YPOG Briefing: Draft decree on the capitalization of so-called fund establishment costs pursuant to Section 6e German Income Tax Act

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On November 15, 2024, the German Federal Ministry of Finance (BMF) published a draft decree on Section 6e German Income Tax Act (GITA).

1. Background

With the introduction of Section 6e GITA at the end of 2019, a statutory provision on the so-called fund establishment costs was introduced for the first time.

The provision aims at treating (running) expenses of certain funds for tax purposes not as tax deductible expenses, but as acquisition costs to be capitalized (in particular the management fee). Section 6e GITA was intended to uphold previous long-standing case law on the so-called contract bundles, which the Federal Fiscal Court abandoned in 2018 (IV R 33/15).

If the provision is applied in the PE/VC sector, ongoing expenses such as the management fee would only have a tax effect for investors subject to tax in Germany at the time of the disposal of investments. In case of corporate investors, these costs would not affect the tax base at all or only marginally (5%). In these cases, the provision would not have a merely temporary tax effect, but rather result in a long-term transformation of deductible operating expenses into non-deductible (or only partially deductible) acquisition costs. With regard to the management fee, this also has a regular effect over several years.

Section 6e GITA is unduly complex and difficult to understand without dealing intensively with the underlying case law. This applies in particular to the scope of the provision. Understandably, the draft decree is unable to eliminate these shortcomings. Nevertheless, the BMF's apparent intention to make the provision manageable despite its complexity should be emphasized positively. At the same time, the draft decree leaves numerous crucial questions unanswered. Further clarifications would be desirable and, from a practical point of view, necessary. According to the draft, the final decree would apply to all open cases.

The draft decree has particular relevance for PE/VC funds. Even if there are very good reasons against applying Section 6e GITA to PE/VC funds, its application to these funds is a recurring issue. In the following, we summarize the most important aspects of the draft decree for PE/VC funds.

2. Scope: No exemption for PE/VC funds

According to the draft decree, all closed-end funds in the legal form of a partnership may be subject to Section 6e GITA. The decree does explicitly refrain from establishing a link to the regulatory concept of investment assets (according to the BMF, single-investor vehicles and

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operating companies outside the financial sector may also be subject to the provision). Accordingly, PE/VC funds structured as GmbH & Co. KG or foreign partnerships would be within the general scope of the provision. In particular, the BMF also considers funds with a (semi-)blind pool concept to be covered. The draft also refers to the statutory provisions according to which funds with a trading and asset-managing tax structure may be subject to Section 6e GITA.

Unfortunately, the draft does not refer to the general idea of Section 6e GITA as an anti-abuse provision that only applies to specific fund structures (i.e., structures serving as a scheme for tax optimization). This idea behind Section 6e GITA would be particularly relevant for PE/VC funds that are not intended to create taxable losses at investor level during the investment period but aim at creating investor returns. The BMF explicitly recognized this in its decree relating to Section 15b GITA and generally exempted PE/VC funds in this context. Such an exemption is also highly recommended with regard to Section 6e GITA.

Nevertheless, the draft decree indicates that it only applies to funds where (i) the fund initiator provides a pre-formulated contract and (ii) the investors as a group do not have any significant influence on it. Both characteristics must be assessed separately and be fulfilled cumulatively. The pre-formulated contract is the central requirement to be assessed from the investor's perspective. Without it, Section 6e GITA is not applicable at all. This fact should be clarified even more in the final decree.

3. Ambiguities regarding the central requirement "pre-formulated contract"

According to the BMF's view set out in the draft, a set of contracts (for which the fund's limited partnership agreement – LPA – shall suffice) is pre-formulated if the individual investors cannot significantly influence either the LPA drafting, particularly around the time of the fund's closing, or the implementation of the LPA and only has the option of accepting the LPA or not becoming a partner in the fund.

According to the draft decree, funds with a blind pool strategy typically have a pre-formulated LPA. Contrary to the statutory provision, the draft decree thereby states a presumption for LPAs being pre-formulated. As there is no legal basis for this presumption, it should be dropped in the final decree. It would also contradict the typical genesis of PE/VC fund LPAs.

Apart from this, the draft decree leaves key questions unanswered, the clarification of which in the final decree would be very helpful from a practical point of view:

- According to the statutory provision, funds without pre-formulated contracts are not subject to Section 6e GITA. The requirement of "significant opportunities to exert influence" mentioned elsewhere in the statute is irrelevant to assess whether a pre-formulated LPA exists. The final decree should clarify this distinction. The draft decree creates the impression that significant opportunities to exert influence are merely the flip side of a "pre-formulated contract". This is not the case and both criteria should be carefully distinguished.

- In addition, the term "contract" is not described in more detail. According to its history, Section 6e GITA requires a set of contracts in which (uniform) acquisition

costs are allocated to various contracts and service components. This is different for PE/VC funds with the LPA as its central contractual document. However, the draft decree seems to (excessively) allow "the LPA" to suffice as a set of contracts.

- Lastly, the standard of "significant influence" on the LPA, as introduced by the BMF, remains unclear. Contrary to the statutory provision, the requirement of "significant influence" creates a link to the requirement of "significant influence", which, however, is irrelevant when assessing a "pre-formulated contract". In this respect, further explanations on the requirements for a pre-formulation would be desirable in the final decree. In our opinion, LPA negotiations between the fund initiators and (anchor) investors are generally a strong indication against a pre-formulated LPA. The same applies to side letters, which should be discussed in the context of the "pre-formulated agreement", but are only dealt with by the draft decree in connection with "significant possibilities of exerting influence" (see below). As a matter of fact, the subscription process of PE/VC funds is regularly accompagnied by negotiations and the investors – unlike in the case of retail funds, for which Section 6e GITA was introduced and which were the subject of the relevant previous case law – are not just in the position to either sign the LPA or not subscribe to the fund.

It should be possible to prove with reasonable means that there is no pre-formulated LPA. In view of its history and character as a special anti-abuse provision in the area of tax loss utilization, a blanket application of Section 6e GITA to all PE/VC funds is unlikely to be intended by the tax authorities. This is also true in view of the fact that Section 6e GITA was introduced to uphold the previous case law (which exclusively related to certain retail funds) but without intending to increase its scope. This is clearly evident from the legislative materials.

4. Significant opportunities to exert influence

The draft decree deals extensively with the "significant possibilities of influence" of investors on the LPA. In strict distinction to the "pre-formulated contract" – a requirement to be assessed from an investor's perspective (see above) – it is a concrete and factual criterion to be assessed from the fund's perspective.

- According to the draft decree, investors must actually be able to influence the main contractual arrangements (in particular the selection of specific investments, their financing and use) and the implementation of contracts themselves.

  These standards cannot be applied to PE/VC funds because they would contradict their regulatory concept (according to which the investors' capital is never managed by the investors themselves, but by a management company and thus always without the investors' possibility of exerting influence). The BMF's requirement would therefore not be permissible under supervisory law.

- According to the draft decree, investor representation on an advisory board is only sufficient for a significant possibility to exert influence if the investors alone may

decide on the composition of the advisory board and may do so at the earliest when 50% of the committed capital has been drawn down.

This standard would never be fulfilled by PE/VC funds and would therefore disregard the LPAC as a criterion for the possibility of exerting influence. That seems highly unpractical.

The BMF seems to assume that the criterion of "significant possibilities of influence" may be relevant for both so-called original acquisition funds (Section 6e (1) sentence 1 GITA) and so-called manufacturer funds (Section 6e (1) sentence 2 GITA). This interpretation is not in line with the wording of the provision. Rather, the requirement is from the outset not relevant for acquisition funds, and thus also for PE/VC funds, and should only be considered in case of manufacturer funds.

Moreover, the general significance of the requirement of "significant possibilities of influence" as interpreted by the BMF remains unclear – funds within the scope of the German Investment Act are unlikely to be able to meet the requirements set by the BMF for regulatory reasons (see above). In practice, the requirement is therefore likely to be of little relevance. Rather, the (non-)application of Section 6e GITA must be decided solely on the basis of a "pre-formulated contract". This is a main reason why a clarification is important that the two requirements are to be distinguished from each other and examined separately.

5. Scope of the fund establishment costs

If Section 6e GITA was applicable, the typical and significant expense items in the PE/VC sector would be included according to the draft letter (in particular costs for fundraising, organizational expenses, management fees, placement fees and legal fees).

According to the statutory provision, the capitalization must occur throughout the investment period. It is still unclear when this period begins and ends. According to the draft decree, the respective LPA provision is irrelevant. Instead, the investment period within the meaning of Section 6e GITA shall begin with the "initial planning activities" (i.e. before the first fund closing) and end in case of multi-asset funds "when all assets acquired in accordance with the investment concept are ready for operation". The BMF allows the blanket assumption that the investment period ends when 80% of the capital commitments have been used for investments in assets. In the case of SPVs with only one investment, the investment period shall end when such investment is "ready for operation".

A uniform investment period may be disadvantageous from an investor's point of view because expenses may then have to be capitalized although they serve to manage portfolio investments that have already been acquired. Nevertheless, the 80% rule achieves a certain simplification. At the same time, there is no apparent legal basis for this rule and the BMF's understanding is clearly inappropriate for PE/VC funds. With these, initial investments are made within an investment period of usually four to five years agreed in the LPA. In the case of VC funds in particular, however, far less than 80% of the

capital commitments are usually drawn down and invested at the end of the investment period.

6. Allocation of fund establishment costs to individual assets

According to the draft decree, the allocation of acquisition costs to the individual assets acquired in a financial year occurs in two stages - firstly, expenses directly attributable to the assets are allocated directly; secondly, the remaining (overhead) costs are distributed in proportion to the first allocations. The draft decree also provides for the possibility of creating adjustment items in the fund’s balance sheet for the purpose of allocating acquisition costs across financial years. Such an item must be created for years in which no acquisitions are made.

7. Summary and outlook

In the case of typical PE/VC funds, there are good reasons against the application of Section 6e GITA. In these cases, there is usually no "pre-formulated LPA" because the LPA is subject to intensive negotiations. On the other hand, the existence of "significant influence" is irrelevant, and the two terms are by no means congruent. This fact should be clarified in the final decree, as in the past this has been a regular item of discussion with the tax authorities. In any event, “significant influence” is only relevant for manufacturer funds, and cannot be required for PE/VC funds in the first place (or for any other investment vehicle within the meaning of the KAGB).

In addition, the draft decree remains vague with regard to key questions and thus is unable to prevent dispute regarding the application of Section 6e GITA in many cases. It would be desirable for the BMF to provide clarification in this respect. Such clarifications could make the final decree a helpful means to assess the scope of Section 6e GITA in practice. Until then, Section 6e GITA remains a controversial statute for many PE/VC funds. As a result, all PE/VC funds have to deal with the scope of this provision (see our recent Tax Talk).