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Florence Moulin

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Editorial – by Florence Moulin

FCPIs and FIPs - the latest rumours

With the 2010 investment deadline for ISF wealth tax efficient products almost upon us, FCPI and FIP venture capital fund managers are wondering about their future, because FCPIs and FIPs come to an end at 31 December 2010.

There may have been little argument about the five-year extension to this personal income tax reduction mechanism in December 2005, but it will be a different story this autumn. The economic climate is now very different:

- Since the government's policy is one of austerity, it will want to cut its expenditure, particularly by withdrawing tax breaks - and FCPIs and FIPs cost over 150 million Euros per year.

- The image of the funds has suffered badly. The recent debates on taxing carried interest, the shortening of investment time limits and the multiple layers of marketing expenses are just a few examples of what finally convinced the sceptics.

- The average return on these vehicles is now known. In 2005, very few Funds had reached maturity and the performance of the funds raised in the first few years had been distorted by the internet bubble. In 2010, things are different. FCPIs were created in 2007 and several years' worth have now reached maturity. And their average return has turned out to be far from flattering.

Nevertheless, FCPIs and FIPs are absolutely essential:

- For financing SMEs. In France, fund inflows fell by 70% in one year, dropping from €12.7 Billion in 2008 to €3.6 Billion in 2009. Of this €3.6 Billion, more than 1 Billion, that is almost one third, was raised from private individuals. This source has remained constant, while over the same time funds raised by institutional investors went through the floor. It is unlikely that there will be any rebound in the next few months (Solvency II Directive, AIFM Directive, withdrawal of certain institutional investors, etc).

- For innovation. Between 1997 and 2008, FCPIs raised €5 billion which was injected into almost 1,000 innovative businesses (90% of them French), employing over 42,000 people and generating revenues of €7 billion.

In many European countries, where no similar mechanisms exist, venture capital is almost non-existent. This is why a number of neighbouring countries, starting with Sweden, are considering introducing venture capital vehicles that are open to private individuals.

Moreover, and although the average return on these vehicles may have turned out to be unexceptional, we should not overlook the fact that (i) this figure masks excellent performances with certain funds producing returns of over 50%, (ii) a number of funds suffered from the Internet bubble bursting, (iii) if fund performance were excellent, there would be no need for tax incentives to attract investors!

Finally, FCPIs and FIPs may represent an annual cost of over € 150 Million in terms of personal income tax breaks, but what is the return on this investment for the public budget? It is of course difficult to prove that without this inflow of capital, the companies being financed would not have renewed their equipment or hired new employees. But the French Finance Ministry cannot limit its evaluation to the direct cost alone. This is no doubt why Christine Lagarde commissioned the finance Inspectorate "*Inspection Générale Des Finances (IGF)*" to conduct an enquiry into the value of these vehicles (in terms of personal and corporate income tax). The report's conclusions are expected to be released at the end of July.

Furthermore, the AFIC (the French Private Equity Association) and AFG (the French Asset Management Association) are firming up their proposals. Several approaches are being considered. Better control over the length of time that the redemption requests can be refused (with a maximum that can exceed the current 10 years and a minimum), spreading the personal income tax deduction, investment policies more closely targeted on financing SMEs (within the meaning of community law) and particularly young SMEs (under 8 years), simplifying the investment rules particularly by simplifying investment quotas and sub-quotas, etc.

Whatever their proposals may be, they need to reach the Finance Ministry soon, since work will start on the draft public budget at the end of June. At this stage, it seems that the Finance Ministry is against extending FCPIs and FIPs in their current state, but would instead favour creating new vehicles.

After it has been prepared, the draft budget will be presented to the final Council of Ministers in September and will then be considered by the National Assembly in mid-October, and then go on to the Senate in November. The main haggling therefore needs to be done during the summer. After that, the ball is in the politicians' court.

Legal News

Decree on restriction of marketing expenses

At the end of 2009, the 2010 Finance Law provided for restrictions on marketing expenses for ISF wealth tax vehicles (Holding companies and Funds), under conditions to be specified by decree. A few weeks later, the IGF recommended banning return commissions on marketing expenses (usually the fund manager returns around one third of its management commission over 5 years to the distributor).

There are therefore fears that the decree made purely and simply ban return commissions or cap marketing expenses. Although no draft legislation is yet available, it is possible that this will only require complete transparency over marketing expenses. Holding companies (to which regulations already apply) and funds would then have to disclose the cumulative total of marketing expenses in their literature.

Financial Markets High Committee

In 2007, Christine Lagarde set up a Financial Markets High Committee with the task of improving competitiveness in the Paris financial markets. This committee has just decided to form a steering committee, headed up by the Director General of the French Treasury, the Chairman of the AFG and the chairman of the AMF, with the task of submitting proposals to Christine Lagarde by the autumn on strategy and on encouraging the development of the asset management industry in France.

It will in particular have the task of preparing proposals for implementation of the new UCITS IV European Directive which will come into force in July. This directive is intended to make it easier to market investment funds internationally and to set up master-feeder funds.

Draft law for setting up remuneration committees in public companies which exceed certain revenue and headcount thresholds.

This draft law will apply only to companies whose shares are admitted to trading on a regulated market. It provides that the board of directors (or the supervisory board) of the company must set up a subcommittee, made up of board members that do not have executive functions, to recommend remuneration policies for corporate officers.

It has been ratified by the National Assembly, and is now to be considered by the Senate.

Draft legislation intended to make remuneration policies for company managers and market operators fairer and more transparent

This draft legislation proposes to cap remuneration for managers of companies benefiting from public support in the form of recapitalisation, restricting termination payments for directors, golden goodbyes, variable remuneration for traders, etc.

Draft financial and banking regulation law

This is designed to increase supervision of financial markets and market operators, to regulate rating agencies, strengthen the AMF's powers and extend exchanges of information between European regulatory authorities, review the rules on public offers (broadening their application), making it easier for SMEs to access Alternext, etc.

The AIFM Directive

On 17 May, the European Parliament Commission for Economic and Monetary Affairs ratified the draft Directive. The following day, in spite of British opposition, Ecofin (which is made up of the finance ministers) also ratified the draft, but a different version of it! It is difficult to summarise a document that exists in several different versions but in the version adopted by the European Parliament, certain provisions would not apply to the Private equity industry (custodian, independent evaluator).

The draft Directive must now enter a negotiation phase between the three players, ie the Council, the Parliament represented by the Deputy Jean-Michel Gauzès and the Commission represented by Michel Barnier.

The European authorities, the dogma of which is now that all financial activity must be regulated, would consider treating separately the Custodian. In order to provide a strong political reaction to the Madoff case, a custodian Directive should be issued soon.

The UCITS IV Directive

The transposition of the UCITS IV Directive should soon be the opportunity, notably for the French Financial Market Authority (AMF), to improve the commercialization of financial products. A simplification of the various statuses of distributors (or even the elimination of some) would be in the process of being studied. It is true that the entanglement of the statuses or the activities has rendered excessively complex the subject. Between the underwriter, the advisors in financial investments, and the other fundraisers, business providers which sometimes develop under an unknown status, the subject has become illegible.

The AMF would also be considering simplifying the management companies' work, notably those which do not manage coordinated funds (i.e. type 2 management companies). Such management companies could more easily resort to financial management delegation, their business program would be lightened and their business activities would be extended notably to underwriting services.

Reduction in the time limits for investing in FCPR, FCPI and FIP venture capital funds: publication of a tax position statement

It should be said that reading this position statement leaves a bad taste in your mouth.

Firstly, the fact that a very large number of scenarios are described in it makes it difficult to understand, especially as it is impossible to derive any general principle from it. A distinction is made between:

- Funds set up before 1st January 2010, and
- Funds set up on or after 1st January 2010[1].

A summary chart, attached as an appendix, sets out the various scenarios.

This position statement is furthermore remarkable in that it is very interpretive in nature:

- for one thing, it is very difficult to match the principles it refers to with any statute law. But we should not put all the blame on the tax office - the law passed last year was particularly badly drafted and obscure. It could even have resulted in inconsistent or dangerous situations, which the tax office has managed to avoid.

- Its interpretive nature is particularly marked on the "wildcard" additional time limit. The tax authorities state that the wildcard does not apply to ISF wealth tax investment quotas. Although this position would appear to be in accordance with the letter of the law, it has never been made explicit. That's how it stands now.
  But where its reasoning seems to be most open to question is on the wildcard additional time limit for personal income tax investment quotas. The tax authorities challenge it for new funds. However, the Monetary and Financial Code provides for the wildcard in several of its regulations. These regulations are still in existence. The text of the 2010 Finance Law contains no provisions on the wildcard. Moreover, at no point in the parliamentary debates was this point brought up. So it is hard to see how a position statement can challenge law currently in force, made by legislative bodies.

Finally, this position statement does not answer all the questions. Which, of course, was not its aim. It was issued only so that professionals would know which sticks they would be beaten with. A tax instruction is badly needed to settle the points of uncertainty. In particular, the tax instruction should answer the following questions:

- how should the exemption for innovative young companies (JEIs), exempting them from the reduction in time limits, be applied?

- which investment quotas are affected by the reduction in investment time limits? The position statement deals only with those quotas which are expressly covered in the statute. It carefully avoids dealing with sub-quotas in young companies under 5 years old (for FIPs) or companies with a share capital of less than €2 million (for FCPIs) and also avoids the 50% tax quota of European companies with an industrial or commercial activity (article 163 5 B of the General Tax

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[1] The set-up date is the date of the certificate of deposit of funds.

Code). Should we understand from this that these quotas are not affected? The tax office instruction ought to answer these questions. In our view, there is no justification for treating sub-quotas differently from main quotas. They should therefore be fulfilled within 16 months. Conversely, the tax quota should not be affected.

Extension of filing deadlines for wealth tax deductions

In principle, the tax certificates that give entitlement to a deduction from wealth tax for investment in SMEs (article 885-0 V 2 of the General Tax Code) or for donations to certain public interest bodies (article 855-0 2 A of the General Tax Code) must be attached to the ISF wealth tax return to be submitted by 15 June at the latest.

The dispensation for taxpayers to attach certificates within 3 months of filing tax returns was confirmed for gifts to certain public-interest bodies (article 855-0 V 2 A of the General Tax Code) by a position statement.

This option was further confirmed by a letter from the Budget Minister, sent to the AFG and the AFIC: "*with effect from the wealth tax due for 2010, taxpayers may fulfil their obligations to make returns on wealth tax deductions for investing in SMEs by filing the deduction documentation within three months of the deadline for filing the wealth tax return. For most taxpayers, for 2010 wealth tax, this means by 15 September 2010 at the latest. A decree, confirming this solution at regulatory level, will be published in the near future in the Official Journal."* This dispensation which applies to all types of investing (direct, holding companies, funds) is therefore expected to continue to apply.

The business value-added levy: the headache of working out the payment on account due on 15 June

As of 1st January 2010, the business value-added levy (CVAE) replaced the minimum regional business tax payment. The new CVAE local tax is due by businesses with revenues of over €500,000 excluding VAT, and particularly by businesses whose main business is managing financial instruments (venture capital funds, holding companies). For these latter firms, special rules for calculating revenue and the value-added generated have been laid down.

These companies must pay the first payment on account by 15 June 2010 at the latest, then a second payment on account by 15 September with the balance due on 3 May 2011.

But to do so, they need to know their revenues and their value added [2]. However, the tax instruction giving details of the method for calculating revenues and value added has not yet appeared! The tax authorities have of course stated that taxpayers can rely on the content of the draft instruction until the final instruction has been published. But that would in turn involve the draft regulation being known!

[2] The first payment on account should represent 50% of the levy due for 2010.

The tax authorities are issuing a draft law on fiscal transparency for partnerships for consultation

The current French tax treatment of "sociétés de personnes" - partnerships - is a system referred to as being "translucent" which means that partnerships are subject to tax but can make profits for tax without being liable for the tax due on those profits. Instead, in accordance with article 8 of the French General Tax Code, the partners in such firms are liable to personal income tax or corporate income tax for their share of the profits arising from their rights in the partnership.

This therefore makes it a system different to that of transparency in which partners would be deemed to own the assets and profits of the firm directly (as is the case for example with co-ownership property companies covered by article 1655 3 of the General Code) and from “opaqueness”, in which the company is liable for tax on its own name, and in which the shareholders are liable for tax only on the increase in their net wealth when the company pays remuneration (as is the case with entities liable to corporate income tax).

This system can produce both tax friction and tax advantages that are sometimes unintended. That is why the tax authorities want to reform the current treatment. They have no intention of putting a system of pure transparency in place. Its complexity in terms of monitoring filing of returns and its inconsistency with legal and accounting rules bar its general application. However, it is expected to move a considerable distance from the current translucent treatment toward pure transparency.

The USA could increase the tax burden on funds

The threat hanging over private equity, real estate and hedge fund managers that the tax treatment of carried interest will be reformed is looming ever larger. This reform was announced a few weeks ago and would result in the current rate of 15% rising to 35% (the rate applying to ordinary income).

Dividends paid to European investment funds

The commission officially requested France to amend its tax rules discriminating against foreign investment and pension funds. By these rules, dividends paid to foreign investment and pension funds (outgoing dividends) are taxed more heavily than dividends paid to French investment and pension funds (internal dividends) A 25% retention is withheld from dividends paid to pension and investment funds from other EU or EEA member states (a percentage that may be reduced if double tax conventions exist), but no withholding or other tax is deducted from French funds. The Commission considers that this measure impedes the free circulation of capital as set out in the Treaty on the Functioning of the European Union (TFEU) and in the EEA treaty.

Report on the removal of tax obstacles to cross-border venture capital investment

The European Commission has issued a report setting out the problems of double taxation that arise on cross-border venture capital investment and puts forward possible solutions. The report sets out the conclusions and recommendations of an independent group of EU tax experts set up by the Commission to look into ways of removing the main tax obstacles to cross-border venture capital investment.

Two major problems are highlighted in the report, and possible solutions are put forward.

Firstly, the presence locally of a venture capital fund manager in the member state in which the investment is made could be considered as being a presence for tax purposes ("permanent establishment") in that State of the fund and for the investors concerned. This could result in double taxation if the return on the investment is also taxed in the country or countries in which the fund or the investors are established. The experts recommend that the presence of a venture capital fund manager should not be deemed to involve a presence for tax purposes of the fund or the investors in the member state where the investment is made. This would reduce the problems of double taxation of cross-border venture capital investment.

The experts then observed that from the tax point of view venture capital funds may currently be treated in very different ways in different member states. So a fund may be considered as tax transparent in one member state, but not in another. This situation can also give rise to double taxation. The experts recommend that EU member states should come to an agreement on mutual recognition of the classification of venture capital funds for tax purposes.

Decree no. 2010-423 of 28 April 2010 implementing article 885 I 2 of the General Tax Code (Dutreil pact)

The decree amends the tax notification obligations for wealth tax exemption for units and shares in companies for which a shareholder agreement for a qualifying transfer of shares has been made (Dutreil pact).

In brief

Professional certification for market operators

The purpose of this new regulation is to require Investment Service Providers to ensure that persons acting on their account (employees or otherwise) have the necessary skill to carry out their functions.

- *Who does this affect?* Investment Service Providers ["prestataires de services d'investissement (PSI)"] and therefore portfolio management companies.

- *Which functions are affected?* The selling function (any individual responsible for advising Investment Service Provider clients), the investment manager function (any person with the power to take investment decisions), the compliance officer function, etc

- *What obligations are imposed on Investment Service Providers?* Investment Service Providers can fulfil their compliance obligations (i) by checking competence in-house, by any suitable method, but using a formal procedure that can be monitored after the event by the AMF, (ii) by ensuring that these persons have passed an approved external examination. The advantage of the second method is that it frees the employer of its obligation to ensure that the minimum required knowledge has been obtained

- *When does this new obligation come into force and how does it apply over time?* The new regulations come into force on 1 July 2010. But Investment Service Providers are not obliged to check the knowledge of any persons in post at 1 July 2010. So people already in post at that date are not affected. But any persons using this transitional exemption clause and who change company, even though they may carry out the same key functions, after 1 July 2010, fall within the scope of the provision and must either pass an approved exam, or be evaluated in house by a formal procedure laid down by the Investment Service Provider.

- *How long does an Investment Service Provider have to ensure that a person who is to carry out a key function and who is recruited after 1 July 2010, possesses the requisite minimum knowledge?* Investment Service Providers will have a minimum of 6 months to ensure (or train if applicable), in-house or externally, that such persons possess the minimum required knowledge.

Instructions:

- 4 L-2-10 no. 51 of 10 May 2010: Exceptional levy on bonuses awarded by credit institutions and investment companies for 2009 - Article 2 of law no. 2010-237 of 9 March 2010 amending the Finance Law 2010.

- 4 C-3-10 no. 48 of 4 May 2010: Costs and expenditure (Industrial and commercial profits, corporate income tax, Common provisions). Interest on third-party capital. Conditions and limits on deduction of interest on advances allowed by shareholders and owners in addition to their share capital. Maximum rate for interest qualifying for tax deduction. 88 of the Finance Law 2010 (Law no.2009-1673 of 30 December 2009).

- 14 A-1-10 no. 45 of 27 April 2010: List of tax conventions entered into by France in force at 1 January 2010.

Upcoming conferences

- 2nd June 2010 - Litigation Breakfast seminar on "La Faute de Gestion" - in partnership with the European American Chamber of Commerce. Speakers : Valérie Lafarge-Sarkozy, Partner et Virginie Reynes, Associate at Proskauer in Paris. In the Paris office of Proskauer, 8.30 am -10.30 am.

- 9 June 2010 - EVCA Summit, Berlin. Speakers include Mary Kuusisto, Partner at Proskauer in London.

- 17 June 2010 - Employment seminar on "Tying and Untying the Knot: Noncompete Agreements in the UK, EU and Latin America -- How to Write Them; How to Fight Them". Speakers : John P. Barry, Daniel Ornstein and Yasmine Tarasewicz, Partners at Proskauer. In the New York office of Proskauer, 8.00 am -10.00am.

- 24 June 2010 - Employment Breakfast seminar Club RH on "Elections professionnelles et représentativité : les nouvelles précisions de la Cour de cassation"- en partenariat avec l'AEF. Speaker : Béatrice Pola, Partner at Proskauer in Paris. In the Paris office of Proskauer, 8.30 am -10.30 am.

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Corporate and Private Equity

If you have any questions regarding the matters discussed in this Newsletter, please contact any of the lawyers listed below:

Daniel Schmidt
33.1.53.05.68.30 – dschmidt@proskauer.com

Florence Moulin
33.1.53.05.68.19 – fmoulin@proskauer.com

Publication E-mail: leaders.dopinion@proskauer.com