



YPOG Briefing:

Investment Funds: New hope and Old Obstacles for PE/VC Funds (Draft Future Financing Act II)

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With the so-called Second Future Financing Act ("**FFA II**"), the German government is planning various legislative amendments to implement its Growth Initiative of July 2024. A draft bill of the FFA II has now been published. In the following, we highlight the most important aspects of the draft for German private equity and venture capital funds ("**PE/VC funds**") resulting from proposed amendments of the Investment Tax Act ("**ITA**").

I. Investment Funds as an Alternative to Trading Closed-End PE/VC Funds?

According to the draft bill, investment funds within the meaning of the ITA that invest directly in corporations without the intention of generating short-term capital gains would not fulfill the standard of "active entrepreneurial management". According to the proposed wording, capital gains from typical PE/VC portfolio investments would be tax-exempt at the level of the investment fund. This could make investment funds (i.e. funds organized as a corporation or on a contractual basis) an alternative to PE/VC funds structured as partnerships. Such an investment fund structure could be of particular interest to non-German investors, as they would not be subject to German tax (filing) obligations when investing in investment funds with direct portfolio shareholdings (unlike when investing in German PE/VC funds with a trading tax status).

According to the draft bill, however, it remains unclear whether the general rules on the distinction between asset-managing and trading activity would also apply to investment funds with direct shareholdings in portfolio companies (noting that the requirements for an asset-managing status would go materially beyond the explicitly required minimum holding period). If so, the investment fund's tax exemption for capital gains would only be eligible under the strict rules for an asset-managing status that also apply to PE/VC funds structured as partnerships. Should this interpretation prevail, investment funds would not be a relevant alternative compared to PE/VC funds structured as partnerships (and operating commercially). Contrary to the straightforward wording of the proposed rule, the commentary on the draft bill seems ambiguous, so that a clarification should occur in the course of further deliberations on the draft bill.

II. Obstacles for Investment Funds Investing in PE/VC Funds with a Trading Tax Status

As a consequence of the draft bill, it remains unlikely that investment funds within the meaning of the ITA will invest in German PE/VC fund partnerships with a trading tax status: The proposed provisions would transform into law the previous view of the German tax authorities (which has been widely criticised in German tax publications) on investments by investment funds in trading (fund)

partnerships according to which all income would be taxable at the level of the investment fund. The proposed new regulation would apply equally to domestic and foreign investment funds, irrespective of whether an investment fund holds its interest in the trading PE/VC fund as a mere passive investor.

The draft bill does not propose changes with regard to the fact that the income of the investment fund from trading PE/VC funds is subject to full corporate income taxation. This also applies to capital gains, for which the tax exemption pursuant to Section 8b (2) and (3) German Corporate Income Tax Act does not apply. Due to full corporate income taxation even for capital gains, direct investment by investment funds in German trading PE/VC funds is likely to become unattractive from a German tax perspective.

The proposed draft bill should be seen against the background that German tax authorities are applying increasingly stricter standards to the asset-managing tax status aspired by many PE/VC funds, thereby increasing the number of German PE/VC funds with a trading tax status. If the draft bill is eventually passed and, thus, makes it more difficult for investment funds to invest in German trading PE/VC funds, strengthening Germany as a fund location (as envisaged by the draft bill) will likely fail with regard to German PE/VC funds.

II. Proposed Amendments to the ITA in Detail

- Investment funds shall be able to invest in trading funds without restriction and without falling outside the scope of the ITA. In our view, however, this does not constitute a new rule, but rather qualifies as a clarification of the current legal situation. Then again, it cannot be ruled out that the supposed clarification will give rise to new ambiguities, as the legislator apparently considers it possible that the term investment fund (*Investmentvermögen*) may be interpreted completely differently under tax law than under regulatory law. Under the current wording of Section 1 (2) sentence 1 ITA, such deviation could be excluded so far.
- The tax liability of an investment fund (likewise under the current legal situation) generally includes trading income generated via a German permanent establishment if the investment fund actively manages its assets in an entrepreneurial way. The draft bill contains several new provisions on the definition of "active entrepreneurial management":
 - Investment funds shall be able to prove that their allocable income, although derived from a deemed trading partnership, actually results from asset-managing activities of such partnership. Such income shall be tax-exempt at the level of the investment fund. However, this provision is likely to have little practical impact for trading German PE/VC funds as they rarely qualify as merely deemed trading partnerships.
 - In accordance with the view currently taken by the German tax authorities, the requirement of "active entrepreneurial management" shall automatically be fulfilled if the investment fund invests in partnerships conducting an actual trade business from a German tax perspective. All income derived from trading German PE/VC funds would therefore be taxable in Germany at the level of the investment fund.

From a systematic approach, the proposed new regulation may be criticized. Active entrepreneurial management should be interpreted as a requirement that must be fulfilled in addition to the trading character of the derived income. According to the draft bill, however, the requirement would no longer have any meaning going beyond

the trading nature of the income. Thus, income of investment funds from the mere holding of investments in trading PE/VC funds would be taxable.

- In contrast, "active entrepreneurial management" shall not be fulfilled in case of direct shareholdings of investment funds in corporations, unless the shareholdings are intended to be disposed after only a short-term holding period. As the proposed provision only covers direct shareholdings in corporations, it is irrelevant for investments in PE/VC funds structured as partnerships. However, from a German tax perspective, it could become more attractive to structure a PE/VC fund as an investment fund within the meaning of the ITA (i.e., as a corporation or on a contractual basis). However, given that the commentary attached to the draft bill contains several ambiguities, it remains possible that the legislator intends to limit the exemption from "active entrepreneurial management" to cases of direct investments which have an overall "asset management character" under general German (income) tax rules.
- The draft bill does still not introduce a tax exemption for capital gains. All income of an investment fund from German trading PE/VC funds is subject to full taxation with German corporate income tax of 15% (plus solidarity surcharge). This is contrary to the taxation of capital gains at the level of other corporate investors which is subject to far-reaching tax exemptions.
 - The draft bill does not change the fact that the investment fund should generally not incur German trade tax if it holds an interest in trading PE/VC funds. However, the proposed rules manifest uncertainties regarding the trade tax burden at the level of trading PE/VC funds in which investment funds hold an interest.
 - According to the draft bill, tax exemptions at investment fund level currently applying to income allocable to certain tax-exempt investors such as churches or charitable foundations shall become inapplicable. Abolishing the tax exemption specifically pertains to trading income from "active entrepreneurial management" that is allocable to tax-exempt investors of an investment fund. Consequently, investment funds that only have tax-exempt investors would realize fully taxable income when investing in German trading PE/VC funds.
 - According to the draft bill, the new provisions would apply from 2026.