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Subject: State Aid SA.63127 (2021/N) – Cyprus
Risk Finance: tax reduction for investments made by natural and legal persons in innovative small and medium-sized enterprises

Excellency,

1. PROCEDURE

(1) On 25 January 2017, in line with Article 11 of Regulation (EU) No 651/2014[1] ("GBER"), Cyprus sent the Commission the summary information about the aid scheme SA.47390 (2017/X) ("GBER scheme") based on Articles 21, 58 and 59 of the GBER.[2] The GBER scheme offered tax incentives until 31 December 2019 to private investors who are natural persons that provide risk finance to small and medium-sized enterprises ("SMEs"), in line with Article 21(3) of the GBER. The

[1] Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty, OJ L 187, 26.6.2014, p. 1.

[2] Cyprus sent the summary information in the standardised format laid down in Annex II to the GBER, together with a link providing access to the full text of the aid measure, including its amendments, within 20 working days following its entry into force. That summary information was published on DG Competition's website in the State aid Registry. http://ec.europa.eu/competition/elojade/isef/.

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period during which natural persons could benefit from such tax incentives was prolonged until 30 June 2021 by virtue of Law 45(l) of 2020[3].

(2) On 18 May 2021, Cyprus notified to the Commission an aid scheme which is a successor of the GBER scheme (which offered a tax incentive to private investors), but which, unlike the GBER scheme, is open not only to natural persons but also to corporate investors (the "new Scheme" or "the measure").

(3) By letter dated 8 July 2021, the Commission sent the Cypriot authorities an information request. By letter of 29 July 2021, Cyprus provided the requested information.

(4) By letter dated 13 September 2021, the Commission sent the Cypriot authorities another information request to which Cyprus replied on 8 October 2021 providing additional information. The Commission requested some further information by letter dated 25 October 2021 and Cyprus replied on 12 November 2021.

(5) The Commission and Cyprus held a video-conference on 10 December 2021 during which some missing information was requested by the Commission and Cyprus provided the missing information by letter dated 30 December 2021. The Commission and Cyprus held tele-conferences on 25 January 2022 and 3 February, following which Cyprus provided some final missing information, by letters on 27, 28 January 2022 and on 3 February 2022 respectively.

(6) By letter of 14 January 2022, Cyprus agreed exceptionally to waive its rights deriving from Article 342 of the Treaty on the Functioning of the European Union ("TFEU")[4] in conjunction with Article 3 of the EC Regulation 1/1958[5] and to have this Decision adopted and notified pursuant to Article 297 TFEU in the English language.

2. DESCRIPTION OF THE MEASURE

2.1. Objective of the new Scheme

(7) The objective of the new Scheme is to incentivise, via fiscal incentives to natural and legal persons, the provision of private risk capital for eligible innovative SMEs in Cyprus. As compared to the GBER scheme, the new Scheme expands the scope of eligible investors to cover legal persons (i.e. corporate investors), in

[3] Cypriot authorities explain that, due to a mistake, they did not notify the extension of the duration of the GBER scheme by Law 45 (I) of 2020 under the Summary Information Form SANI2 to the Commission for publication in the Official Journal of the European Union. The amended law was published on 5 May 2020 in the First Annex (I) of the Official Journal of the Republic of Cyprus (No 4755), available at: http://www.cylaw.org/nomoi/arith/2020_1_045.pdf.

[4] OJ C 202, 7.6.2016, p. 47.

[5] Regulation No 1 determining the languages to be used by the European Economic Community, OJ 17, 6.10.1958, p. 385.

line with the Guidelines on State aid to promote risk finance investments ("Risk Finance Guidelines")[6].

(8) State intervention is necessary because of the limited availability of alternative financing in Cyprus, which is traditionally a key form of financing for start-ups and innovative businesses. The problem of general under-financing and specifically the lack of growth in spending on research, development and innovation is exacerbated by the dominance of SMEs as a structural characteristic of the small economy of Cyprus. That problem is also reflected in Cyprus' research and development expenditure, which is far below the Union average (0.74 % vs 2.19 % of the gross domestic product[7]).

(9) The new Scheme grants the possibility to deduct eligible risk finance investments in an innovative SME (see recital (12)) from the taxable income of both natural and legal persons. The new Scheme constitutes an incentive for making investments in innovative SMEs to investors who are not only natural persons but also corporate investors, an element that Cyprus expects to give fresh impetus to increased financing of innovative SMEs. The Cypriot authorities consider the timing for the granting of that incentive appropriate in view of the very low deposit rates that may increase the appetite of investors (both individuals and corporates) to take greater risks and invest in start-ups and innovative SMEs.

(10) In order to allow the assessment of the expected positive effect of the aid in terms of the development of the activities concerned in accordance with Cyprus' specific objectives, the Cypriot authorities have committed to apply two performance indicators[8]:

(a) the envisaged private sector investment in eligible undertakings (expected to be more than EUR 3 000 000 per year).

(b) the expected number of private investors (both natural persons and corporate investors) investing in eligible undertakings under the new Scheme (expected to be over 60 investors per year).

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6 OJ C 508, 16.12.2021, p. 1.

7 https://www.cystat.gov.cy/el/PressRelease?id=58481

8 The performance indicators will be included in the Explanatory Note submitted along with the draft bill in the House of Representatives, after its approval by the Council of Ministers. They will be also published at the website of the Cypriot Ministry of Finance.

2.2. zBrief description of the new Scheme

2.2.1. Beneficiaries

2.2.1.1. Eligible undertakings

(11) The new Scheme aims at raising private equity financing for eligible undertakings that are innovative SMEs[9], as further defined in recital (12) and provided that such SMEs do not fall outside the scope of application of the GBER.

(12) Innovative SMEs are defined in the submitted draft of the revised Income Tax Law (new Article 9a (1)), as any SME that is:

a. "*carrying on a business activity within the Republic of Cyprus; and*

b. which should, at the time of the investment, be an unlisted SME[10] *that has drawn up a business plan for the risk-finance investment; and, in addition, meets at least one of the following conditions:*

i. does not operate in any market;

ii. operates in any market for less than seven years following its first commercial sale[11]*;*

iii. requires an initial risk finance investment which, based on a business plan prepared in view of entering a new product or geographical market, is higher than 50 % of its average annual turnover in the preceding five years:

and

c. which has been approved through the following process[12]*:*

[9] The term "small and medium-sized enterprise" is defined, for the purposes of interpreting Article 9a of the above Income Tax Law of Cyprus, in accordance with the definition included in the GBER.

[10] The Cypriot authorities have also noted that innovative SME must not be listed on the Cypriot stock exchange or any other stock exchange, except alternative trading platforms.

[11] It is understood that the limitation of seven years referred to in the above conditions does not apply in the case of financing follow-on investments provided that the total amount of risk finance mentioned in Article 21(9) of the GBER is not exceeded; the possibility of follow-on investments was foreseen in the original business plan submitted to the Ministry of Finance or other competent authority, in accordance with the provisions of paragraph (c) of this definition; and the undertaking receiving follow-on investments has not become linked, within the meaning of Article 3(3) of Annex I of the GBER with another undertaking other than the financial intermediary or the independent private investor providing risk finance under the measure, unless the new entity fulfils the conditions of the SME definition.

[12] In addition to complying with Article 21(5) of the GBER in the context of the definition of the new Scheme's eligible undertakings, Cyprus introduces additional criteria in its national law regarding the definition of an 'innovative SME'.

(1) in order to be considered as an 'innovative SME", the enterprise must be approved as such by the Ministry of Finance or another authority designated by the Minister of Finance, following an application by the interested undertaking that will include a certificate issued by an external auditor certifying that the research and development expenditure, as recognised in accordance with the international accounting standards and which may include capitalised costs, represents at least 10 % of its total operating expenditure: (i) in at least one of the three previous fiscal years prior to the fiscal year during which the investment is made[13]*, or (ii) in the case of a start-up enterprise without any financial history, in the audit of its current fiscal period.*

It is understood that in case of a start-up enterprise without financial history and no possibility to provide an audit of its current fiscal period, the approval can be established based on the enterprise's business *plan*[14]. […]

[…]

(3) An enterprise shall cease to be an innovative SME for the purposes of this [Law] at any time it receives a total amount of risk finance investment of more than EUR 15 million in accordance with Article 21(9) of the General Block Exemption Regulation (EU) No 651/2014.

d. *The enterprise must not be excluded from the scope of application of the General Block Exemption Regulation (EU) No 651/2014, notably, inter alia:*

   i. *it is not an undertaking in difficulty, as defined in Article 2(18) of the General Block Exemption Regulation (EU) No 651/2014*

   ii. *it is not subject to an outstanding recovery order following a previous Commission decision declaring an aid granted by the same Member State illegal and incompatible with the internal market*.

In addition to the conditions set out in point (c)-(1) of paragraph (1) of the new Article 9a the Cypriot authorities submitted that an undertaking will be considered as an 'innovative SME" and will be approved as such by the Ministry of Finance or another authority designated by the Minister of Finance, following

[13] The Cypriot authorities have noted that such a certificate must be consistent with the undertaking's audited financial statements, which is to establish the costs of research and development. The financial statements must include clearly visible categories of research and development expenditure.

[14] The above-mentioned business plan must describe the ability to develop new or clearly improved products, services or processes with high technological or industrial risk identified as innovative in their sector/market.

an application by the interested undertaking that will include proof that it has met at least one of the following criteria over the last three years:

(i) The undertaking has obtained funding from one of the following: SME Instrument (Phase I and/or Phase II), EIC Pathfinder and EIC Accelerator of the EU Financial Programme Horizon 2020, or from one of the EIC Pathfinder and EIC Programmes Accelerator of the EU Financial Programme Horizon Europe 2021-27;

(ii) The undertaking has received a Seal of Excellence in the programmes referred to above;

(iii) The undertaking has received funding from the PRE-SEED, SEED or INNOVATE Innovation Programmes or from other respective Innovation programmes to be announced under the National Framework Programmes for Research[15] run by the Research and Innovation Foundation[16].

(13) The tax relief will not be used to support buy-outs in eligible undertakings nor to support export-related activities towards third countries or Member States nor to be contingent upon the use by the eligible undertakings of domestic over imported goods.

2.2.1.2. Eligible risk finance

(14) Tax relief is to be provided to eligible investors making only equity investments through the purchase of full-risk, ordinary shares, which are newly issued by an eligible undertaking and are held for at least three years.

2.2.1.3. Eligible investors

(15) Eligible investors can be natural persons as well as legal persons provided they are independent from the company they invest in.

2.2.2. Duration

(16) The planned duration of new Scheme is, as from the date of notification of the Commission's Decision approving it, until 31 December 2023.

2.2.3. Form of aid and maximum amounts

(17) The form of the aid is that of an income tax relief applicable on the taxable base.

(18) Investors providing finance to eligible undertakings may receive a tax relief of up to 30% of the amount invested provided that the following conditions are complied with:

15 SA.101277, 'Restart 2016-2020 Programmes', See information sheet communicated by Cyprus regarding State aid granted under Commission Regulation (EU) No 651/2014 at: https://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_101277.

16 https://www.research.org.cy/en/

(a) the maximum amount deducted from an investor's taxable income does not exceed 50% of that person's taxable income in the fiscal year in which the investment is made;

(b) the deduction, to the extent not granted because of the above restriction, may be carried forward and granted in the following five years, subject to the above percentage limit;

(c) the amount deducted may not exceed a total of EUR 150 000 per year.

(19) The measure does not provide for any tax relief on dividends received in respect of qualifying shares.

(20) The measure does not provide for any fiscal incentive in the form of capital gains tax relief in the case of any profit on the sale of qualifying shares or in the form of deferred capital gains tax liability on disposal of qualifying shares.

2.2.4. *Granting authority*

(21) The authority granting aid under the new Scheme is the Ministry of Finance.

2.2.5. *Legal basis*

(22) The legal basis of the new Scheme is the proposed draft law "Income Tax (Amendment) Law of 31 (I)/2021[17]/Income Tax (amendment) Law of 45(I)/2020/Income Tax (amendment) Law of 135(I)/2016". The implementing provision will be Article 9a of the amended Income Tax Law.

2.2.6. *Budget*

(23) The new Scheme covers the specific period from the date of the notification of the Commission's decision approving the new Scheme until 31 December 2023. It is estimated that the overall budget (foregone taxes) of the new Scheme would be around EUR 937 000 annually based on the estimation that 50 eligible undertakings would receive investments from (natural and legal) persons benefitting from the new Scheme[18].

2.2.7. *Transparency*

(24) The fiscal incentive is described in the Practical Guide on "Tax incentives for individuals investing in innovative business', which is posted on the website of the Deputy Ministry of Research, Innovation and Digital Policy[19].

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[17] https://www.mof.gov.cy/mof/tax/taxdep.nsf/All/9A3883E6EFDFCF8AC22581F7003C15EC?OpenDocument

[18] The estimation is based on the number of persons who claimed the tax relief under the GBER scheme, as described in recital (1) (50 persons * EUR 150 000 = EUR 7 500 000 *12.5% = EUR 937 000).

[19] https://www.dmrid.gov.cy/dmrid/research.nsf/euprogramms_el/

2.2.8. *Cumulation*

(25) The Cypriot authorities have committed to respect the provisions on cumulation specified in section 3.2.4.4 of the Risk Finance Guidelines.

3. ASSESSMENT OF THE MEASURE

3.1. Existence of State aid

(26) For a measure to constitute State aid within the meaning of Article 107(1) TFEU, all the conditions set out in that provision must be fulfilled. First, the measure must be imputable to the State and financed through State resources. Second, the measure must be liable to affect trade between Member States. Third, it must confer a selective advantage on its recipient. Fourth, it must distort or threaten to distort competition.

(27) The new Scheme has its legal basis in various provisions of Cypriot tax laws (recital (22)). It is thus imputable to the State.

(28) By providing for fiscal incentives in the form of income tax relief described in section 2.2.3, the State foregoes income tax revenues, to which it would otherwise be entitled in the absence of the new Scheme. The measure is thus financed from State resources.

(29) According to the Risk Finance Guidelines, the Commission has to verify the existence of aid at both the level of the investors and at the level of the eligible undertakings (investees).

3.1.1. *Aid to investors*

(30) The Commission distinguishes between two types of investors benefitting from the new Scheme: natural persons and corporate investors.

(31) Under the measure, investors obtain an advantage in the form of a reduction of their taxable income that equals 30% of the undertaken investment up to EUR 150 000 per year, which is an advantage they would not have obtained in the absence of that measure. Further, that fiscal incentive is only provided to certain private investors: namely, only those who invest equity finance into the eligible undertakings; hence the measure at the level of investors is selective.

(32) In addition, investors benefitting from support under the new Scheme compete with other investors (natural persons, corporate undertakings) on the market for company shares, and it cannot be excluded that the aid distorts or threatens to distort competition on that market. That market is open to trade between Member States.

(33) In view of the above, the measure qualifies as State aid to the investors insofar those investors qualify as undertakings.

(34) Article 107(1) TFEU applies only to undertakings. Therefore, insofar as the tax relief is provided to private investors who do not perform economic activities and therefore do not constitute undertakings within the meaning of Article 107(1)

TFEU (i.e. natural persons), the advantage does not constitute State aid to the investors within the meaning of that provision. The Commission recalls that where a shareholding only gives rise to the exercise of rights attached to the status of shareholder as well as, if appropriate, the receipt of dividends, which are merely the fruits of the ownership of an asset, the investor will not be considered an undertaking if it does not itself provide goods or services on a market. In contrast, insofar as the tax relief is provided to private investors who are undertakings, it constitutes State aid to those investors within the meaning of Article 107(1) TFEU. This is notably the case where private investors are business angels or individual venture capital investors, who manage their investments and in that capacity act as undertakings[20].

(35) The Commission notes that the new Scheme has an effect on trade between Member States, since investors benefitting from it may invest throughout the internal market. Consequently, the new Scheme distorts investment flows between Member States by making investments in the target undertakings more attractive.

(36) The new Scheme also distorts competition in relation to the investors. As a tax exemption that is only provided to investors who have a specific profile (i.e. that they invest in the eligible undertakings), the benefit to which the new Scheme gives rise distorts or threatens to distort competition by strengthening the financial position of investors on the markets on which they may operate.

3.1.2. Aid to the eligible undertakings

(37) The income tax relief incentivises investors to commit capital to innovative SMEs. As a result, the target undertakings obtain an advantage in that they receive better access to capital than they would have in the absence of the measure. That advantage is selective in nature because only the eligible undertakings may benefit from such investments. The eligible undertakings obtain an advantage, regardless of whether the investor is an undertaking or not.

(38) Finally, the measure has the potential to distort competition and affect intra-Union trade because it enables target SMEs to develop their economic activities and those undertakings compete with other undertakings in their respective markets within the Union.

3.1.3. Conclusion on the existence of aid

(39) In light of the foregoing, the Commission considers the new Scheme to constitute State aid within the meaning of Article 107(1) TFEU to corporate investors and investors who are natural persons, in so far as they are undertakings, as well as to the target undertakings benefitting from this new Scheme.

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[20] Case C-222/04 *Cassa di Risparmio di Firenze SpA and Others*, EU:C:2006:8, paragraphs 107 to 112 and 125.

3.2. Lawfulness of the aid

(40) By notifying the measure prior to its implementation, the Cypriot authorities have respected the notification and standstill obligations laid down in Article 108(3) TFEU and the conditions mentioned in point 31 of the Risk Finance Guidelines.

3.3. Compatibility assessment of the aid

(41) Since the new Scheme constitutes State aid, the Commission must examine whether that aid is compatible with the internal market. The Commission notes that the measure does not fall entirely within the scope of Article 21 of the GBER, since that provision does not allow granting risk finance aid in the form of fiscal incentives to corporate investors. The Commission will therefore examine whether the new Scheme, given that it falls outside the scope of the GBER due to its design parameters (see paragraph 33(d) of the Risk Finance Guidelines), may be deemed compatible on the basis of the TFEU.

(42) Article 107(3)(c) TFEU provides that State aid to facilitate the development of certain economic activities may be considered to be compatible with the internal market, where such aid does not adversely affect trading conditions to an extent contrary to the common interest.

(43) The Risk Finance Guidelines outline how the Commission will apply Article 107(3)(c) TFEU with regard to aid measures that qualify as risk finance measures.

(44) The measure aims at providing fiscal incentives to private investors for leveraging more private capital into the risk capital market. The notified measure thus constitutes a risk finance measure, and has to be assessed in accordance with the Risk Finance Guidelines. The new Scheme was notified under the 2014 Risk Finance Guidelines[21], which expired at the end of 2021. As the notifiable risk finance aid is intended to be awarded after 1 January 2022, the Commission will apply the rules set out in the 2021 Risk Finance Guidelines for the compatibility assessment of such aid, in accordance with paragraph 194 of these Guidelines (see recital (2)).

(45) Paragraph 23 of the Risk Finance Guidelines provides that aid to large enterprises is, as a rule, not covered by those Guidelines. That requirement is met, as the new Scheme provides that eligible undertakings are only SMEs (see recital (12)). In addition, the new Scheme is in line with paragraph 24 of the Risk Finance Guidelines, which excludes companies listed on the official list of a regulated market from their scope. That requirement is met (see recital (12)).

(46) Further, paragraph 25 of the Risk Finance Guidelines prohibits any risk finance aid measure that does not involve private investors, while paragraph 26 excludes risk finance aid where private investors do not undertake any appreciable risk, and/or where the benefits flow entirely to the private investors. Under the new Scheme private investors would have to finance the investment from their own resources and are exposed to the risk of poor performance or capital loss on their

[21] Communication from the Commission – Guidelines on State aid to promote risk finance investments (OJ C 19, 22.1.2014, p. 4).

investment. Although the tax advantage improves performance of the investment as it decreases the taxable income of the investors, investors remain – in a meaningful manner - exposed to the future performance of their investments both on the upside, but also on the downside. Therefore, the new Scheme meets the requirements of paragraphs 25 and 26 of the Risk Finance Guidelines.

(47) In addition, paragraph 27 of the Risk Finance Guidelines provides that risk finance aid covered by those Guidelines may not be used to support buy-outs. That requirement is met (see recital (13)).

(48) Further, paragraph 28 of the Risk Finance Guidelines state that risk finance aid will not be considered compatible with the internal market under those Guidelines if awarded to: (a) undertakings in difficulty, or (b) undertakings which are subject to an outstanding recovery order following a previous Commission decision declaring an aid granted by the same Member State illegal and incompatible with the internal market. That requirement is met (see recital (12)).

(49) Paragraph 29 of the Risk Finance Guidelines excludes from the scope of application of the Guidelines, aid to export-related activities towards third countries or Member States. That requirement is met (see recital (13)).

(50) Under the Risk Finance Guidelines, a series of conditions laid down in their section 3 has to be verified by the Commission and if it can be ascertained that the aid is in line with all of them, the Commission can declare it compatible with the internal market, as analysed in the following recitals.

3.3.1. The aid facilitates the development of an economic activity

3.3.1.1. Identification of the supported activity (section 3.1.1 of the Risk Finance Guidelines)

(51) As indicated in paragraph 42 of the Risk Finance Guidelines, risk finance aid measures cover companies from a wide range of economic sectors, ensuring that certain SMEs have access to the necessary amount and form of finance to perform or further develop their respective economic activities.

(52) Based on the information provided by the Cypriot authorities regarding the eligible undertakings, as described in recital (12), the Commission notes that the Scheme covers all sectors but is limited to providing support only to undertakings that have the status of an ‘innovative’ SME.

3.3.1.2. Incentive effect (section 3.1.2 of the Risk Finance Guidelines)

(53) Paragraphs 43 and 44 of the Risk Finance Guidelines specify that "*aid can only be found compatible with the internal market if it has an incentive effect ... [that] induces the aid beneficiary to change its behaviour by undertaking activities which it would not carry out without the aid or would carry out in a more restrictive manner due to the existence of a market failure.*" In addition, paragraph 47 of the Risk Finance Guidelines specifies that "*once the need for State intervention has been properly identified and the measure has an appropriate design, it can be assumed that an incentive effect is present*".

(54) The Cypriot authorities take the view that the aid has an incentive effect because activities that started before the submission of an application for aid are not eligible for aid under the new Scheme.

(55) The Commission notes that by improving the investment returns for the investors via the tax relief, the new Scheme encourages investors to make risk finance investments which they would not have made without the incentives. At the same time, however, the new Scheme still provides for investors to be sufficiently exposed to the future performance of their investments, thereby encouraging them to make efforts to find the investments with the best risk/return characteristics.

(56) Since the measure addresses a market failure (as further established in recitals (58) - (70)) and is appropriately designed (as demonstrated in recitals (71) - (84)), the Commission concludes that the requirement that it has an incentive effect is respected, in line with section 3.1.2 of the Risk Finance Guidelines.

3.3.2. The aid does not adversely affect trading conditions to an extent contrary to the common interest

(57) In accordance with paragraphs 50 to 52 of the Risk Finance Guidelines, the Commission will assess whether the positive effects of the aid outweigh its negative effects on competition and trading conditions. The Risk Finance Guidelines further clarify that "*in order to establish if the distortive effects of the aid are limited to the minimum, the Commission will verify whether the aid is necessary* (see Section 3.2.2), *appropriate* (see Section 3.2.3), *and proportionate* (see Section 3.2.4). *To enable it to carry out that verification, the Commission requires that Member States submit evidence in the form of an ex ante assessment as described in Section 3.2.1".*

3.3.2.1. Need for State intervention (section 3.2.2 of the Risk Finance Guidelines)

(58) According to paragraphs 53 and 54 of the Risk Finance Guidelines, "*State aid can only be justified if it can bring about a material development that the market cannot deliver itself... and may be necessary to increase the provision of risk finance in a situation where the market, on its own, fails to deliver an efficient outcome or does not deliver in a timely manner*." Further, paragraph 56 sets out the obligation for Member States "*to prove that a specific market failure or other relevant obstacle exists beyond the legal presumption on which the General Block Exemption Regulation is based*", on the basis of an in-depth ex ante assessment or, where appropriate, a series of assessments.

(59) The Cypriot authorities submitted a series of studies and reports - amounting to an ex ante assessment – in order to provide evidence demonstrating a specific market failure, which the new Scheme is designed to address in a targeted way.

(60) The Commission notes that the new Scheme (like the previous GBER Scheme), explicitly targets innovative SMEs in their early stages, i.e. it targets situations where the expected market failure, in the form of a funding gap, resulting from information asymmetries[22], is more severe. The scope of the measure, in regards

[22] Such asymmetry occurs because SMEs (especially innovative ones) are often unable to demonstrate their credit-worthiness or the soundness of their business plans to investors and banks. Since they lack

to the covered eligible undertakings, is stricter than the corresponding Article 21(5) of the GBER, considering that the latter can covers as eligible undertakings even SMEs which are not innovative.

(61) The Cypriot authorities explain that due to insufficient other sources of financing for research and development (R&D), innovative SMEs do not manage to cover all their financing needs by bank credits; often risk capital is therefore the only possibility for those undertakings to obtain sufficient financing. In a Union-level comparison, Cyprus scores particularly poorly in its R&D expenditure which amounts to 0.74% of its GDP compared to the Union-average corresponding figure, which amounts to 2.19% of the GDP (see recital (8)).

(62) The Cypriot authorities noted that access to finance remains the biggest challenge, as evidenced in the 'Small Business Act Fact Sheet' of 2019 for Cyprus, issued by the Commission,[23] where the performance of Cyprus seems to be lower than the Union average in all the indices related to risk finance (venture capital investments, equity funding for new and growing firms, business angels funding for new and growing firms):

"Access to finance is the most challenging SBA area for Cyprus despite many policy initiatives in the recent past. The still high degree of private indebtedness, the high proportion of non-performing loans and the financial sector's continuing lack of stability create a difficult environment for SMEs' access to finance".[24]

(63) The 'Small Business Act Fact Sheet' of 2019 for Cyprus also states:

"*alternative sources of finance such as venture capital, equity funding and business angel funding for new businesses are scarce in Cyprus*".

Further, the same report under the topic "Skills & Innovation" has found that:

"*Finance and support is one of the country's weakest innovation dimensions. [Overall,] Cyprus' lowest scores are for the private co-funding of public R&D expenditure and the R&D expenditure in the business sector indicators".*

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a proven track record and sufficient collateral, they face difficulties in attracting finance because, for transactions involving SMEs, with a lower investment amount, investors may not find it worthwhile to undertake the same type of active screening and research as they would for larger or more established companies. See paragraphs 3 and 68 of the Risk Finance Guidelines.

[23] "2019 SBA Fact Sheet Cyprus", p.10, available at https://ec.europa.eu/docsroom/documents/38662/attachments/6/translations/en/renditions/native.

[24] In addition, another older study conducted by PWC on behalf of the European Investment Bank in mid-2017 had found that: *"The viable demand for equity finance can be estimated between EUR 30m and EUR 35m. [...] [but] the Cypriot equity market is among the least developed in Europe."* In terms of demand, the study found that the equity finance was *"mainly sought for by start-ups for seed financing"* while *"the gap appears to be strongest for Business Angels, financing start-ups."* "Assessing the potential use of Financial Instruments in Cyprus", pp. 159-160, available at: https://www.structuralfunds.org.cy/uploadfiles/20170728%20CY%20Final%20Report.pdf.

(64) In addition, as found by the GEM-2019/2020 National Report[25], the major weakness of the entrepreneurial ecosystem in Cyprus lies in the access to finance:

"Regarding entrepreneurial finance, despite the fact that the condition has been improved over the years, it has decreased comparatively to the results of the last few years (3.6 this year, compared to 4.2 in 2018/2019 […]".

(65) This is further corroborated by the recommendation of the Technopolis Group consultancy[26] to Cyprus' national Research and Innovation Foundation, in the Group's Interim Evaluation Report of the funding programme "RESTART 2016-2020" and of Cyprus' participation in the Horizon 2020 programme, to (of 5 November 2020):

"Explore the possible introduction of demand-side measures in order to decrease the dependence on project funding among start-ups and SMEs (e.g. public procurement, stimulating Venture Capital, etc.)".

(66) In the same Interim Evaluation Report, the Technopolis Group notes that:

"there is an overreliance on competitive funding in the public research system as well as among SMEs and start-ups in the private sector". The Technopolis Group concludes that '*additional instruments would be needed also to address the conditions that hinder the scaling up of SMEs and start-ups*".

(67) In addition, according to a survey carried out within that evaluation by the Technopolis Group for the purposes of its Interim Evaluation Report, high-tech SMEs and start-ups represented 93% of the industry actors that received public financing. However, out of all the respondents who had applied but failed to receive a Horizon 2020 grant, only 5% of the industry actors, (i.e. high-tech SMEs and start-ups) implemented the same project with own financing. Own funding of the project, even with a reduced scale and less ambition, was an option only for about one in four (24%), while, 14% abandoned the idea and 42% re-submitted an application to another RESTART funding programme run by the national Research and Innovation Foundation. In addition, more than 50% of the researchers and about 40% of the industry actors responding to the survey, indicated that without Horizon 2020 funding, the project was put on hold because of the lack of alternative funding sources.

(68) The Cypriot authorities also submitted that due to the underdeveloped nature of the venture capital market activity in Cyprus, the Ministry of Finance is in advanced talks with the European Investment Fund (EIF) to set up a State-Funded

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25 From the lowest "Score 1 = Highly insufficient" until "Score 9 = Highly sufficient". The National Expert Survey was based on the responses of Cyprus' national experts regarding nine Entrepreneurial Framework Conditions, including Entrepreneurial Finance. See, "Entrepreneurship in Cyprus - National Report 2019/2020" by the Global Entrepreneurship Monitor, p. 34, available at: https://www.gemconsortium.org/economy-profiles/cyprus.

26 The Technopolis Group is a consultancy firm for the evaluation of science, technology and innovation, which was awarded the contract to conduct Cyprus' Interim Evaluation Report of the RESTART 2016-2020 programme and of Cyprus participation in the EU's Framework Programme for Research and Innovation for 2014-2020: Horizon 2020; https://www.eprocurement.gov.cy/epps/cft/prepareViewCfTWS.do?resourceId=3641062.

Equity Fund. The EIF has undertaken a market assessment and points out that the local market, although emerging, lacks locally-based venture capital or private equity funds for start-ups and innovative companies.

(69) Finally, in the case of innovative SMEs and start-ups, the European Semester 2019 Country report for Cyprus[27] notes the persisting challenges for those enterprises to gain access to finance in the context of limited bank credit supply and very few alternative financing sources, which hinder the SME's scale-up and the start-ups' access to seed capital. The European Semester 2020 Country report for Cyprus[28] points out that alternative funding sources such as venture capital, crowdfunding and equity financing are still restrained.

(70) Based on the above, the Commission concludes that Cyprus has demonstrated that the eligible undertakings suffer from a lack of supply of financing alternative to debt financing. The Commission notes that the new Scheme seeks to develop the alternative financing by incentivising a larger group of investors to provide risk finance investment to eligible undertakings. The Commission positively notes that the fiscal incentive is designed in a way minimising the aid (see section 3.3.2.3), while still addressing the issue of undersupply of alternative financing. In a context of a venture capital market in early stages of development, the Commission concludes that the existence of the market failure, which the measure aims to address, can be considered as demonstrated on the basis of the evidence submitted by Cyprus.

3.3.2.2. Appropriateness of the aid (section 3.2.3 of the Risk Finance Guidelines)

(71) Fiscal incentives must fulfil certain conditions in order to determine that they are the appropriate measures to achieve the intended objective of the aid, in accordance with paragraphs 91 to 95 and 123 to 128 of the Risk Finance Guidelines. The *ex ante* assessment must demonstrate such appropriateness, in accordance with paragraph 58 of the Risk Finance Guidelines.

(72) The Commission notes that the proposed fiscal measure is based on Cyprus' finding of a specific market failure and the measure is targeted towards a specific category of eligible undertakings, notably innovative SMEs, in accordance with paragraph 123 of the Risk Finance Guidelines. The Commission also recalls that the eligible undertakings remain unchanged under the new Scheme as compared to the GBER scheme: only innovative SMEs in their early stages are eligible.

(73) The selection of a fiscal incentive as the most appropriate measure is part of Cyprus' policy objective to offer a healthy and balanced ecosystem of various risk finance options in the market. A fiscal incentive is a measure that has been already tested in and is known by the market in so far as investors who are natural persons are concerned. In the new Scheme, only the scope of the eligible investors changes (i.e. the fiscal incentive is extended from natural persons to corporate investors) so that the measure provides the necessary incentive for such corporate investors to invest in innovative SMEs.

[27] https://ec.europa.eu/info/publications/2019-european-semester-country-reports_en

[28] https://ec.europa.eu/info/publications/2020-european-semester-country-reports_en

(74) In addition, the *ex ante* assessment provides evidence regarding the financial sector's continuous difficulty to provide for the demanded equity finance and the limited venture capital and business angel funding for innovative SMEs in Cyprus. The scarcity of supply of alternative sources of financing to debt financing is thus sufficiently demonstrated.

(75) Extending the fiscal incentive to corporate investors can increase the supply of risk finance, in line with the corresponding demand from the side of innovative SMEs.

(76) In a situation of a market with under-developed supply of financing alternatives to debt financing, such as the situation in the Cypriot market, fiscal incentives to encourage the strengthening of such a market are an appropriate instrument.

(77) Based on the above, the Commission concludes that the new Scheme, which extends the benefit of the fiscal incentive previously available under the GBER Scheme, also to corporate investors, is appropriate to address the issue of scarce alternative sources of funding for innovative SMEs in Cyprus.

(78) Further, according to paragraphs 91 to 94 of the Risk Finance Guidelines, the Commission will consider to what extent the measure is an appropriate instrument to achieve the intended objective of the aid compared to other policy instruments.

(79) In that regard, the Cypriot authorities have also adjusted the scope of the proposed eligible underlying risk finance to equity financing, excluding loans, guarantees and other types of risk finance, as the most appropriate means to provide aid that would specifically increase risk financing targeting the specific market failure identified.

(80) The new Scheme contains specific limits on the percentage of the invested amount that the natural and corporate investors can claim for the purposes of the income tax relief, as well as on the tax break amount which can be deducted from the investor's tax liabilities (recital (18)). Therefore, the measure meets the criteria laid down in paragraph 124 of the Risk Finance Guidelines.

(81) Moreover, the Commission notes that Cyprus has produced evidence demonstrating that the selection of the eligible undertakings has been made public as that selection is included in Cyprus' tax legislation and has also received generally adequate publicity regarding the scope and the technical parameters of the measure (recital (24)). Therefore, the measure meets the criteria laid down in paragraphs 125 and 128 of the Risk Finance Guidelines.

(82) In addition, the measure is designed to last a limited amount of time, due to expire on 31 December 2023 (recital (16)). Therefore, the measure meets the criteria laid down in paragraph 126 of the Risk Finance Guidelines.

(83) The Commission notes that the same tax relief was already provided in Cyprus for all natural persons under the previous GBER scheme, and, in accordance with paragraph 127 of the Risk Finance Guidelines, the Commission takes into account the submission of the Cypriot authorities that there are no other relevant fiscal incentives that currently exist in Cyprus. Under the new Scheme the income tax relief will be open to all investors fulfilling the applicable criteria regardless of

their place of establishment, in accordance with paragraph 128 of the Risk Finance Guidelines.

(84) Based on the above, the Commission concludes that the measure is an appropriate instrument compared to other policy instruments that may or may not involve aid.

3.3.2.3. Proportionality of the aid (section 3.2.4 of the Risk Finance Guidelines)

(85) In accordance with paragraphs 132 to 134 of the Risk Finance Guidelines, "*State aid must be proportionate to the market failure which it is intended to address in order to achieve the relevant policy objectives … [and] the aid must be limited to the strict minimum necessary to attract funding from the market to overcome the market failure […] without generating undue advantages*".

(86) Further, in accordance with paragraphs 151 to 153 of the Risk Finance Guidelines, applicable to the Commission's analysis of proportionality of fiscal incentives in the form of income tax relief, at the level of the investors, the Cypriot authorities confirmed that the aid granted (income tax relief) is subject, both to natural and legal persons, to the following provisions:

a) the income tax relief is to be provided to eligible investors making only equity investments through the purchase of full-risk, ordinary shares, which are newly issued by an eligible undertaking and are held for at least three years (see recital (14)), which is in line with paragraph 152 of the Risk Finance Guidelines;

b) that relief can only be available to investors who are independent from the company invested in (see recital (15)), which is also in line with paragraph 152 of the Risk Finance Guidelines;

c) as the aid is in the form of income tax relief, investors providing finance to eligible undertakings can receive relief up to a cap fixed at 30% of the invested amount provided that the following provisions are complied with (see recital (18)):

(i) the maximum amount deducted from an investor's taxable income does not exceed 50% of that person's taxable income in the fiscal year in which the investment is made;

(ii) the deduction, to the extent not granted because of the above restriction, may be carried forward and granted in the following five years, subject to the above percentage limit;

(iii) the amount deducted may not exceed a total of one hundred and fifty thousands of euros (EUR 150.000) per year,

which is in line with paragraph 153 of the Risk Finance Guidelines.

(87) The Commission notes that investments made under the new Scheme, to innovative SMEs, are made by private investors without any direct participation of public investors (except for the fiscal benefit). In addition, the tax relief cap of 30% of the invested amount implies that the investors bear sufficient risk and are therefore expected to screen the target undertakings and only invest in those

undertakings which offer the most promising projects, thus instilling a commercial logic into the risk finance scheme. The effective private investor participation of 70% is above the private investor participation thresholds as defined in GBER (ranging from 10% to 60% percent). The introduction of a commercial logic and the significant private investor participation are conducive to develop a sound risk finance market in Cyprus. This ensures that all investment decisions are commercially driven by the individual decision of private investors.

(88) Under the new Scheme investors, while they benefit from the tax exemption, cannot claim any tax credits on capital losses. Consequently, investors remain sufficiently exposed to the consequences of their investment decisions, which is expected to encourage them to search for the best investment vehicle, which makes investments more targeted.

(89) As regards the proportionality requirements of the Risk Finance Guidelines for fiscal instruments at the level of final beneficiaries, in accordance with paragraphs 133 and 151 of the Risk Finance Guidelines, the "*total investment for each beneficiary undertaking must not exceed the maximum amount fixed by Article 21 of the General Block Exemption Regulation*", i.e. EUR 15 million. As described in recital (12), the measure respects that condition and the underlying legal framework, since it contains an explicit reference to this limit.

(90) In light of the foregoing, the Commission considers that the measure is proportionate.

3.3.2.4. Cumulation (section 3.2.4.4 of the Risk Finance Guidelines)

(91) As indicated in recital (25), the Cypriot authorities committed to respect the provisions on cumulation, specified in section 3.2.4.4 of the Risk Finance Guidelines.

3.3.3. Avoiding undue negative effects of risk finance aid on competition and trade (section 3.2.5 of the Risk Finance Guidelines)

(92) In accordance with paragraph 161 of the Risk Finance Guidelines, *"[F]or the aid to be compatible, the negative effects of the aid measure in terms of distortions of competition and impact on trade between Member States must be limited and must not outweigh the positive effects of the aid to an extent that would be contrary to the common interest*".

3.3.3.1. Positive effects to be taken into account

(93) As explained in paragraph 162 of the Risk Finance Guidelines, "*the main positive effect that risk finance aid aims to bring about is to improve access to finance for the undertakings concerned*".

(94) The Commission, in accordance with paragraphs 163 to 166 of the Risk Finance Guidelines, notes that the new Scheme, by providing increased access to risk finance for innovative SMEs, supports undertakings which are active in innovative activities.

(95) For that reason, Cyprus has defined relevant performance indicators (see recital (10)) that must be met in order for the new Scheme to be considered as delivering

its positive effects in line with the objective that has been set (as set out in recital (7)). The Commission notes that the performance indicators defined by the Cypriot authorities allow the Commission to measure the expected effects of the aid with regard to the objective pursued. Considering that the objective set by the Cypriot authorities is to increase access to risk finance for innovative SMEs, the indicators are appropriately designed to demonstrate whether such innovative SMEs will have received better access to risk finance by virtue of the new Scheme. The indicators also provide the Commission with sufficient data to assess, in the future, whether the new Scheme will have provided an incentive to both categories of eligible investors to undertake such investments and the amounts invested by each category of investors. Therefore, the measure meets the criteria laid down in paragraphs 164 and 165 of the Risk Finance Guidelines.

3.3.3.2. Negative effects to be taken into account

(96) In accordance with paragraphs 167 to 169 of the Risk Finance Guidelines, "[*T]he State aid measure must be designed in such a way that it limits distortions of competition and trade within the internal market. In the case of risk finance measures, the potential negative effects have to be assessed at each level where aid may be present*".

(97) The Commission notes that the income tax relief does not reduce any other incentives for private investors to provide funding to eligible undertakings as it acts in a complementary way to other financing incentives, nor does the income tax relief replaces the normal business risk of investments that investors would have undertaken even in its absence. Taking account of the demonstrated market failure, the Commission considers that it is less likely that the income tax relief will result in the crowding out of private investors. Therefore, the measure meets the criteria laid down in paragraph 169 of the Risk Finance Guidelines.

(98) The Commission also notes that the new Scheme targets growth-oriented undertakings which are unable to attract an adequate level of financing from private resources but may become viable with risk finance State aid in the form providing of a tax relief to such new private investors. Therefore, the measure meets the criteria laid down in paragraph 171 of the Risk Finance Guidelines.

(99) Further, at the level of the final beneficiaries, the measure does not seem to have distortive effects on the product markets where the eligible undertakings compete as it is not sector-specific. Nor does it give preference to certain sectors over others, and it therefore meets the criteria laid down in paragraph 174 of the Risk Finance Guidelines.

3.3.3.3. Balancing of the positive effects against the negative effects of the aid

(100) Paragraph 177 of the Risk Finance Guidelines requires the Commission to balance "*the identified negative effects of the aid measure in terms of distortions of competition and impact on trade between Member States against the positive effects of the aid"*.

(101) The Commission notes that, as regards competition distortions at the level of the investors, the measure targets a well-defined market failure, which substantially reduces the risk of crowding out. Private investors are still incentivised to focus on the performance of their investments, the risk investment amounts per

undertaking are not excessive, as there is a maximum percentage of the tax relief to be provided in relation to the invested amount and a second overall cap in relation to the maximum amount that such relief can provide as a deduction from the taxable income of such investors, and the measure targets a specific category of SMEs (as opposed to mid-caps and large undertakings).

(102) In addition, as regards competition distortions at the level of the target undertakings, the measure explicitly excludes undertakings in difficulty and focuses on innovative SMEs (recital (12). The new Scheme is thus targeted at growth-oriented undertakings which are unable to attract an adequate level of financing from private resources but may become viable with risk finance aid. The nature and conditions of the tax relief incentivises private investors to make a selection of the eligible undertaking they will invest in, based on a commercial logic, as they bear the biggest part of the risk of such investment.

(103) In light of the foregoing, the measure can be considered to be designed in such a way so as to limit the distortion to competition and minimise undue advantages and its positive effects may be considered to outweigh any potential negative effects on competition in the internal market.

3.3.4. Transparency (section 3.2.6 of the Risk Finance Guidelines)

(104) Paragraphs 179 to 184 of the Risk Finance Guidelines require for the Commission to ensure that the aid complies with its transparency requirement.

(105) As indicated in recital (24), Cyprus has committed to fulfil the transparency requirement specified in section 3.2.6 of the Risk Finance Guidelines.

(106) In light of all the foregoing, the Commission concludes that the new Scheme fulfils the conditions set out in the Risk Finance Guidelines for a risk finance aid to be deemed compatible with the internal market.

4. CONCLUSION

The Commission has accordingly decided not to raise objections to the aid on the grounds that it is compatible with the internal market pursuant to Article 107(3)(c) of the Treaty on the Functioning of the European Union.

If this letter contains confidential information, which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site: http://ec.europa.eu/competition/elojade/isef/index.cfm.

Your request should be sent electronically to the following address:

European Commission,
Directorate-General Competition
State Aid Greffe
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Stateaidgreffe@ec.europa.eu

Yours faithfully,

For the Commission

Margrethe VESTAGER
Executive Vice-President

CERTIFIED COPY
For the Secretary-General

Martine DEPREZ
Director
Decision-making & Collegiality
EUROPEAN COMMISSION