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New rules for venture capital

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In an effort to deliver on its promise stipulated in the coalition agreement on November 11 2005 to create an "internationally attractive framework for venture capital", Germany's grand coalition has prepared a set of new rules expected to be enacted in mid-2008. The heart of this reform is the introduction of a Venture Capital Act. As an ancillary measure, the existing rules of the Act on Funds for Private Investments in Companies are also to be amended. A related proposal concerns the introduction of special legislation to limit the risks of financial investments which, however, focuses on investments in listed companies and therefore should not have a direct impact on the venture capital market.

The Venture Capital Act intends to promote equity or equity-related investments in young and innovative companies, especially in the technology sector, by introducing a new type of regulated venture capital fund, the VCI fund. Most German venture capital funds are unregulated vehicles; they are not subject to special legislation and neither the funds nor their managers require a licence or permission.

The Venture Capital Act applies only to venture capital investments (VCIs) - that is, investments in companies that fulfil the following criteria:

(i) They are organised as corporations.

(ii) They are located within the European Economic Area.

(iii) They have a maximum equity capitalisation of €20 million at the time of investment.

(iv) They are not older than 10 years.

(v) They are not publicly traded.

Approval and supervision

VCI funds can be structured in varying legal forms, for example, as limited partnerships (GmbH & Co KG) or as companies with limited liability (GmbH). Any such vehicle with the purpose of investing in VCIs may seek approval as a VCI fund. The German Federal Financial Supervisory Authority, BaFin, grants the formal status. It is also responsible for the supervision of VCI funds.

The initial approval requirements are low. A VCI fund must have an equity capital of at least €1 million, 25% of which must be paid in upon approval, the remaining 75% within 12 months. In addition, a VCI fund must have at least two directors (individuals, not entities), who must be "reliable and professionally suitable".

As part of its supervision, BaFin examines whether a VCI fund fulfils the mandatory investment criteria. Most importantly: (i) at least 70% of its capital must be invested in VCIs; (ii) a VCI fund may not hold more than 90% of the capital in any target company; and (iii) no single investment may account for more than 40% of the VCI fund's capital. With regard to investors, VCI funds must have a minimum commitment of €50,000.

Tax status and benefits

The Venture Capital Act does not introduce a comprehensive tax regime. Rather, VCI funds are generally taxable under the existing rules applicable to their legal form. Thus, VCI funds organised as partnerships will be treated as tax-transparent (regarding trade tax, only if they qualify for non-business treatment), while corporations will be subject to corporate income tax and trade tax.

However, the Venture Capital Act does have tax implications. Under the proposed rules, a VCI fund enjoys certain tax benefits, the most prominent of which is a status of deemed non-business treatment for VCI funds organised as partnerships. Non-business treatment means that the partnership is fully tax-transparent for German (corporate) income tax and trade tax purposes. Partnerships engaged in trade or business, on the other hand, are subject to trade tax on their level and thus not fully tax-transparent. Furthermore, non-business treatment of a fund leads to favourable taxation of carried interest for the carry holders.

To qualify for deemed non-business treatment under the proposed rules, a VCI fund may not: (i) trade investments on a short-term basis; (ii) invest in securities, money market instruments and investment funds; (iii) advise portfolio companies, grant loans to portfolio companies or take up loans on the fund level; (iv) recycle proceeds from investments; (v) act on a market by using professional experience; or (vi) enter into atypical silent partnerships. These activities may, however, be performed by a corporate subsidiary of a VCI fund without harming its favourable tax status.

These criteria are still subject to intense discussion between the federal ministries involved and German venture capital experts. It is not yet entirely clear whether they will be adopted as outlined above. The key issue is that the proposed rules are not consistent with, and in some respects are more restrictive than, the current administrative practice applied to unregulated funds.

Today, a great number of German venture capital funds (and even more buyout funds) already qualify for non-business treatment relying on the criteria of an administrative notion of the Federal Ministry of Finance of 2003, or are protected by a binding ruling of a financial authority confirming non-business treatment. It is therefore arguable whether VCI fund status is more a burden than a benefit in comparison with unregulated funds.

Apart from the deemed non-business status, VCI funds will benefit from extended loss carry-forward rules in respect to investments in portfolio companies with accumulated losses. These rules are widely regarded as helpful.

Act on Funds for Private Investments in Companies

Although most German venture capital funds are organised as unregulated funds, a regulat-

ed status is available under the Act on Funds for Private Investments in Companies (UBG status). A major benefit of UBG status is an individual tax exemption from German trade tax. The UBG status was originally legislated in 1987 and later liberalised on numerous occasions, but has not yet seen a major breakthrough. Only a few funds are acting under this status, usually vehicles from the domain of mutual savings banks. The current proposal aims to liberalise UBG status even further.