The Circular presents a “safe harbor” for Fund design, but it does not allow room for market-driven variations, even as to elements that should not affect taxation.

Taxation of Venture Capital and Private Equity Funds in Germany

On November 27, 2001, the German Ministry of Finance issued a draft Circular on the income tax treatment of venture capital funds and private equity funds (Funds) in Germany. Market participants have eagerly awaited this guidance. Previously, the German tax authorities had signaled their intention to treat Funds, to a large degree, as commercial partnerships and not as tax-transparent, non-commercial vehicles. If this had become the rule, it would have devastated private Fund investment in Germany, since investment returns (including capital gains) could have become subject to tax. Fund investments normally are made on the assumption that capital gains will be received tax-free by private and (beginning in 2002) corporate investors.

The good news is that the draft Circular offers a “safe harbor” for Fund structures organized in Germany. This is intended to provide a degree of comfort to potential Fund investors. Notably, the safe harbor is not as narrow as officials had earlier indicated it might be. Under the Circular, Funds which are structured within the safe harbor guidelines will produce a return that will be taxed as if the investors were direct shareholders in the investee companies. In other words, approved Funds will be treated as look-through, non-commercial vehicles for tax purposes. The bad news is twofold: (i) the draft Circular sets forth only one safe harbor for structuring a German Fund, and indicates that a Fund must fit tightly within this safe harbor to ensure favored tax treatment; and (ii) the Circular offers no guidance for non-German Funds. Unfortunately, it remains unclear whether variations from the elements of the Circular’s safe harbor will be tolerated, even if economically necessary.

The Circular describes a model Fund structure with elements that it characterizes as integral to a German Fund. (The Circular does not address Funds established in the Channel Islands, Bermuda, or similar jurisdictions with a favorable regulatory or tax regime.) The Circular establishes different rules for Funds with and without incubators. A summary of the Ministry of Finance’s safe harbor criteria is set forth below.

Venture Capital Funds and Private Equity Funds without Incubators

Safe Harbor Criteria
For German Funds without incubators, the Circular sets forth the following criteria for favored tax treatment:

A Fund must aim at financing (i) start-ups and new ventures, (ii) the expansion of medium-sized companies, (iii) the spin-off of business units, or (iv) buy-outs. In each case, a Fund shall acquire shares and equity-like participations in investee companies, which are typically established in the legal form of a corporation (direct investments) or a non-commercial partnership (in the case of a fund-of-funds).
For the most part, a Fund shall be set up by one or more initiators who contribute capital, know-how, and experience to the Fund through their networks. A Fund is to be organized as a non-commercial partnership for tax purposes, specifically as a limited partnership (Kommanditgesellschaft), the sole general partner of which is a German limited liability company (Gesellschaft mit beschränkter Haftung, or GmbH). The general partner makes no investment and has no economic interest in the partnership. The investors make investments and hold limited partnership interests (equity participations).

The day-to-day management of a Fund is to be carried out by the General Partner, but the main management activities regarding investment and divestment decisions are conducted by a separate limited partnership or by individuals who hold special limited partnership interests (Managers). The general partner typically receives a management fee of 1.5 to 2.5 percent of the Fund’s subscribed capital, and the Managers receive about 20 percent of the net operating income (Betriebsergebnis) of the Fund.

A Fund must hold the shares in the investee companies on average for three to five years. The average term of a Fund is eight to twelve years.

Investments shall be financed out of a Fund’s own assets, although special governmental grants (staatliche Förderung) may be available as loans. A Fund may not manage the investee companies. The Fund’s influence is restricted to the exercise of its statutory and contractual rights as a shareholder. As to fundamental management decisions, however, a Fund may hold consent or veto rights exercised by the Managers. Also, the Managers may have a seat on the Supervisory Board of the investee companies.

- The Circular’s safe harbor for a Fund structure does not apply to either (i) non-German Funds or (ii) Funds that make use of independent advisory companies that are part of the group of the initiator, but that are truly independent from the Fund and provide their consultancy services to the general partner of the Fund. Moreover, the Circular does not address German Funds organized in the legal form of a civil law partnership (Gesellschaft bürgerlichen Rechts). The Circular’s reference to a “typical” Fund structure creates substantial uncertainty as to the treatment of Funds that are not fully based on the typical structure. The Ministry of Finance chose not to promulgate general criteria to be taken into consideration in determining the tax status of a Fund, but simply established a one-size-fits-all safe harbor for Funds, irrespective of market needs.

**Qualification for Income Tax Purposes**

Income from a Fund investment is treated either as investment income (Einkünfte aus Kapitalvermögen) or as income from a commercial trade or business (gewerbliche Einkünfte). This distinction has significant impact on private investors. This is because private investors are not taxed on capital gains from a Fund that is regarded as a non-commercial partnership, assuming certain additional requirements are satisfied (see below). Conversely, investors are taxed on capital gains from a Fund that is regarded as a commercial partnership. In addition, Funds that are found to be commercial partnerships may suffer other adverse consequences, such as trade tax exposure.

Whether income is classified as investment income or income from a commercial trade or business depends on the source of the income. In principle, investment income arises from private asset administration carried on to preserve existing assets, whereas income from a commercial trade or business arises from ongoing activities carried on to generate profits.

Reflecting decisions made by the German Supreme Tax Court, the draft Circular provides that a Fund that holds securities will normally generate tax-favored investment income (i.e. it will not be considered to be engaged in a commercial trade or business) if the following criteria are met:

- **a) No Use of Third-Party Loans.** The Fund may not use third-party loans to purchase shares in investee companies, with the exception of governmental grants. Any form of debt capital from outside sources will lead to commercial income.
b) **No Management Organization.** The Fund itself may not maintain its own management organization for the management of investee companies. Office space and working staff are allowed to the extent they are necessary to administer the Fund’s equity holdings as a passive investor.

c) **No External Use of Market Experience.** The Fund may not make use of its market experience for the account of a non-investor third party. The Managers, however, are permitted to make use of their know-how and practical experience in the course of managing the Fund.

d) **No Dealing in Securities.** The Fund may not offer securities to the general public nor may it deal in securities for a third party’s account. Moreover, the Fund’s investments must not be made on a short-term basis. That is, the Fund must maintain its shareholdings for three to five years. Capital gains may not be reinvested, but must be distributed in accordance with the Fund’s regulations.

e) **No Commercial Involvement in Investee Companies.** The Fund must not participate in the management of the investee companies. In this respect, close attention should be paid to the remuneration of the Managers. If the participation of the Managers in the profit of the Fund deviates from their share in the nominal capital of the Fund, this may indicate that the Managers and the Fund participate in the management of the investee companies.

Holding a seat on the supervisory board of the investee company does not by itself mean that a Fund is conducting a commercial trade or business. Consent rights may be problematic, however, if they permit the Fund to exercise direct influence on the management of the investee companies.

- Although the Circular indicates that a Fund may be treated as a commercial trade or business if the above criteria are not met, the Circular does not make clear which criteria are flexible and which not.

For example, the Circular does not indicate whether the use of a short-term interim debt facility would result in the Fund being treated as a commercial enterprise, in a situation where the Fund is fully invested but an investee company needs more liquidity in order to avoid bankruptcy. The same is true with regard to guarantees.

Similarly, it is not clear what happens if a Fund acquires shares in a company where Managers have a duty to actively advise the management of the investee companies under corporate governance standards. Nor is it clear when Fund-consent requirements with regard to management decisions of the investee company are regarded as the conduct of a commercial activity by the Fund.

What is clear, unfortunately, is that the uncertainty created by the Circular is likely to limit activity by German initiators in establishing venture capital and private equity funds in Germany.

### Taxation of Investors’ Profits

If the activities of a Fund qualify as commercial activities, the earnings and profits of the investors will be taxed as income from a commercial trade or business. As a result, for individual investors, half of all capital gains and dividends would be taxed (under the so-called “Half Income System”) at ordinary rates. In addition, Fund profits may be subject to trade tax at the Fund level.

On the other hand, if the activities of a Fund qualify as asset administration, Fund income received by individual investors would be treated as tax-favored investment income so long as the investors hold the Fund interests as part of their private assets (Privatvermögen). Consequently, capital gains realized by such private investors would, in principle, be taxable only if (i) the investor, indirectly through the Fund, holds or has held, at any point in time during a five year period prior to disposal, one percent or more of the stated capital of the investee company, or (ii) the investor disposes of the Fund unit, or the Fund disposes of shares in the investee companies, within one year after the relevant acquisition. If taxation does occur, again the Half Income System (for natural persons) would be applicable.

In the hands of corporate investors, capital gains and dividends are, in principle, exempt from corporation tax under the new corporation tax regime in Germany.

Tax-favored treatment does not apply to the carried interest of the Managers. Only in the unlikely case
where the profit participation of the Managers is proportionate to their equity participation does their profit qualify as investment income. In that case, the general rules for the taxation of private investors would apply mutatis mutandis. A disproportionate carried interest will normally be treated as income from self-employment or from a commercial trade or business. If the carried interest is regarded as compensation for services, neither the Half Income System nor the tax exemption generally available to corporate investors is applicable.

**Venture Capital Funds and Private Equity Funds with Incubators**

**Assumptions**

With regard to Funds with incubators, the news is not so good. The draft Circular assumes that incubators are established in the legal form of stock corporations (Aktiengesellschaft). Such incubators typically advise and monitor start-up companies even prior to incorporation, acquire majority shareholdings, and give support to companies on their way to initial listing on a stock exchange.

The incubators and the Funds are separate legal entities. However, both are typically under the influence of the initiators, and there may also be an identity of shareholders. Some incubators act on the basis of contractual obligations only, rather than in connection with share ownership in the investee company.

**Qualification for Income Tax Purposes**

According to the draft Circular, such incubators conduct a commercial trade or business, and the activities of an incubator, irrespective of the nature of the relationship between the incubator and a related Fund (whether corporate or contractual), affect the character of the Fund and result in the Fund being treated as a commercial trade or business. Consequently the income of investors received from an incubated Fund will normally be regarded as commercial income not eligible for favorable tax treatment (see above).

**Effective Dates**

The Circular will be applicable to all cases that have not been finally settled, if application favors the taxpayer. In other words, if a tax assessment is still subject to appeal, the Circular will apply. To the extent the contents of the Circular tighten existing rules and the administrative practices, the new rules shall take effect only with regard to Funds which are set up (gegründet) after March 31, 2002.

**Summary**

While the Ministry's Circular on Funds is surely a step in the right direction, it does not go far enough. The Circular presents a “safe harbor” for Fund design, but it does not allow room for market-driven variations, even as to elements that should not affect taxation. As a result, the Circular will not make German Funds competitive with Funds established elsewhere.

We expect that the Ministry of Finance will issue the final version of the Circular on the income tax treatment of venture capital and private equity Funds in Spring 2002.

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