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PRIVATE EQUITY FUND STRUCTURING IN GERMANY

International harmony vs national fragments

Private equity professionals navigating national and cross-border regulations will need to address three legal changes set to take effect in Germany this year, writes Andreas Rodin

***Rodin:** funds structures have become an international commodity*

There has been a huge demand for private equity worldwide. This is true for emerging markets as well as mature markets. Technology makes progress all around the world, not just in one country. People conduct research and develop patents, products and service ideas everywhere. Financing growth is a challenge for every business regardless of its residency and its growth potential is not limited to its own country. Globalisation of the economy has already become reality.

These international trends have been taken into consideration by long-term oriented institutional investors when planning their investment strategies, as well as private equity firms when structuring their investment funds. Since the global financial crisis in 2008, regulators have acknowledged these international trends and have co-operated to create a single regulatory framework for investment fund managers and their funds. In 2011, the EU introduced the Alternative Investment Fund Managers Directive (AIFMD), which had to be transposed by the member states into national law by July 2013. This was followed in 2015 when the European Commission announced its intention to create a single capital markets union by 2019.

As a consequence, private equity funds structures have become a global commodity characterised by legal and business terms that are internationally recognised and governed by regulatory rules that have, to a large extent, been harmonised. On the other hand, each fund structure is embedded in a specific national context that has a particular impact on taxation of the fund and its investors, as well as those regulatory matters that are not governed by internationally harmonised rules. This is a challenge for fund managers because they operate in more than one country and, as a consequence, are exposed to the national laws of several jurisdictions.

Germany has been an important country for private equity: international investors rely on German products; German start-ups and medium-sized enterprises look for private equity financing; and German institutional investors have identified international private equity as an attractive asset class. But German legislation has always been complex and its interpretation and application to private equity funds sometime conflicts with the fact that private equity fund structures are characterised by standardised terms that are internationally recognised.

This year's German contribution to the legal supplement deals with three legislative projects that will become effective in Germany and will have an impact on the private equity industry: the new German regulatory framework for debt funds; Germany's reaction on the European Court of Justice's decision of 9 December 2015 on VAT on management fees; and the new German investment tax act.

DEBT FUNDS; LOAN ORIGINATION

Under the German Banking Act (KWG), loan origination, including restructuring and prolongation, requires a banking licence regardless of whether carried out alone or in combination with a bank deposit business. In order to define a precise border between the scope of application of the KWG and the German Capital Investments Act transposing AIFMD into German law (KAGB), alternative investment fund managers (AIFM) have been expressly excluded from the scope of application of the KWG, and are only subject to the requirements under the KAGB, when

performing collective portfolio management and related services within the meaning of AIFMD.

Initially, the German regulatory authority, BaFin, had taken the position that loan origination, restructuring and prolongation do not form part of the services of an AIFM under AIFMD unless specifically permitted in the KAGB (such as for real estate funds). In contrast, regulations regarding European Venture Capital Funds (EuVECA) and European Social Entrepreneurship Funds (EuSEF) and European Long-Term Investment Funds (ELTIF) specifically refer to loan origination as permitted investments, and AIFMD does not contain product regulation and is silent on loan origination.

In May 2015, BaFin announced that it will change its administrative practice and extend the exemption of AIFM from the scope of application of the KWG when engaging on behalf of their managed alternative investment funds in loan origination if the AIFM complies with specific regulatory rules outlined in the May 2015 letter.

Moreover, BaFin confirmed that restructuring and prolongation of unsecuritised loans will no longer be considered as loan origination for investment law purposes and hence are now permitted for closed-ended retail AIF as well as for closed-ended and open-ended special AIF. The new regulatory rules were adopted by parliament in January and entered into force on 18 March.

The new legislation introduces general rules for loan origination and specific rules on shareholder loans. The regulatory restrictions on loan origination and shareholder loans depend on the status of the AIF (closed-ended or open-ended Special AIF or Retail AIF) and the AIFM (fully authorised or sub-threshold AIFM or third country AIFM).

Which AIF may originate loans? Closed-ended Special AIF – ie funds that do not grant redemption rights prior to the end of their term and in which only professional investors and semi-professional investors who are sophisticated and experienced and invest at least €200,000 – may originate loans subject to the following restrictions: (i) The closed-ended AIF may itself borrow only up to an amount not exceeding 30 percent of its capital reserved for investments – ie the aggregate capital commitments less the aggregate amount of all direct and indirect fees and expenses which are borne by the investors (the "Investment Capital"). (ii) Consumer loans are excluded. (iii) Loans granted to any one single borrower shall not exceed in the aggregate 20 percent of the Investment Capital.

Special rules apply to shareholder loans granted by a closed-ended special AIF to its portfolio companies. They are permitted up to an amount not exceeding in the aggregate 50 percent of the Investment Capital if one of the following conditions is fulfilled: (x) the borrowing portfolio company is an affiliate of the closed-ended special AIF, or (y) the loan is sub-ordinated and shall only be repaid if and to the extent the borrower has sufficient freely available annual surplus or net asset surplus or otherwise freely available assets exceeding its liabilities or (z) the principal amount of the loan does not exceed twice the acquisition costs of the equity investment held by the closed-ended special AIF in the borrowing portfolio company.

In case a subordinated loan is granted and the closed-ended special AIF does not itself borrow in excess of 30 percent of its Investment Capital the limitation of 50

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percent of the Investment Capital for all shareholder loans does not apply. In case a shareholder loan is granted to an affiliated portfolio company the AIFM must ensure that the affiliated portfolio company itself complies with the above restrictions when originating loans.

Open-ended Special AIF and Closed-Ended Retail AIF are only permitted to grant shareholder-loans subject to the above restrictions and with respect to closed-ended retail AIF further subject to a limitation of 30 percent of the Investment Capital. Open-ended retail AIF – except of real estate funds – are not permitted to originate loans or to grant shareholder loans.

Restrictions on AIFM managing loan originating AIF. Fully Authorised AIFM managing loan originating AIF must comply with certain minimum requirements in respect of risk management. BaFin will issue guidance and more details in a specific administrative pronouncement which will reflect the risk management principles set out in the BaFin circulare 10/2012 (BA) for the credit business of banking institutions. Fully authorised AIFM managing AIF that

only grant shareholder loans or originate loans which were permitted already under the old rules or managing AIF established under the EuVECA, EuSEF or ELTIF Regulation do not have to comply with the new specific BaFin risk management rules. In all cases, however, fully authorised AIFM managing AIF that originate loans or grant shareholder loans or acquire unsecuritised loan obligations shall comply with the special notification requirements for so-called "large exposure loans" pursuant to Section 14 KWG if the principal amount of the loan exceeds certain thresholds.

Sub-Threshold AIFM. The above requirements applicable to fully authorised AIFM generally apply to sub-threshold AIFM as well. However, the new specific risk management requirements do not apply to sub-threshold AIFM managing AIFM that only grant shareholder loans.

EU-AIFM. The exemption of AIFM and AIF originating loans from the KWG also applies to EU-AIF and their AIFM if they are fully authorised under AIFMD or authorised under the EuVECA, EuSEF or ELTIF Regulation. The above restrictions on loan origination and requirements with respect to managing debt funds do not apply to them. When originating loans in Germany, they have to comply only with the rules established by their relevant EU member state or the rules pursuant to the directly applicable relevant EU Regulation.

Third Country AIFM. Third country AIFM are eligible for the exemption of loan origination in Germany from the scope of application of KWG only in respect of those third country AIF for which an authorisation has been obtained from BaFin for marketing to semi-professional investors. Loan origination in Germany by a third country AIFM on behalf of a third country AIF for which an authorisation has been obtained only for marketing to professional investors continues to be prohibited also under the new legislation.

The new legislation is a major step towards harmonisation of the German rules on debt funds. While previously German AIFM were not permitted to establish and manage debt funds and non-German AIFM were not permitted to originate loans form German borrowers, this will now be possible.

It becomes obvious that Germany's restrictive interpretation of the term investment fund conflicts with the guidelines presented by the ECJ

VAT ON MANAGEMENT FEES

While the European VAT rules provide for an exemption of managing investment funds from VAT, they do not contain a definition of the term "investment fund". When transposing the European VAT rules into their national law, all member countries applied it to those vehicles that are defined as investment funds under their domestic rule. As a consequence, the scope of application of the VAT exemption was different from one member state to another. The most restrictive position was taken by Germany. Under the current VAT act only management of open-ended funds complying with a specific product regulation set out in the investment tax act is eligible for the VAT exemption. In its decision of 9 December 2015 the European Court of Justice once again dealt with the limitations imposed on the member states by the European VAT rules when determining which investment funds are eligible for the VAT exemption.

The ECJ confirmed again that the member states' power to define the term investments is limited by the prohibition on undermining the very terms that are employed by the EU legislative. It must also be exercised consistently with the objectives pursued by the European VAT exemption and with the principle of fiscal neutrality inherent in the common system of VAT.

Because the legislation on VAT was harmonised before that of regulations relating to the authorisation and supervision of investment funds, the member states – including Germany – originally determined that only those funds that are regulated at national level and subject to licensing and oversight rules are eligible for the exemption. However, the member states' power to define is overlaid by the co-ordination, at EU level, of laws relating to the supervision of investment funds, their investments and their managers. On the basis of these statements made by the ECJ one can reasonably draw the conclusion that management of those investment funds is eligible for the VAT exemption whose managers are subject to AIFMD.

Germany's position. It becomes obvious that Germany's restrictive interpretation of the term investment fund conflicts with the guidelines presented by the ECJ. On 25 February the government

initiated legislative proceedings to amend the VAT act as follows: investment funds eligible for the exemption include UCITS and AIF that are comparable with UCITS and pension assets pooling vehicles. In its reasoning government sets out the features that shall be decisive upon determining whether an AIF can be compared with a UCITS. They include the following: the AIF itself must be subject to regulation similar to the UCITS regulation; the AIF shall be available for investment by the same categories of investors as for UCITS; the AIF operates in the same frame of competition as UCITS; the AIF issues units to several investors; each investor's return on its investment in the AIF shall be equal to its pro rata share of profits realised by the AIF during the period of such investor's investment in the AIF; the investors share in the profits and losses realised by the AIF; the AIF shall invest its assets according to the risk diversification principle.

The wording of the proposed new legislation and government's reasoning do not correctly summarise the statements of the ECJ in its 9 December 2015 decision. The ECJ expressly stated that EU regulatory legislative as such limits the member states' power to define the term "investment funds". In contrast, Germany takes the position that only the EU rules on UCITS and regulatory rules substantially similar to the UCITS rules limit the member states' power to define. This appears to be a misinterpretation of the position taken by the ECJ.

There is a real concern that also under the new legislation closed-ended private equity funds will not be eligible for the VAT exemption regardless of whether the AIFM is fully authorised under AIFMD.

NEW INVESTMENT TAX ACT

In the course of 2016 the rules on taxation of funds and their investors will be amended. The tax rules applicable to funds organised as limited partnership will not change and the general tax rules for partnerships continue to be applicable. Non-German investors of fund partnerships that are eligible for non-business treatment do not have to file tax returns in Germany and their German tax liability is limited to withholding tax on dividends distributed by German portfolio companies. New rules, however, will become effective for all funds organised as corporate vehicles.

Taxation on Fund level. German as well as non-German corporate-type funds will be subject to German tax on the fund level only in respect of the following income items: dividends received from German portfolio companies; ordinary income and capital gains derived from German real estate; profit shares from a typical silent partnership or profit sharing loans entered into with a German issuer; business income that is effectively connected with a German permanent establishment or agent. Capital gains realised by a corporate-type fund upon the sale of German equity investments will not be taxable on the fund level (unless derived from a trade or business effectively connected with a German permanent establishment or agent). No trade tax will be levied against corporate-type funds unless engaged in trade or business effectively connection with a German permanent establishment.

Taxation on Investor Level. Distributions of a German corporate-type fund will not be subject to German withholding tax. German resident investors will be subject to tax on the following proceeds from corporate-type funds: distributions received from the fund a pre-determined tax basis and capital gains realised upon disposition or redemption of fund interests. German individual investors pay tax thereon at the flat rate of 25 percent. German corporate investors pay corporate income tax and trade tax thereon and the 95 percent exemption otherwise applicable to income derived from equity investments are excluded.

Because corporate-type funds are themselves treated as taxpayers, the proceeds items subject to tax on the investor level are eligible for a partial tax exemption in case of funds invested equity instruments or real estate. The size of the partial tax exemption depends on the type of the fund (equity or real estate fund – German or non-German) and the type of investor (individual or corporate investor in case of a fund invested in equity instruments). In order to avoid that proceeds remain untaxed for an unlimited period of time on fund level, investors shall pay tax on a pre-determined tax basis equal to the excess of a so-called base return over the distributions actually made by the fund. The base return is the product of net asset value per fund interest as of the beginning of a calendar year and 70 percent of the base interest under the German valuation act (which is the German prime rate announced from time to time by the German federal reserve bank plus 450 basis points). In order to avoid a double taxation, the aggregate amount of all pre-determined tax bases that were taxed by an investor during its holding period shall be deducted upon determining the net capital gain upon disposition or redemption of fund interests. ■