMVM, Annual report on venture capital (2017)), most of the value invested in Portugal is in "traditional" private equity, representing 80.3% of said value invested (with growth capital representing 21.5% of total value invested, replacement capital 4.4%, turnaround transactions 33.8%, management buy-ins 0.4% and management buy-outs 17.3%), while "venture capital" represents 19.7%

(although the Portuguese expression "*capital de risco*" bears greater resemblance to the term "venture capital" than to either "private equity" or "buyout"). In spite of being markedly different in terms of, among others, investee companies and transaction structures (i.e. buyout and growth players typically invest in mature companies with solid cash flow generation or growth opportunities while venture capital actors make high-risk bets on early stage companies with very volatile growth and development prospects) the regulation is "one size fits all" for both asset classes. In any event, and for ease of reference, the authors refer to "venture capital" as alluding to both buyout/growth/distressed investments and venture capital investments.

2. Venture Capital Investment Vehicles

Under the Venture Capital Legal Regime,[7] the following (regulated) vehicles may be used to invest in venture capital:

– venture capital companies, also known as private equity companies (*sociedades de capital de risco*), which may or may not be "AIFMD compliant" and which may invest on their own account or via the management of venture capital funds (*fundos de capital de risco*, VCFs);
– VCFs; and
– venture capital investors, commonly known as "business angels" (*investidores em capital de risco*), set up as limited liability companies held by a sole quotaholder (*sociedade unipessoal por quotas*), which represents a means for individual investors to make venture capital investments through an incorporated vehicle.

The distribution of value under management between VCFs and venture capital companies[8] is as follows:

Table 1 – Comparison of the value under management between VCFs and venture capital companies

	Management companies	Value under management (in thousands of EUR)	Share (%)
Private equity companies	46	209,000	4.6
VCFs	95	4,307,000	95.4
Total	141	4,516,000	100.0

Source: CMVM, Annual report on venture capital (2017).

Akin (from a legal and regulatory perspective) to venture capital is investment in social entrepreneurship (*empreendedorismo social*), under the Venture Capital Legal Regime, which aims to "develop adequate solutions to social problems, with the objective of achieving a quantifiable and positive social impact".[9]

Venture capital and social entrepreneurship funds can also be incorporated as European Venture Capital Funds (EuVECA) and European Social Entrepreneurship Funds (EuSEF), respectively. EuVECA and EuSEF allow for the respective fund managers, who raise funds solely through qualified investors and comply with additional criteria set out in the relevant regulations, to market the participation units issued by such funds within the European Union (i.e. with no need for additional regulatory requirements being imposed by the "host" Member State or States).

Finally, venture capital investment, notably in start-ups and early stage companies, can also be structured via unregulated vehicles, to avoid regulatory costs and oversight. These structures are typically used by the venture capital units of large companies and family offices, where ownership of the vehicles is not dispersed amongst third-party investors.

3. Private Equity/Venture Capital Funds Versus Other Investment Funds

As mentioned in section 1., the venture capital regulatory landscape has been heavily influenced by implementation of the AIFMD into Portuguese law and consequently the organizational requirements of VCF managers are substantially harmonized relative to other alternative investment fund managers (and, to some extent, UCITS managers).

Nevertheless, the assets in which VCFs invest are very different from those in which other types of funds invest: in particular, (i) UCITS may not invest in companies that are not publicly traded and (ii) real estate funds, the most common alternative investment funds in Portugal, may invest in private companies only in very narrow circumstances (which must, in any event, be companies whose purpose is connected with the real estate industry).

Furthermore, venture capital investment in Portugal is still subject to less stringent regulation relative to other investment funds, regarding notably authorization procedures for funds and fund managers and micro-prudential regulation, in relation to, for instance, real estate funds. This is because, on the one hand, VCFs are not usually considered "beacons" of concentration of financial risk and, on the other hand, because in a political sense injecting equity capital into SMEs, start-ups and troubled companies has always been looked upon favourably (as opposed to, for instance, the negative connotations associated with investment in speculative financial instruments, by hedge funds, or in highly leveraged real estate projects, by real estate funds).

4. Lifecycle of VCFs

The lifecycle of a VCF commences with the raising of funds by investors. Investors, or unit holders, will commit

of total value invested (with seed investment representing 5% of total value invested, start-up investment 9% and early-stage investing 5.8%).

7. Approved by Law 18/2015. *See* chs. II, III and IV of Title II therein.
8. No statistics are available for the value under management of venture capital investors (*investidores em capital de risco*), since this is not relevant.
9. Art. 4 Law 18/2015.

to subscribe participation units in the fund and, in the negotiation process, will usually have a say in the fund's constitutional documents, notably regarding management regulation.

Although VCFs may be marketed to retail investors (and, in that regard, general securities law provisions regarding public offers shall apply) for the most part institutional and professional investors are the entities that place capital in the former.

Under the Venture Capital Legal Regime,[10] VCFs may not have a subscribed capital of less than EUR 1 million. Any given unit holder may not subscribe for less than EUR 50,000 of participation units in a VCF.

Once the fund is incorporated and the participation units are subscribed for, the latter are gradually paid-up, as amounts are drawn to make investments or pay the expenses of the fund via capital calls made by the management entity.

VCFs are legally allowed to invest in equity, debt and hybrid and convertible instruments in companies. They may also contract derivatives to hedge exposure to risk and apply treasury surpluses in financial instruments. According to the latest statistics,[11] VCFs and private equity companies invest mainly in equity participations (26.7% of value under management) and debt instruments (shareholder loans, quasi-equity contributions and others, representing 59.9% of value under management).

It should also be noted that investments by VCFs and private equity companies are "national" in nature, with approximately 90% of assets under management invested in Portuguese companies.[12]

Regarding the return of capital of the fund to the respective unit holders, the "textbook" approach would be to distribute the proceeds of the funds upon dissolution and liquidation of the same, since the underlying logic of venture capital investing is to keep the (illiquid) assets it holds until maturity and afterwards terminate the fund. Nevertheless, VCFs may also return capital to investors via capital reductions (for purposes of releasing excess capital) or even distributions of dividends.

Dissolution of VCFs may occur following the term of the fund, resolution of the unit holders, cancellation of the fund's registration by CMVM (for instance, if registration was obtained by providing false or misleading information) or following a decision by CMVM grounded on a breach of the management regulation or applicable legal or regulatory provisions, or to guarantee the protection of unit holders or the market.

Following dissolution, the liquidation process is initiated, which culminates in the redemption of the fund's participation units to the benefit of the unit holders (within a year following the date of commencement of the liquidation process) and the preparation of liquidation accounts and a report to be delivered to CMVM.

5. Limitations on Investment by Private Equity/Venture Capital Funds

For the purposes of preventing conflicts of interest and the misuse of these vehicles for ends that are not envisaged by the law, venture capital companies and funds cannot:

- execute transactions not related to pursuing the relevant scope or investment policy (depending on whether the relevant vehicle is a company or fund);
- invest in securities admitted to trading in a regulated market in excess of 50% of the vehicle's assets;
- acquire rights over immovable assets besides those necessary to pursue its activities;
- invest over 33% of the value available to be invested, applied or not, in a company or group companies, within 2 years of the date of the first portfolio investment, on the basis of the acquisition value;
- invest, in respect of VCFs, over 33% of its assets in another VCF or, in respect of venture capital companies, over 33% of its assets in VCFs managed by other entities;
- invest, in any way, in companies that control the venture capital company or management entity of the VCF or which are in a group relationship with the latter prior to the investment; or
- grant credits or guarantees, in any form or capacity, with the objective of financing the subscription or acquisition of any securities issued by the venture capital company, by the VCF, by the respective management entity or by companies mentioned in the previous paragraph.

Other investments made by VCFs and related parties (such as its management entity or other funds managed by the latter) must be subject to the approval of the fund's unit holders.

Other restrictions on a venture capital company or fund investment may be self-imposed (in the by-laws or management regulations, as applicable) or may be the result of agreements entered into with public authorities, notably those involving the attribution of European Structural and Investment Funds or other governmental or European financial aid.

In fact, pursuant to recent methods for the attribution of such European funds, a number of VCFs have been incorporated in Portugal with public funds (in part) for the purposes of investing in SMEs, notably start-ups in high value-added sectors.

Under the terms of the respective tenders and "financing" agreements entered into with the awarding authorities, VCFs incorporated in such a manner face a number of restrictions (which were designed notably for the purpose of avoiding falling foul of applicable State aid rules set out under EU law) with regard to the investments they can

10. Approved by Law 18/2015.
11. CMVM, *Relatório Anual da Atividade de Capital de Risco* [Annual report on venture capital] (2017), available at https://www.cmvm.pt/pt/EstatisticasEstudosEPublicacoes/Publicacoes/CapitaldeRisco/Documents/Relat%C3%B3rio+Capital+de+Risco+2017.pdf.
12. Id.

make, notably regarding territorial scope and the characteristics of the beneficiary companies (for example, in many cases the latter must be qualified under EU law as SMEs).

6. Fund Incorporation Formalities and Mechanics

The Venture Capital Legal Regime[13] provides that VCFs are subject to prior registration with the Portuguese Securities Market Regulator (CMVM).

The request for registration of a VCF must be lodged by its management entity[14] and must be accompanied by the following details/documentation:
- name;
- identification of management entity;
- expected date of incorporation;
- draft management regulation; and
- draft agreement to be entered into with the depositary of the fund and respective statement of acceptance issued by such depositary.

It is worth noting that under the Venture Capital Legal Regime[15] and the General Regime for Collective Investment Undertakings,[16] the obligations that the depositary must comply with vary depending on whether or not the managing entity of the fund meets the thresholds for assets under management of the AIFMD. If the managing entity of the fund does not meet such thresholds, the depositary does not have to comply with the obligations concerning depositary entities set out under the AIFMD and respective regulations.

The decision to register the fund is notified to the applicants within 15 days counting from the date the registration request is received or, if applicable, from the date when subsequent information or documentation requests are made by the CMVM. If the CMVM does not reply within such a 15-day period, the request for registration is deemed to have been tacitly denied.

Finally, the Venture Capital Legal Regime[17] provides a "fast-track procedure" for certain types of VCFs, typically those addressed to more sophisticated investors. This means that a managing entity of a VCF (i) which is not marketed to the general public and the unit holders of which are solely qualified investors (for example, credit institutions, insurance firms, investment firms, collective investment undertakings or pension funds); or (ii) which has a minimum subscription value subscribed by investors in fund units of EUR 500,000, may incorporate the fund solely by issuing a "prior notice" (*comunicação prévia*) to the CMVM.

7. Fund Governance

The main actors in the governance of a VCF are as follows:
- the management entity;
- the unit holders;
- the depositary;
- service providers; and
- investment/strategic committees.

The management entity, which must be allowed under statute (and by the relevant regulatory authorities) to manage VCFs pursuant to the Venture Capital Legal Regime[18] (venture capital companies (*sociedades de capital de risco*), regional development companies (*sociedades de desenvolvimento regional*)[19] and entities that are authorized to manage close-ended alternative investment funds), is legally bestowed with the powers to manage the fund on behalf of the unit holders. The management entity is further bound by fiduciary duties to protect unit holders' interests and grant the latter a fair and equitable treatment (meaning that, *ceteris paribus*, unit holders shall not be treated preferentially).

The management entity of VCFs is remunerated through a one-time arrangement or set-up fee and periodic management fees. Additionally, arrangements are often set up for the management company and/or its directors to benefit from the "upside" in the fund's investments by directly investing in the fund and subscribing special class participation units that grant the holder the right to earn a "carried interest" provided certain "hurdle" rates of fund performance are achieved. These arrangements often exist due to demands by market investors (i.e. non-management unit holders) that incentives be aligned between investors and management by the latter having "skin in the game" or, in other words, a direct stake in the fund that will give management exposure to the downside and upside risks in fund performance.[20]

As mentioned, unit holders in VCFs are, for the most part, passive investors. Under the Venture Capital Legal Regime, unit holders may only decide on matters that are provided for under the law and the management regulation and solely following a proposal made by the management entity. Fund unit holder protection is also safeguarded by legal provisions on investment limitations (enumerated above) and, particularly procedures and policies on, among others, subcontracting, risk management and the prevention of conflicts of interest, which must be adopted by the latter.

The depositary is a key player in the governance of VCFs, as it is the entity responsible for the registration of the relevant participation units and, also, safekeeping of the fund's assets, which consist of securities (in principle,

13. Approved by Law 18/2015; *see* art. 7 therein.
14. It should be noted that activities concerning VCF management are also, under the provisions of the Venture Capital Legal Regime (approved by Law 18/2015) or other relevant legislation, subject to prior registration with CMVM (or authorization by other relevant regulatory authorities, as applicable).
15. Approved by Law 18/2015.
16. Approved by PT: Law No. 16/2015, of 24 Feb. 2015.
17. Approved by Law 18/2015.
18. Id.
19. Governed by the provisions of PT: Decree Law No. 25/91, of 11 Jan. 1991.
20. Although these arrangements are common, the existence of carried interest need not be inevitable. This remuneration scheme depends on the business model of the fund manager and, where such carried interest is indeed included in the fund regulations, the fund may not perform well enough to allow for such carried interest to be paid out (owing to the volatility of this asset class). In fact, capital losses and even write-offs may occur in respect of fund divestments.

the majority of such funds' assets). In funds managed by AIFMD-compliant managers, the depositary plays an even more important role, among others by ensuring that consideration regarding transactions relating to fund assets is delivered according to market practice and ensuring the unit holders that applicable law and fund management regulations are being complied with.

Investment committees are advisory bodies that are fairly common in the venture capital arena in Portugal. Investment committees are composed of the management company and relevant unit holders in the fund and their powers usually consist in providing non-binding opinions in respect of certain investments and transactions to be executed by the latter.

Finally, external service providers to which fund management activities are outsourced are still a novelty in the Portuguese legal market (as fund managers usually internalize all such activities, notably including fund accounting, reporting and "clerical" activities). Nevertheless, it is expected that foreign entities from other, more "advanced" jurisdictions in terms of fund management in Europe will commence requesting passports to operate funds in Portugal, and as such an increase in local "fund administration" providers may be on the horizon (enabling the said foreign fund managers not to incorporate or establish branches in Portugal).

8. Taxation of Venture Capital Vehicles in Portugal

8.1. Introductory remarks

The majority of tax incentives with a direct impact on personal and corporate income taxes are included in the Tax Incentives Statute (*Estatuto dos Benefícios Fiscais*), which includes a set of rules for venture capital companies, business angels and more thoroughly for VCFs and their investors.

8.2. Taxation of venture capital companies

Venture capital companies have been foreseen in the law since 1986. In 1987, a special tax regime was created for companies incorporated in that year that included a broad, albeit temporary, exemption from the main taxes applicable at the time. The tax regime has been successively amended and tightened over the years[21] and presently the corporate income tax paid by venture capital companies is determined in the same way as for any other company operating in Portugal. Namely, it benefits, in principle, from a participation exemption on dividends and capital gains on shareholdings of at least 10% held uninterruptedly for a year.

In contrast to ordinary companies, however, venture capital companies may deduct from the corporate income tax that otherwise would have been due an amount equivalent to the corporate income tax due in the past 5 years, provided that that amount is invested in companies with a potential for growth and valorization. This deduction is made in the year the investment is made and if the corporate income tax of the year is not enough to offset the amount available for deduction, the remaining amount may be deducted in the subsequent 5 years.[22]

8.3. Taxation of investors in venture capital (business angels) that incorporate single quota-holder companies

A specific regime for business angels, i.e. venture capital investors that invest through single quotaholding companies, has also been provided for in the law since 2007. Since 2012, business angels[23] benefit from a tax incentive allowing for a deduction of an amount corresponding to 20% of the investment[24] made through their single quotaholder companies up to 15% of their personal income tax liability.[25]

8.4. Taxation of VCFs

8.4.1. Introduction

Portuguese VCFs do not differ much from their foreign counterparts,[26] considering that their activity is regulated by and based on EU law. Some specific differences, however, exist. First, because Portugal does not recognize, for legal and tax purposes, Anglo-Saxon-type vehicles that combine the general partner and limited partners and, second, because the tax regimes are not harmonized. So, each Member State is free to determine its regime, provided it observes EU law and other international limitations (for example, tax treaty commitments).

21. For a summary of the evolution of the tax regime applicable to these companies, *see Reavaliação dos Benefícios Fiscais. Relatório do grupo de Trabalho criado por despacho de 1 de Maio de 2005 do Ministério de Estado e das Finanças*, Cadernos de Ciência e Técnica Fiscal 198, p. 136 (2005).

22. *See* PT: Tax Incentives Statute, art. 32-A. This article was introduced into the law at the end of 2011 and entered into force in the beginning of 2012. According to art. 3 of the Tax Incentives Statute, tax incentives have a lifecycle of 5 years if they are not prorogated. Therefore, as this tax incentive was not prorogated by law, at the present date this tax incentive, despite being foreseen in the law, is not in force. It could, however, be reactivated by year-end.

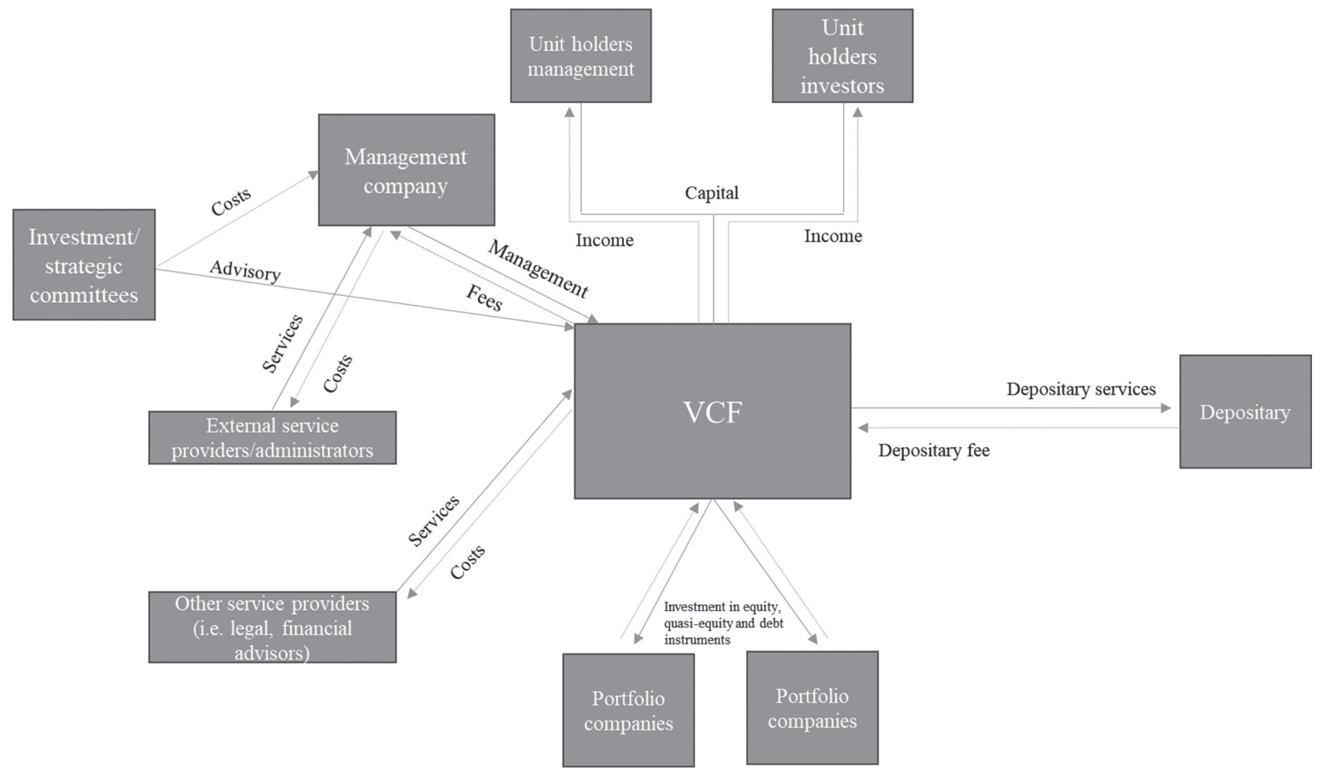
23. As well as some other special investors, such as individual investors in start-up companies certified according to the COMPETE programme and individual investors certified by the IAPMEI under the FINICIA programme. COMPETE is a programme to promote the competitiveness and the internationalization of Portuguese companies. IAPMEI is a public institute that supports small and medium-sized enterprises. FINICIA is a programme to finance start-up companies.

24. Any increase in equity of companies that use the monies received in investments that have the potential of growth and valorization is qualified as an investment for this purpose. An investment made in listed companies or in companies controlled by other companies does not qualify as an investment for this purpose, except for an investment made in venture capital companies and venture capital funds, and credit, financial and insurance companies.

25. *See* art. 32-A Tax Incentives Statute. For the statute of limitation in relation to this tax incentive, *see supra* n. 22.

26. According to A. Joseph, *The Changing Fortunes of Private Equity*, 9 Derivs. & Fin. Instrums. 6, p. 221 (2007), Journal Articles and Papers IBFD, "private equity entities are generally formed as limited liability partnerships, which include both limited and general partners. The liability of the limited partners is restricted to their agreed capital contribution to the partnership, whereas general partners have unlimited liability. In a typical private equity structure, general partners act as managers of the partnership and will be entitled to "carried interests".

Diagram 1 – Simplified diagram of a VCF structure



In the funds industry, the fundraising process is normally organized through an introduction to potential investors (such as institutional investors like pension funds, but also high-net-worth individuals and corporations), of an information memorandum produced by the venture capitalist. Subsequently, it is necessary to draft the fund regulation, which covers a myriad of different aspects, from restrictions on the use of capital, the venture capitalist contribution to the fund,[27] how the investors may be required to draw down capital and loans,[28] the conditions (usually restricted) under which reinvestment is permitted,[29] the different fees, which usually include management fees, transaction fees (including arrangement fees, syndication fees, break-up fees and directors' fees), the hurdle rate,[30] the carried interest,[31] distributions to investors, the terms under which co-investment is allowed, as well as the suspension and termination of the fund.

For a simplified diagram of a VCF structure considering its main actors as presented above (section 8.), *see* Diagram 1.

As a rule, from a cash-flow point of view, capital passes through the VCF to the target companies, either as share capital, quasi-equity or debt instruments. It is then expected that cash arises, usually in the form of a dividend, interest or refund of capital and debt. In addition, VCFs seek to increase the target's value and then sell, obtaining capital gains. This income may be used to pay the different service providers, including the management company, but it is expected that, at some stage, the unit holders will be remunerated.

In fact, investors contribute capital to the fund and make commitments to provide loans to the fund once suitable investment opportunities have been identified in order to receive a preferential return on their fund loans (hurdle rate) and potentially have the possibility to share profits in excess of the return with the carried interest holders, which may own participation units in the fund directly (usually a different category of units) or indirectly (usually through the management company).[32] It is up to them to establish the fund, identify investors and, at a later stage, investments, negotiate the terms of the investments, manage such companies in consideration for a management fee and oversee the exit, eventually receiving the carried interest.

27. "Most funds require an investment by the general partner so as to align the general partner's interest with that of the limited partner (usually between 1% and 5% of the committed capital). This also allows the general partner to access profit attached to the equity shares of the fund". *See* H. Lamon, *Financial Buy-Outs: Structuring the Fund*, 11 Derivs. & Fin. Instrums. 4, p. 153 (2005), Journal Articles & Papers IBFD, which is closely followed in this article.
28. "The investors will normally subscribe to the fund-raising from the outset but the capital commitment will only be drawn down subsequently as needed to make the investments. This also minimizes the time during which the fund holds uninvested cash, which adversely affects its IRR. If necessary, the fund documentation may provide for penalty charges for late payment of capital commitments"; *see* Lamon, id., at p. 154.
29. Normally, only in the event of an early exit, when reinvestment can boost the internal rate of return of the fund.
30. The hurdle rate (also known as preferred return) is the rate of return that is guaranteed to the investors; *see* Lamon, *supra* n. 27, at p. 154.
31. Once the loans and preference return have been paid off (i.e. once the hurdle rate has been reached), the profit-sharing ratio changes so that the carried interest holders typically have 20% and the investors 80%.
32. Lamon, *supra* n. 27, at p. 153.

As the diagram shows, there are several other players that have an active role in this activity, providing these services to the fund or the management company and receiving the corresponding remuneration.

Carried interest plays an important role in the funds industry, as it may be said that it is the main driver to motivate the venture capitalist to work toward improving the fund's performance. Another common feature in the industry is the introduction of ratchet clauses.[33]

As the fund has a limited life, reinvestment of the investment proceeds is usually not allowed and the initial proceeds are generally distributed to the investors as a reduction in capital invested in the fund.[34]

8.4.2. *Historical background*

Portuguese VCFs have been addressed under the law since 1991.[35] Until 2003, however, there was no specific tax regime for funds covered by the special tax regime for investment funds.[36] In a nutshell, the special tax regime for investment funds provided for taxation of the income obtained by the funds and an exemption at the level of investors. Players argued that the tax regime applicable to Portuguese investment funds was not competitive; therefore, the tax regime applicable to investment funds was changed in 2015 to bring it in line with other EU jurisdictions. According to the regime presently in force, taxation was changed to the investor level whilst the investment fund, albeit subject to tax, is now, in practice, mainly exempt;[37] it is only taxed at a low rate on its net asset value. Because Portuguese investment funds are subject to corporate income tax (although, as said, in practice mainly exempt), the Portuguese tax authorities consider them to be covered by the Portuguese tax treaty network.[38] The investment fund taxation regime, however, no longer applies to VCFs.

8.4.3. *Tax regime applicable to VCFs*

In the beginning of 2013, a special tax regime applicable to VCFs that are incorporated and operate according to Portuguese law entered into force. According to this regime, these VCFs are exempt from corporate income tax.[39] Therefore, all income obtained by a Portuguese VCF is exempt from income tax, in an attempt to make VCFs tax neutral investment vehicles and attract alternative private capital to the market, shifting taxation to investors. Based on the fact that these funds are liable to tax (only benefiting from a subjective exemption from corporate income tax), there is an obligation to fulfil some ancillary obligations, including the filing of the annual corporate income tax return. Because VCFs are legally exempt from corporate income tax, they are generally not covered by the Portuguese tax treaty network. This is in contrast to their treatment under the investment funds regime.[40]

This subjective exemption is similar to the exemption under Portuguese law for other types of funds, such as pension funds, retirement savings funds, education savings funds, retirement/education savings funds and forest resources real estate investment funds.[41] What differentiates these very different types of funds is taxation of the investors.

33. According to Bundgaard, "[p]eople considering investing in startups or other risky companies face challenges of illiquidity and information shortfall. To alleviate these difficulties, venture capitalists have created what can be viewed as innovative HFIs [hybrid financial instruments]. In respect of convertible bonds, some of these problems might be resolved by making the conversion ratio dependent on the performance of the company. Referred to as a "ratchet" convertible, a feature of this type of security is an option that converts into a declining ratio of company shares as the rate of return on the investment exceeds a certain ceiling. Conversely, the option might convert into an even greater number of shares as the investor's rate of return falls below a given floor. Compared to the return on a convertible note with a fixed rate of conversion, the return on a ratchet convertible is less exposed to the fortunes of the company: it pays more than a fixed-rate convertible in respect of a less successful company but less than a fixed-rate convertible in respect of a company that is very successful. The entrepreneur is given an ever-increasing upside incentive; a venture capital investor is given downside protection", *see* J. Bundgaard, *Convertible Debt Instruments in International Tax Law – Part 1*, 57 Eur. Taxn. 4, p. 138 (2017), Journal Articles & Papers IBFD. Alongside this hybrid financial instrument, the investor may, upon the exit, transfer to the entrepreneur part of the shares received on the ratchet at a reduced price, according to certain performance targets, to enable the entrepreneur to participate in part of the gain on the sale of the shares to a new investor, as the gain results mainly from the skills of the entrepreneur in enhancing the value of the business. These types of clauses should be properly structured to avoid questions regarding whether it should be regarded for tax purposes as a stock-option type of income, a bonus or as a capital gain.
34. Usually, the fund's regulation determines the manner in which distributions must occur. A typical example is the granting of two classes of participation units and establishing that the income of the fund is first distributed until the unit holders have been repaid the amount of the capital they invested. Subsequently, the income of the fund is distributed pro rata to each investor until it has reached the hurdle rate. The remaining amount available is to be distributed as follows: 80% to all unit holders and the remaining 20% to the unit holders that are entitled to the carried interest.
35. In this section, the authors analyse the taxation of Portuguese venture capital funds, as well as their resident and non-resident investors. Currently, the clear majority of investments made by Portuguese VCFs are made in Portuguese resident entities. The taxation due in connection with investments made by foreign funds in Portugal and the taxation payable by investors resident in Portugal that participate in foreign funds is not discussed herein.
36. *See* F. Banha, *Capital de Risco. O Impacto da Fiscalidade* (Vida Económica 1998).
37. In fact, the main types of income received by investment funds (i.e. investment income, rental income and capital gains) do not contribute to the taxable profit of the fund. Only business income obtained by the fund contributes to the taxable profit subject to corporate income tax.
38. This is not relevant in respect of non-resident investors in investment funds in securities because their income is, in principle, exempt from tax in Portugal. It may be relevant, however, for non-resident individuals and corporate bodies that invest in real estate investment funds because they are taxed at a rate of 10%. In relation to these, the income is considered income from immovable property for the purposes of art. 6 of the applicable tax treaty and the income derived from the sale, including redemption of participation units or shares, is considered capital gains for the purposes of art. 13 of the applicable tax treaty.
39. Art. 23 Tax Incentives Statute. According to *The Global Venture Capital and Private Equity Country Attractiveness Index* designed by IESE's Centre for International Finance, in conjunction with EMLYON Business School (2009/2010), available at https://media.iese.edu/research/pdfs/ST-0288-E.pdf, Portugal ranks 34 amongst the 125 countries analysed, given that its strongest key driver is taxation, which ranks in 10th position. The Index analyses 125 countries according to 6 key drivers: economic activity, depth of capital markets; taxation; investor protection and corporate governance; human and social environment; and entrepreneurial culture and deal opportunities (*see* https://blog.iese.edu/vcpeindex/portugal/).
40. For a discussion on this matter, *see*, for instance, J. Wheater, *Liability to Tax and Treaty Benefits*, 15 Business Law Intl. 1, p. 67 (Jan. 2014).
41. VCFs are also VAT taxable persons, although operations tend to be exempted from VAT without the right of deduction because they fall

8.5. Taxation of investors in VCFs

Regarding the taxation of investors in VCFs one should draw a distinction between the person who is entitled to such income (an individual or a corporate entity), the place of its residence[42] and, last but not least, the nature of the income, i.e. whether capital gains or losses from the sale are at issue or another transfer for consideration of the participation units in the fund or other income, including redemption of the units.

8.5.1. *Resident individuals*

Accordingly, income obtained from units in Portuguese VCFs by resident individuals is subject to personal income tax through a 10% withholding tax. This is a final withholding if the income is obtained outside the scope of a business activity. Despite being a final withholding, the individual may opt to tax this income together with his remaining income. In the event that the individual exercises this option, only 50% of the dividends distributed by the fund will be considered taxable income.[43] Similarly, capital gains obtained by resident individuals from the sale of participation units are taxed at the rate of 10% if obtained outside the scope of a business activity and the individual does not opt to tax the capital gain together with his remaining income.

8.5.2. *Resident entities*

The income obtained by resident corporate bodies from units in Portuguese VCFs, including their redemption, is subject to corporate income tax by way of a 10% withholding tax, unless exempt from corporate income tax (due to being investment income), as is the case with regard to pension funds. The difference in relation to individuals is that whilst the withholding for the former may be a final withholding, for companies the withholding is merely a payment on account of its final corporate income tax liability to be determined at a later stage.

The VCF tax regime does not establish any rule for the taxation of capital gains obtained by companies resident in Portugal as a result of the sale of participation unit in the funds. Taking into account that the VCF tax regime is very detailed on the taxation of the funds and their participants, it can be concluded that the capital gains obtained by companies resident in Portugal as a result of the sale of participation units in the funds would not be subject to tax (equating the tax treatment in practical terms to that granted in respect of capital gains obtained by non-resident companies, as will be evident in section 8.5.4.).

Due to the lack of a specific rule setting out the tax treatment of capital gains obtained by companies resident in Portugal upon the sale of participation units in the funds, another possible interpretation would be to consider that the capital gains obtained by resident companies from the sale of units in VCFs were taxable at a rate of 10%, as applies in respect of income obtained from the redemption of the units. It can be argued, in favour of this interpretation, that income from the redemption of units is generally treated as a capital gain[44] so there should be no reason to distinguish capital gains from the sale of units from capital gains from the redemption of units.

If this were to be the result, however, the legislator in principle would have clearly stated this. Therefore, the most prudent interpretation is to consider that capital gains obtained by resident companies from the sale of units in the VCF are subject to corporate income tax in accordance with the general terms.[45]

8.5.3. *Non-resident individuals*

Non-resident individuals (without a permanent establishment (PE) in Portugal to which the income is attributed) are subject to personal income tax by way of a final withholding at a rate of 10% on the income obtained from the units in Portuguese VCFs, including their redemption. Capital gains from the sale of participation units in Portuguese VCFs obtained by non-resident individuals may either be exempt from personal tax or taxed at a rate of 10%. The capital gains will be exempt if the non-resident individual is not resident in a listed tax haven according to the Portuguese blacklist of offshore jurisdictions.[46]

8.5.4. *Non-resident entities*

Finally, the income obtained from the units by non-resident legal entities (without a PE in Portugal to which the income is attributed), including from its redemption, is exempt from corporate income tax in Portugal,[47]

under the exemption for financial operations, which means that VAT borne by VCFs tends to be a final cost of the fund. VCFs may also be subject to stamp duty, which may be levied in Portugal, among others, on financial operations upon the grating of credit and on guarantees, as well as on interest and commissions charged by financial institutions, if no exemptions are available. In this regard, an important binding ruling of the tax authorities was recently published (Ruling number 2018001066 of 1 Nov. 2018), which states that VCFs are covered by the exemption from stamp duty on the use of credit, associated guarantees, interest and commissions charged by the credit institutions. According to the wording of the law, this exemption only covers venture capital companies (not funds), as well as financial institutions foreseen under EU law. Although investment funds and venture capital funds are not financial institutions under Portuguese law, the tax authorities considered that because they are financial institutions according to EU law they must also benefit from the said stamp duty exemption.

42. According to recent statistics (CMVM, *supra* n. 11), the majority of unit holders in Portuguese VCFs are entities resident in Portugal (85.6%), mainly corporate bodies, although the number of individuals investing in these funds is increasing.
43. According to the progressive tax rates in force in 2018, this option should only be considered by individuals who obtain no other taxable income and the dividends paid by the VCF should not exceed approximately EUR 10,000 (depending on the applicable threshold).
44. *See*, in general, PT: Tax Code – Income and Gains of Individuals, art. 10(1)(a)(5), Primary Sources IBFD and for participation units in investment funds sec. 22-A(1)(d) Tax Incentives Statute.
45. It is not possible to benefit from the participation exemption regime applicable to capital gains obtained in connection with the sale of shares (10% in capital held for 1 year) foreseen in PT: Code of Taxation of Income and Gains of Collective Persons, Primary Sources IBFD, as one of the requirements of this regime is that the shares sold be from an entity that is subject and not exempt from corporate income tax, which is not the case in respect of VCFs.
46. According to the terms defined in PT: Ordinance 292/2011 of 8 Nov. 2011, as amended.
47. To benefit from the exemption, the beneficiary must demonstrate to the company that manages the fund, before any income is paid, that it is not resident in Portugal. Such demonstration depends on the nature

except if (i) the non-resident legal entity is resident in a tax haven listed in the Portuguese blacklist of offshore jurisdictions[48] or (ii) more than 25% of the non-resident legal entity is held, directly or indirectly, by entities resident in Portugal.[49] If it is verified that one of these two exceptions applies, the income is subject to a final withholding tax at a rate of 10%. Capital gains derived from the sale of units are taxed in the same way as non-resident individuals, which means that they are either exempt or taxed at a rate of 10%, even if the non-resident legal entity is resident in a tax haven listed in the Portuguese blacklist of offshore jurisdictions.

To the extent that the *ratio legis* is clear in respect of the tax treatment at the level of the fund, it is also clear regarding the tax treatment at the level of investors, albeit in this instance it can be subject to criticism, as it puts Portuguese corporate capital in a disadvantageous position vis-à-vis foreign corporate capital. This discrimination against entities resident in Portugal may lead domestic corporate investors to invest through structures domiciled abroad, as, instead of being taxed at the ordinary corporate income tax rate on the income distributed by the VCF, they will be taxed at a rate of 10% or may even benefit from a full exemption if the resident entity does not hold more than 25% of the structure domiciled abroad that invests in the Portuguese VCF.

of the beneficiary (namely if it is a central bank, an international body recognized as such by the Portuguese State, a public law entity or similar agency; a credit institution, a financial company, a pension fund, an insurance company domiciled in any OECD member country or in a country with which Portugal has entered into a tax treaty; an investment fund or other collective investment scheme domiciled in any OECD member country or in a country with which Portugal has entered into a tax treaty in force or a tax information exchange agreement in force; or other investors). If this is not demonstrated, the fund shall withhold the tax due in connection with any income payment made to the investor. If the fund is obliged to withhold tax on income paid because the non-resident beneficiary does not present the required documentation or makes a payment without withholding the tax due, the entity that manages the fund is joint and severally liable with the fund for any unpaid tax. Moreover, certain ancillary information (such as the identity of the non-resident beneficiaries that receive the income) must be provided to the tax authorities. This information may be provided by the management entity or by the entity where the units are registered.

48. In the absence of a better explanation, it seems that there is a clear legislative intention to promote the capitalization of Portuguese venture capital funds, as in order to combat the use of offshores, generally, the payment of investment income to such entities is subject to an aggravated withholding tax rate of 35% (and not merely 10%).

49. The exemption will apply to non-resident legal entities that are 25% or more held by entities resident in Portugal, provided the non-resident legal entity (i) is resident in an EU Member State, in a state of the European Economic Area that is bound to administrative cooperation in tax matters in terms equivalent to the administrative cooperation available in the European Union, or in a third state with which Portugal has concluded a tax treaty that provides for the exchange of information in tax matters; (ii) is subject to and not exempt from tax in accordance with Council Directive 2011/96/EU of 30 November 2011 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, art. 2, OJ L 345/8 (2011), Primary Sources IBFD or another tax similar to the Portuguese corporate income tax, provided the applicable rate is not lower than 60% of the Portuguese tax rate, i.e. 60% of 21%; (iii) has a direct or indirect 10% shareholding or voting rights for an uninterrupted period of 1 year in the Portuguese resident entity; and (iv) the sale of units is not considered as part of an artificial construction or series of constructions with the main purpose, or one of its main purposes, being obtaining a tax advantage.

8.5.5. Taxation of the carried interest

One issue that usually raises concern in connection with this industry, in the international landscape, and in respect of comparative law, is the taxation of a carried interest.[50] Under Portuguese law, however, specific rules for the taxation of carried interest have not been enacted since the special tax regime for VCFs was created back in 2003. This was due to the need to promote this industry, which, at that time, was still embryonic. The objective was to create the conditions for venture capitalists to flourish in an economy traditionally averse to risk.

This area is, currently, still not subject to controversy, which can be explained by the reasons mentioned in this section and the relatively small gains obtained from this activity according to recent statistics.[51]

In the absence of rules specifically dealing with the tax treatment of carried interest, the applicable tax regime will depend on the way it is structured. In this regard, the most common alternatives are to hold the participation units that are entitled to the carried interest directly or to hold the units through a corporate entity (which can be the management entity).

As mentioned, the income received by resident individuals from units in VCFs is subject to personal income tax through a withholding at a rate of 10%, which is of a final nature if the income is obtained “outside the scope of a commercial, industrial or agricultural activity”, to use the wording of the law. Taking into account that, by its very nature, the carried interest is an extraordinary form of income and is uncertain, as it depends on the fund performing well and the fact that, if actually received, it will only be at the end of the life of the fund, it cannot be considered income received within the scope of a commercial activity (and certainly not within the scope of an industrial or agricultural activity). In fact, the performance of a commercial activity is remunerated by way of income that takes into account the business or trade effectively pursued by the individual, which is manifestly not the case with regard to carried interest that has no direct link with the activity developed by the individual, which is remunerated by way of a management fee or salary.[52] Therefore, in the authors’ opinion, the carried interest associated with certain participation units, if received directly by individuals resident in Portugal, should be taxed at a final withholding tax rate of 10%.

If, however, the carried interest is received through a corporate entity, it will be subject to a withholding at the rate of 10%, which is merely a payment on account of the final corporate income tax to be determined at a later stage.

50. For a discussion of a case decided in Sweden, *see* S. Berkvist et al., *The Stockholm Administrative Court of Appeal’s Ruling in the Nordic Capital Case – Taxation of Carried Interest*, 15 Business Law Intl. 2, p. 143 (2014).

51. According to recent statistics (CMVM, *supra* n. 11), 16.1% of the disinvestment made by VCFs in 2017 resulted in capital gains, 27.7% in capital losses and 56.2% did not register gains or losses.

52. The salaries and bonuses of the venture capitalists in their capacity as directors or employees of the management entity are subject to personal income tax at progressive rates, as well as social security contributions and may even be subject to an autonomous rate of corporate income tax.

9. Conclusions

The current legal and regulatory framework regarding venture capital in Portugal has been in place since 2015. In this article, the authors provided an overview of the different types of investment vehicles for venture capital, the typical lifecycle of the funds, limitations on investment, incorporation formalities and governance.

The tax regime applicable to VCFs plays an important role in the promotion of this industry mainly due to the tax advantages granted to resident individual investors and to non-resident (corporate and individual) investors. The rationale for this competitive tax regime is the need to attract different forms of financing to the Portuguese business community, which is mainly composed of small and medium-sized enterprises.

As statistics demonstrate, the relatively modest level of profitability in connection with venture capital investment in Portugal has contributed to the stability of the tax regime over the years, including the treatment of carried interest.

It is apparent that foreign investors are increasingly becoming interested in this type of structure, which is explained by the resurgence of interest in the Portuguese economy and the stability of the tax regime associated with VCFs.