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INVESTMENT RULES

Regulatory shifts in Germany

German pension funds face new restrictions on their private equity investments under moves to enact AIFMD, writes Andreas Rodin

***Rodin:** fund managers need to prepare themselves for the new rules*

This year will see some important changes to the rules covering alternative investments in Germany. German pension funds face new curbs on the types of private equity funds to which they can commit capital. There are also revised regulations governing the way that losses can be carried forward for small and medium enterprises, and a new Investment Act which amends the tax rules for German investors.

The regulatory shifts come after a distinctly mixed year for the German private equity industry. Total private equity investment in German companies slumped 13 percent to €5.7 billion, with total proceeds from exits down significantly by 50 percent to €2.92 billion, according to the 2016 private equity annual outlook released by the German Private Equity Association – the BVK – at the end of February.

Fundraising, however, had a better year, with the total amount of funds raised by German private equity firms surging 52 percent to €2.33 billion.

Dig deeper and some other contrasting trends emerge. In terms of fundraising, buyout funds had a much more successful year, collecting €1.27 billion of committed capital, a 250 percent increase on 2015 levels. Venture capital funds proved less attractive, raising a total of €554 million, down 25 percent from the previous year.

But the buyout versus venture capital fortunes were reversed when it came to deals. Venture capital investments totalled €940 million, up 11.5 percent from 2015. But buyout and minority growth investments fell 17.5 percent to €4.76 billion.

In all, 1,011 German companies received private equity investment in 2016: 56 percent were backed with venture capital, 32 percent with growth capital and 1 percent with replacement capital. Buyout deals accounted for the remaining 11 percent.

The exit data also throws up some interesting statistics. Proceeds realised by trade sales increased by 15 percent against a 68 percent fall in proceeds from IPOs and sales to other financial institutions.

In all, 40 German private equity firms responded to the BVK fundraising survey. Of these, 23 intend to set up new funds in 2017 targeting total capital commitments of €3.1 billion – with €1.6 billion by 14 new venture capital funds. Nine are less than €100 million, two are between €100 million and €200 million and three are larger than €200 million. The remaining €1.5 billion is for growth capital and buyout investments.

So what of the outlook for 2017? Just over half of those surveyed believe that investor attitudes towards Germany and private equity investments will remain unchanged and 70 percent expect competition for investor capital to remain the same. The tax and regulatory environment is also regarded as stable, with more than 80 percent saying they do not expect new tax or legal regulations because Germany will have its federal elections later this year.

More than a third of German private equity firms expect a moderate increase in their new investments for 2017, but two-out-of-three believe valuations remain too high.

In terms of exits, venture capital firms are more optimistic than buyout firms, with 60 percent expecting more exit activity against the 70 percent of buyout firms that believe there will be no change in 2017.

NEW PENSION FUND RULES

German pension funds are some of the most important investors in alternative assets both domestically and overseas. Their investments are governed by something called the

Ordinance on Investments of Tied Assets which was amended in April 2016 to enable the Alternative Investment Fund Managers Directive to be enacted in domestic law.

In December 2016, the German Federal Financial Services Authority, better known as BaFin, published a draft circular for consultation on the application and interpretation of the ordinance. While the final circular has yet to be agreed by BaFin, one can assume that the basic principles outlined in the draft will not change.

The changes are significant and alternative investment fund managers intending to solicit capital from German pension funds should prepare themselves for discussions with this investor group on how to accommodate their regulatory needs. The following summarises the draft circular.

Alternative investment funds are eligible for an investment by a German pension fund or pension scheme only if they fall into one of the four groups specifically defined in the ordinance.

The first group includes European Union and OECD closed-ended private equity funds, referred to in section 2 (1) no. 13 b) of the ordinance. The term private equity refers to instruments exposing the fund to entrepreneurial risks of their portfolio companies. These instruments include participation in the corporate equity capital as well as equity-related instruments and other corporate financing instruments.

Pure debt instruments do not qualify as private equity. The circular, however, confirms that a fund is considered as exposed to entrepreneurial risks if each debt-financing decision is taken and monitored on a case-by-case basis for each portfolio company as part of due diligence.

The circular further confirms that short-term borrowing at the fund level cannot exceed 10 percent. The private equity fund manager must either be resident in the European Economic Area and subject to authorisation or registration under the AIFMD or resident in a full member state of the Organisation for Economic Co-operation and Development and for the purpose of investor protection subject to public regulation substantially comparable in substance with the regulatory rules under the AIFMD.

In the case of an investment in a private equity fund of funds, the manager-related requirements have to be fulfilled only at the fund of funds level.

The circular contains limits to how much the pension fund can invest. A German pension fund's capital commitment cannot exceed an amount representing 1 percent of its total tied assets. A "look-through" approach is only permitted under the circular in the case of an investment in a private equity fund of funds. In general, though, the ordinance would expect the 1 percent concentration limit to apply on a "look-through" basis.

"The changes are significant and alternative investment fund managers intending to solicit capital from German pension funds should prepare themselves for discussions"

Finally, the German pension fund's capital commitments to all private equity funds shall not exceed certain diversification thresholds under the risk as well as the participation quota.

The second group, covered by section 2 (1) no. 14 c) of the ordinance, includes EU (open-ended or closed-ended) special alternative investment funds and »

HOW BUYOUT AND VENTURE CAPITAL FUNDS COMPARE

German private equity is marked by a distinction between buyout and venture capital funds. Of the 73 funds currently raising capital, 15 of the 18 funds larger than €200 million were buyout funds, while 75 percent of 31 funds that are less than €100 million are venture capital funds, according to the 2016 private equity annual outlook released by the German Private Equity Association.

	VC	Buyout
AVERAGE FUND SIZE	€86m	€199m
CURRENTLY BEING INVESTED	€3.4bn	€6.8bn

Source: German Private Equity Association

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» closed-ended retail alternative investment funds investing in real estate assets, including real estate companies. These funds must be managed by an EU AIFM subject to full authorisation or an EEA AIFM subject to public regulation for the purpose of investor protection that is comparable in substance with the regulatory rules under the AIFMD.

The circular imposes limits on the borrowings of the real estate fund. Long-term borrowing is only permitted for real estate funds that are investing directly, and not for real estate funds of funds, and is limited to a maximum of 60 percent of the gross value of the real estate assets.

Short-term borrowing of up to 30 percent of the fund's net asset value is permitted for real estate funds and real estate funds of funds that are investing directly. A German pension fund's capital commitments to real estate funds are not allowed to exceed certain thresholds under the real estate quota.

The third group, covered by section 2 (1) no. 16 of the ordinance, includes investments in open-ended EU special alternative investment funds managed by an AIFM that has the same features as the manager of an eligible real estate fund. Almost all German pension funds (as well as insurance companies) have established special funds as their own (captive) platform for investments in alternative assets.

> **As a consequence of BaFin's restrictive position under the circular, investments in debt funds managed by third-country managers would not be possible at all**

For this reason, the vital issue is whether their (captive) special fund is eligible to invest in a particular alternative investment fund. Investments in unlisted closed-ended alternative investment funds are eligible assets from an investment regulatory perspective if they are securities within the meaning of the EU Directive No. 2007/16 under the UCITS Directive.

BaFin, however, has always taken a more restrictive position with regards to investments covered by its insurance regulatory framework. Here the circular states that an investment in an open-ended (captive) special fund is an eligible investment for the tied assets only if the special fund is "transparent" from a regulatory perspective and, as a consequence, its assets meet specific requirements under its insurance regime.

However, a definitive answer as to whether investments in closed-ended alternative investment funds qualify as securities within the meaning of the UCITS Directive has yet to be given. Based upon our interpretation of the ordinance and the circular, the answer should be yes; provided that the investments in unlisted securities, including investments in closed-ended alternative investment funds, shall not exceed an aggregate 20 percent of the special fund's net asset value.

The last group, covered by section 2 (1) no. 17 of the ordinance, includes investments in EU alternative investment funds that are not retail real estate funds nor covered by 13 b), 14 c) and 16 of section 2 (1) of the ordinance. This group includes pure debt funds. They are eligible investments if managed by an EU AIFM subject to full authorisation under the AIFMD or an EEA AIFM subject to public regulation for the purpose of investor protection that is comparable to standards guaranteed under the AIFMD.

Investments in funds managed by third country managers are not eligible. In the case of an investment in a fund of funds falling under no. 17 of section 2 (1) of the ordinance, BaFin requires that the manager of each subfund fulfills the manager requirements set out under no. 17. This requirement is not included in the ordinance and contradicts the statement relating to (closed-ended) private equity funds of funds that come under no. 13 b).

As a consequence of BaFin's restrictive position under the circular, investments in debt funds managed by third-country managers would not be possible at all.

The capital commitments of a German pension fund or pension scheme to all funds pursuant to no. 17 shall not exceed an aggregate 7.5 percent of its total tied assets.

In the case of an investment in a closed-ended fund falling into any of the four groups, the German pension fund or pension scheme must be permitted to freely dispose of its investment in a secondary transaction agreed with another financial institution or investment grade rated purchaser (either pursuant to the fund documentation or a side letter).

THE INVESTMENT TAX ACT

Germany's new Investment Tax Act was finally approved by parliament and the second chamber in summer 2016 and the new rules will apply from 1 January, 2018 onwards. The basic new tax principles had already been presented in the *PEI* legal special 2016 and the final rules now approved are summarised below.

The new Investment Tax Act excludes from its scope all funds that are organised as partnerships. Partnership funds and their investors will not be taxed in accordance with the special rules under the Investment Tax Act, but via tax rules that are generally applicable to partnerships.

As a consequence, managers of international fund partnerships have to prepare themselves in the future to discuss with German investors including specific

provisions relating to German tax law in their side letters. This includes the request to prepare a partnership return setting out separately and uniformly each German investor's allocable share of the fund partnership's profits determined in accordance with German tax law and to provide the investors with the necessary information on low taxed foreign investment income to comply with the German Foreign Tax Act which requires any German investor to file a separate return with respect to its attributable share of low taxed foreign investment income and provide German investors with the necessary information on non-taxable return of capital from a corporate portfolio company required under the German Corporate Income Tax Act to ensure that such returns will not be taxed.

The new rules only apply to German and international funds treated as corporate taxpayers, including Luxembourg corporate investment companies and Luxembourg FCPs. They are subject to German corporate income tax only on certain items of German source income, including distributions on equity and debt instruments issued by German issuers, rental income derived from German real estate, capital gains realised upon the sale of German real estate and business income that is connected with a German permanent establishment or agent.

Capital gains realised upon the sale of shares of German portfolio companies (other than real estate companies) are not subject to German tax at the fund level. For German source income that is subject to withholding tax under German tax law the applicable tax rate is 15 percent which will already be applied at source.

German investors will be subject to German tax in respect of income derived from a corporate German or international fund as follows: all distributions received from the fund, their pro-rata share of the fund's retained earnings determined in accordance with a simplified formula set out in the new Investment Tax Act and capital gains realised upon the sale of their interests reduced by their shares of the fund's retained earnings.

In order to mitigate the effects of double taxation on the level of the fund and its investors, the three items of income taxable at investor level are eligible for a partial exemption depending on the respective fund type. With respect to equity funds that invest at least 51 percent of their value in equity participations, the partial exemption for which taxable German corporate investors are eligible is 80 percent.

However, the burden of proof that the 51 percent threshold has been fulfilled by the fund rests with the German investor. As a consequence, managers of international corporate private equity funds may expect requests from their German investors in side letters for additional information regarding the instruments held by the fund during each fiscal year. ■

NEW RULES FOR CARRYING FORWARD LOSSES

New legislation is also altering the rules governing how small and medium-sized enterprises can, during their start-up and expansion phase, carry forward tax losses when subject to a change of ownership.

The general rule is that they reduce proportionately if during a consecutive period of five years between 25 percent and 50 percent of the voting rights of the loss-making company have been transferred and cease altogether if more than 50 percent of the voting rights have been transferred. In each case, this refers to the amount that losses brought forward exceed the hidden reserves of the loss-making company.

Effective as of 1 January, 2017 the German Corporate Income Tax Act was amended by a new section 8d. Under the new legislation, a loss-making company can, together with its tax return, file an application to carry forward all of the losses if there has been a change of ownership.

The new rules require the loss-making company to have operated for the three calendar-year period preceding the calendar year of the qualifying change of ownership in exclusively the same business. The business operated by the loss-making company will be determined by reference to certain defined qualitative features, such as the services or products of the loss-making company, the group of customers, the markets in which its operates and the professional qualifications of its employees.

If a so-called "disqualifying event" occurs in any of the following years, the loss excess over the hidden reserves that was reported at the end of the calendar year preceding the event will automatically cease to exist and cannot be used anymore. The term "disqualifying" event includes, among others, termination of the relevant business, change of the purpose of the relevant business, commencing another business, tax consolidation with a profitable company and transfer of assets of the loss-making company at a value of less than the fair market value. While this new legislation is important and a great success, it is obvious that its application is dependent on the fiscal authorities appropriately determining the qualitative features of the relevant business. ■