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GERMANY

The quiet revolution

Private equity continued making inroads in the German economy in 2017, with controversy surrounding whether private equity funds should get VAT exemptions, writes Andreas Rodin of P+P Pöllath + Partners

Rodin: *European VAT rules are a source of dispute*

The German economy continued to develop strongly in 2017 with private equity and venture capital among the growth industries. Private equity investment was up 67 percent to €11.3 billion, according to the 2017 annual report released by the German Private Equity Association – the BVK – at the end of February.

While the total invested in venture capital remained unchanged, buyout investments rose by three-quarters, with growth capital and minority investments doubling. In all, 1,100 companies received financing – 600 in the form of venture capital. Exit proceeds were up 25 percent on 2016 levels at €5.42 billion. Half of the exits were trade sales and 40 percent were secondary buyouts. Fundraising was in line with 2016 levels at €2.98 billion, buoyed by a 12 percent rise in venture capital fundraising. The total raised by buyout funds fell by a third.

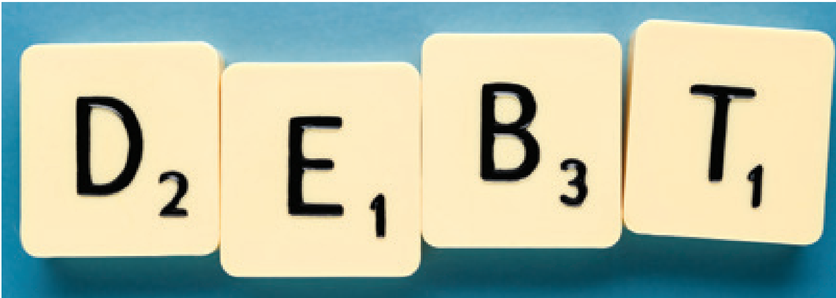
Private equity plays an important role in the German economy. There are around 300 private equity firms in Germany providing capital to more than 1,000 companies last year. The total number of companies backed by private equity now exceeds 5,000, employing 960,000 staff, with €37 billion of private equity investment over the past five years .

A more detailed analysis of the figures supports certain specific features of the German economy. While buyout investments represent 80 percent of the total amount invested in 2017, the total number account for only 13 percent of the companies receiving private equity or venture capital.

The regional allocation of investment reflects the fact that Germany is a federation divided into 16 states each with its own economic policy. Five states – Northrine-Westfalia, Berlin, Bayern, Hessen and Baden-Württemberg – accounted for 83 percent, or around €9.40 billion, of the €11.3 billion invested. Berlin remains Germany's hub for private equity start-ups, and small and medium-sized enterprises remain very much the backbone of the economy: 90 percent of the recipients of private equity investment employ less than 500 staff and have sales of below €50 million. Important industry segments include industrial products and services (39 percent), bio-technology and healthcare (16 percent), communication, computer and electronic technologies (15 percent) and consumer goods and services (11 percent).

On expectations for 2018, 50 percent of private equity firms believe that investment levels will remain unchanged, with 40 percent expecting an increase. Sixty percent of venture capital firms and 47 percent of buyout firms believe enterprise valuations will rise. Twenty fund managers said they intend to continue with fundraising in 2018, but the targets are lower. The aim in 2017 was to raise €4.4 billion but only €2.98 billion was actually raised. For 2018, the projected figure is €3.3 billion, consisting of €1.9 billion for buyout funds and €1.4 billion for venture capital. Fundraising in Germany continues to be a challenge. Historically the most important group of investors have been large German family offices and 83 percent of the firms believes that this will not change.

The legislative process ground to a halt in early summer ahead of the federal elections in September 2017, and has yet to resume. The Christian Democrats and the



DEBT: THE MISSING ELEMENT

One potential change is in attitudes to debt funds. The financing of small and medium-sized companies has long been regarded as important by both the European Commission and member states such as Germany. An amendment to investment legislation has released debt funds and their managers from the need to obtain a banking license. As a result, venture debt is now being seen as one of the missing elements in the capital structure of early stage companies.

For this reason, the German ERP Special Fund managed by the German Ministry for Economic Affairs has started an analysis of the venture debt market with a view to providing funding to venture debt funds through the existing ERP-EIF Mezzanine Facility for Germany managed by the European Investment Fund, with German and European institutions, including KfW (the German reconstruction bank) and the European Investment Bank, to provide co-funding of direct venture debt investments. Similarly, the InnovFin Equity early stage facility established by the European Commission under the Horizon 2020 Rules plays an important role in Germany by providing pre-seed and early stage capital to commercialise technologies for enterprises spun out of German research institutions.

Social Democrats who will once again form the government did not mention private equity in their coalition agreement and had little to say about venture capital. There are measures to encourage start-up investments by institutional investors, and a national digital fund is to be launched by public institutions together with industry investors. But little progress has been made in the idea, mooted a year ago, of a fund-of-funds capitalised with equity from public institutions and "leveraged" by institutional investors ranking senior to the public institutions (similar to the successful Danish model).

> **"A major problem for German investment firms is the way that the German federal finance ministry interprets European VAT rules on the management of investment funds**

Overall, private equity firms appear cautious, with 70 percent of those surveyed by the BVK describing investor attitudes towards Germany and private equity investment as "unchanged" and 82 percent not anticipating a change or improvement in legal or tax conditions.

VAT ON MANAGEMENT COMPENSATION?

A major problem for German investment firms is the way that the German federal finance ministry interprets European VAT rules on the management of investment funds. Until the end of 2007, the compensation paid to general partners of funds organised as a partnership qualified as a non-VATable priority profit share. This interpretation was revoked in 2007 and management of investment funds established after 31 December 2007 was characterised as a VATable exchange of services. Based upon the German interpretation of the European VAT rules, they are not eligible for an exemption.

Levying VAT on management compensation increases costs because private equity and venture capital funds do not qualify as entrepreneurs for VAT purposes and so cannot recover VAT paid on management services.

The difficulty for the German authorities is that VAT systems have been harmonised in the European Union, making these German provisions for dealing with private equity funds and their interpretation a European matter, not a domestic one. Article 135 (1) (g) of the VAT »

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» Directive states that the management of special investment funds, as defined by the member states, is exempt from VAT. According to the European Court of Justice, this does not, however, entitle member states to determine which types of investment funds should receive VAT exemptions.

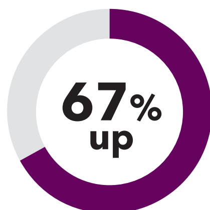
Member states have, however, historically had the right to define which funds are covered by the European concept of special investment fund under national law. The member states had this definition competence because the VAT exemption was introduced prior to the EU's harmonisation of laws pertaining to the rules for approval and supervision of certain investment funds, first via the UCITS Directive and then by the AIFM Directive.

The UCITS Directive concerns both UCITS investment funds and their managers, while the AIFM Directive solely concerns the approval and supervision of managers of alternative investment funds and only indirectly the supervision of the funds themselves. The rules for the approval and supervision of AIFs remain a national competence for member states that is limited by certain provisions in the AIFM Directive governing the supervision of AIFMs.

- The question of the rights of member states to interpret these directives themselves has been tested in the European Court of Justice, notably in the case of Dutch real estate fund Fiscale Eenheid (C-595/13). The ruling in the Fiscale Eenheid case suggested that the introduction of the UCITS Directive has curtailed the member states' rights to decide what qualifies as a "special investment fund" (and is therefore exempt from VAT).

Venture debt is now being seen as one of the missing elements in the capital structure of early stage companies

GERMAN PE GROWTH



€11.3bn

German PE investment in 2017

€5.42bn

German exits in 2017

Source: German Private Equity Association

The Fiscale Eenheid case did, however, cover the period after the introduction of the UCITS Directive, but before the advent of the AIFM Directive. The question that now arises is to what extent the introduction of the AIFM Directive has curtailed member states discretion in deciding exactly which investment funds are eligible for the VAT exemption.

This question was addressed by Denmark to the VAT Committee of the European Commission. Danish tax authorities are worried that member states are interpreting this in different ways. In advance of the meeting on 1 December 2017, the Commission produced a working paper (No. 936 – taxud. c. 1 (2017) 6168695) on 9 November 2017 that sets out the Commission position as follows:

- As laid down in judgements by the European Court of Justice, UCITS investment funds are eligible for the VAT exemption.
- AIFs should be recognised as investment funds for VAT purposes if they have similar characteristics to UCITS investment funds to such an extent that they compete with them, undertake the same transactions and are subject to specific kinds of state supervision.

Based upon this interpretation, the Commission identified in the Working Paper No. 936 five characteristics that have to be fulfilled by an AIF in order to be eligible for the VAT exemption. These comprise (i) being collective investments in financial assets of capital raised from the public; (ii) operating on the principle of risk-spreading; (iii) investors bearing the risk of the fund; (iv) being subject to state supervision; and (crucially) (v) being subject to the same conditions of competition

and appealing to the same circle of investors as UCITS.

Working Paper No. 936 was discussed by the VAT Committee during its meeting of 1 December 2017. The minutes were published on 27 February 2018 (taxud. c. 1 (2018) 1220166). The minutes show that the interpretation of the term "investment fund" under the VAT Directive and how it applies to AIFs in accordance with this "comparability" test was the most controversial point. While all Committee members could agree to the first four of the five conditions described above, a majority of them were opposed to the fifth condition, which would make it more difficult to argue that private equity funds are VAT exempt as investment funds.

However, two delegations, apparently including Germany, saw a merit in this fifth condition. Two weeks later, on 13 December 2017, the German federal finance ministry issued their own administrative pronouncement on the interpretation of what constitutes an investment fund that is eligible for a VAT exemption and included condition (v) from the Working Paper No. 936 of the Commission services – something that had been rejected by the majority of the VAT Committee members.

As Denmark pointed out, it is important to have uniform practice for the internal market to function properly in terms of equal competition in the member states. Against this background, it is frustrating that Germany published its administrative pronouncement two weeks after the majority of the VAT Committee members had rejected the idea that exempt funds should have the "same conditions of competition and appeal to the same circle of investors as UCITS".

INVESTMENTS OUT OF TIED ASSETS

Investments made by German pension funds and so-called "small" insurance companies out of their tied assets are governed by a specific ordinance issued by the German federal finance ministry under the German Insurance Supervisory Act. Investments by the larger insurance companies out of their tied assets are governed by Solvency II. Occupational pension schemes are governed by state rules in an ordinance setting out which investments can be made out of tied assets. After a one-year consultation period, BaFin published in December 2017 its administrative pronouncement on the application and interpretation of the ordinance (the "Investment Circular"). With respect to private equity funds, the new Investment Circular contains the following rules:

Investments in directly investing private equity funds and private equity funds of funds continue to be eligible investments if the following conditions are met: (i) they are invested in equity and equity-related instruments and subordinated loans issued by unlisted companies and (ii) the fund is (a) organised as a closed-ended fund under the laws of a member state of the European Economic Area or the OECD and (b) managed by an AIFM authorised by, or registered with, either the regulatory authority of an EU member state or the regulatory authority of a member state of the European Economic Area or the OECD.

The above fund and manager-related requirements do not apply to the sub-funds into which an eligible fund of fund invests. In the past there was uncertainty as to the question of whether borrowings are permitted on fund level. The new Investment Circular now provides that directly investing private equity funds can generally borrow, in particular to bridge capital calls, without any time limits for which such borrowings can be outstanding. Private equity funds of funds are now permitted to raise short-term debt up to 10 percent of the value of their sub-fund investments.

Institutions falling within the scope of the ordinance often make private equity investments through their own special funds. The new Investment Circular expressly provides that such special funds can invest up to 20 percent of the value of their assets into eligible private equity funds meeting the above requirements.

The new Investment Circular imposes restrictions on investments in debt funds. These investments can be allocated to the private equity basket only if the fund invests in subordinated corporate debt or if the fund is able to conduct a separate due diligence on the business of the borrower and to monitor its debt investment by accessing the borrower's own management reports.

Otherwise, investment in debt funds can only be allocated to a debt fund basket if the following requirements are met: The debt fund must be established as an investment fund under the laws of an EU member state and must be managed by an AIFM that is authorised either by BaFin or a regulatory authority of a member state of the European Economic Area, in a way that is comparable to a full AIFMD authorisation. In case of a debt fund of funds the above requirements have to be fulfilled by each sub-fund as well. Investments in third country debt funds and investments in debt funds managed by a third country AIFM are not permitted. The total amount that can be invested under the ordinance into eligible debt funds must not exceed 7.5 percent of the value of the tied assets of the respective institution. ■