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Debt Funds for Institutional Investors: Current Developments in German Regulatory and Tax Law

These days, debt funds are an investment class in high demand by German institutional investors. This development results in part from the new regulatory framework to which German insurance companies, pension schemes of professional organizations (*berufsständisches Versorgungswerk*) and pension funds are subject. In response, the German banking regulator has softened the restrictive administrative practice regarding loan origination by funds. Loan origination by funds is thus now permissible under certain conditions and no longer subject to a license requirement under the German Banking Act (*Kreditwesengesetz – KWG*). The following article will introduce the new regulatory framework for debt funds and their investors and explain taxation aspects of this asset class, which are also continuing to evolve.

The supervisory framework for German institutional investors

German insurance companies and pension funds are subject to the Investment Ordinance (*Anlageverordnung – AnlV*) for the investment of restricted assets, pursuant to which these investors may invest their restricted assets only in certain asset classes. Each asset class has its own requirements. The Investment Ordinance in force until 3 March 2015 allowed investment in debt funds only to a limited extent and under very strict requirements. This changed with the new Investment Ordinance enacted on 3 March 2015: Under the new Investment Ordinance the investment in open-ended or closed-ended funds investing 100% in loans is permitted, provided that such funds are EU funds managed by a fully regulated manager licensed under the AIFMD. Under certain circumstances, investment in funds established in the OECD is permitted as well, provided that the manager is subject to comparable regulatory supervision, the fund's invest-

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ment strategy is focused on the long-term holding of loans and the manager performs comprehensive due diligence in advance of the investment. German pension schemes of professional organizations (*berufsständisches Versorgungswerk*) not supervised by the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin*) are not necessarily subject to the Investment Ordinance but submit themselves to it via internal statutes or the law of a German federal state.

While the Investment Ordinance remains applicable to insurance companies only until the end of 2015, it remains relevant for pension schemes of professional organizations (*berufsständisches Versorgungswerk*) and pension funds. Starting in January 2016, the provisions of Solvency II will apply to most insurance companies. Solvency II also provides incentives for these investors to invest in debt funds. Based on the look-through approach inherent to Solvency II, taking loans into account is advantageous because investments in loans are in many cases subject to favourable regulatory capital requirements compared to equity investments. This positive new regulatory framework is only interesting, however, if sufficient products (debt funds) are available for investors to use the new regulatory leeway. This is addressed in part by new developments in the banking supervision law.

The new framework for debt funds under banking supervision law

For German investment law this year was a turning point in the regulatory treatment of loan origination by investment funds. Previously, commercial loan origination in Germany had been exclusively restricted to banks.

Previous legal framework in Germany

Previously funds were prohibited from originating loans except via a few exceptions. This prohibition also applied to loan origination by foreign funds to borrowers in Germany. To the extent permitted by product regulation, investment funds could previously only acquire pre-existing loan obligations and used so-called “fronting banks” for that purpose. These banks originated loans and subsequently sold the resulting obligations to the fund. This solution proved practical only to a limited extent. The BaFin equated the payout, amendment of contractual terms, or prolongation of a loan with loan origination. The graduated payout of different loan tranches by the fund was likewise not possible.

Legal situation in other European states

By classifying isolated loan origination as a banking activity, Germany significantly exceeds the requirements from Brussels. European banking regulation requires a banking license only for financial institutions engaging in loan origination as well as accepting deposits. It is thus possible to raise debt funds in other European states, including the popular fund centres of the United Kingdom, Luxembourg and Ireland. European fund regulation does not make a general statement on this issue. The Alternative Investment Fund Managers Directive (AIFMD) only regulates fund managers, not fund products. Where the European legislature has provided a legal framework for individual fund products (EuVECA, EuSEF and ELTIF), loan origination is explicitly permitted.

BaFin’s new administrative practice in Germany

Within the efforts to create a unified European market for investment funds in recent years, the European Securities and Markets Authority (ESMA) has suggested that it may take on the unified regulation of debt funds. Anticipating this, BaFin has fundamentally changed its previous administrative practice regarding loan origination by German funds.

By letter dated 12 March 2015, BaFin announced that loan origination by German funds will from now on be regarded as part of collective asset management by the fund manager and thus subject to the German Capital Investment Act (*Kapitalanlagegesetzbuch – KAGB*). Because investment supervision and banking supervision are legally strictly separated due to an exemption in the KWG, BaFin thus removed loan origination by German funds from the scope of banking supervision.

Implications of the new administrative practice for non-German funds

Although the KWG exemption also pertains to managers of EU funds and even third-country funds, BaFin now takes the view that its new administrative practice does not apply correspondingly to managers of EU and third-country funds. The exemption of Sec. 2 para. 1 no. 3c KWG shall instead only apply when the foreign manager can be assumed to be subject to supervision comparable to that to which German investment fund managers are subject. That is only the case when the respective AIF may also be marketed at least to semi-professional investors under the KAGB. A marketing notification of a third-country manager for marketing to professional investors, on the other hand, does not suffice because it does not require comparable supervision.

This interpretation raises doubts not only because it contravenes the express wording of the exemption, but also because it discriminates against foreign managers and their funds. For German managers of German funds, only compliance with certain provisions of the AIFMD, not the entire AIFMD, is required.

Impending amendments of the law

Unrestricted loan origination by investment funds is an at times controversial topic of discussion under the heading of "shadow banking". As already announced in the BaFin letter, loan origination by German investment funds will be comprehensively regulated as part of the law to implement the UCITS V Directive (*OGAW-V-Umsetzungsgesetz*).[1] The impending provisions only apply to German funds. The treatment of non-German funds remains unresolved, in particular against the backdrop of the questionable BaFin practice.

According to the consultation draft published on 3 July 2015 it is envisaged to reserve loan origination exclusively for German closed-ended special AIFs (i.e., funds exclusively reserved for professional and semi-professional investors and not granting redemption rights) to avoid mismatched maturities.

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[1] At the time this article was submitted for publication, the law was only available in draft form (dated: 3 July 2015).

In addition, loan origination to a single borrower shall be limited to 20% of the fund's investment capital. The fund itself shall only be allowed to borrow up to an amount equal to 30% of the investment capital. Loans to consumers are prohibited. Shareholder loans are considered loans as well so that private equity funds fall under the new provisions, although with certain relief, provided that the shareholder loans do not exceed the equity investment as well as an aggregate amount of 30% of the investment capital of the fund.

It is important good news that modification and prolongation of loan agreements are no longer deemed to constitute "loan origination." Therefore open-ended investment funds that are prohibited from originating loans may restructure loans as long as the acquisition of loan obligations is permitted. The acquisition of such obligations is envisaged to be limited to a maximum of 50% of net investments.

Moreover, all debt funds shall meet appropriate requirements relating to the risk and liquidity management system when they acquire loan obligations or originate loans other than shareholder loans. Risk management shall be oriented towards bank underwriting guidelines. In addition, certain rules of conduct are to be observed. These requirements will also apply to registration-only (not authorized) fund managers of debt funds that otherwise mainly fall outside the scope of the KAGB due to the small size of the assets under management.

The new rules do not apply to loan origination already permitted to a certain extent for real estate funds and specifically regulated German investment companies (*Unternehmensbeteiligungsgesellschaften*).

Tax Aspects

The taxation of debt funds and their investors depends primarily on the legal form of the fund vehicle. While the legal form may be dictated by supervisory law, there is no synchronization between the requirements under supervisory law and the tax consequences resulting therefrom. Various tax regimes may apply:

- Where the debt fund is an investment fund (*Investmentfonds*) within the meaning of the German Investment Tax Act ("InvStG"), such debt fund is subject to a special investment tax regime pursuant to the concept of so-called semi-transparency.

- Otherwise, the tax rules for so-called partnership investment companies (*Personen-Investitionsgesellschaften*) (Sec. 18 InvStG) or corporate investment companies (*Kapital-Investitionsgesellschaften*) (Sec. 19 InvStG) apply to the debt fund, depending on its legal form.

- The applicable German investment tax rules are likely to be subject to thoroughgoing and systemic changes as of 1 January 2018. On 21 July 2015 the German Federal Ministry of Finance released a discussion draft for a proposed German Investment Tax Reform Act ("InvStRefG-E"), which is currently under public consultation.

Irrespective of the tax regime applicable in an individual case, debt fund proceeds, i.e. interest or interest-type income, when received by taxable German institutional investors are generally subject to German corporate tax (*Körperschaftssteuer*) and German trade tax (*Gewerbesteuer*) at a combined tax rate of approx. 30%. Hence, debt funds are not tax-driven products. Nevertheless, tax considerations play a central role for debt funds. Among the relevant aspects are: avoiding multiple tax layers as a consequence of interposing a fund vehicle; reducing source taxation; and eligibility of debt fund interests for certain tax-exempt investors and specialized funds (*Spezialfonds*).

Investment funds pursuant to the InvStG

Debt funds qualify as investment funds (*Investmentfonds*) within the meaning of the InvStG only if they comply with specific investment tax product rules. This is the case if:

- the debt fund is open-ended (i.e. it grants redemption rights to its investors) or its shares are exchange-listed;

- the debt fund is invested in certain assets (the eligibility of unsecuritized debt is generally unrestricted) and complies with certain rules regarding its investment activity, for example relating to the principle of risk diversification or limitations of leverage (such compliance is likewise generally possible for debt funds); and

- the aforementioned investment restrictions are reflected in the fund documentation.

According to BaFin's recommendations and in line with planned legislative changes, German debt funds are only to be organized as closed-ended specialized funds (*Spezialfonds*). Hence, German debt funds will qualify as investment funds only on an exceptional basis, when listed on a stock exchange and in compliance with the aforementioned product rules. A German debt fund qualifying as an investment fund is exempt from German income tax (Sec. 11 InvStG). For non-German debt funds taxation at the fund level depends on national law. The "classic" fund jurisdictions such as Luxembourg and Ireland grant tax exemptions for all usual fund types. Irrespective of whether an investment fund distributes or retains its income, an institutional investor's share of interest or interest-type income realized by the debt fund will be subject to taxation ("income deemed distributed", *ausschüttungsgleiche Erträge*).

For tax-exempt institutional investors any proceeds from an investment fund should be tax-exempt pursuant to their tax exemption as an entity. Investments in debt funds conceived as qualifying "investment funds" are thus suitable for such investors. This is also the case for institutional investors investing through a (specialized) investment fund, which is itself subject to the investment tax product rules; for such a fund, interests in other "investment funds" are eligible assets without limitation.

Partnership Investment Companies

A debt fund organized as a German or non-German partnership which is not an investment fund within the meaning of the InvStG is a partnership investment company (Personen-Investitinsgesellschaft) within the meaning of Sec. 18 InvStG. Hence, the general rules for taxation of partnerships and their partners apply. This may continue to be true after the InvStRefG-E has come into force.

Business vs. Non-Business

A partnership is not a taxpaying entity for German income tax purposes. The investors themselves are the taxpayers for German income tax purposes. For German institutional investors it is relevant whether a debt fund organized as a partnership is engaged in a trade or business from a German tax perspective or is eligible for non-business treatment. Such debt fund is engaged in a trade or business for German tax purposes if it is (i) deemed to be in business due to its legal structure (*gewerbliche Prägung/Entprägung*) or (ii) engaged in business activities.

Whether or not the fund is deemed to be in business depends on purely formal criteria. Thus, a choice can effectively be made through fund structuring. Non-German funds in the legal form of a partnership and not specifically structured for the purpose of being deemed not in business for German tax purposes will in most cases be deemed to be in business on the basis of their structure.

According to relevant case law, an activity is seen as "business" if it primarily relies on redeploying assets as opposed to enjoying the fruits from and preserving the assets' substance, which would be seen as asset management, i.e. a non-business activity. Such assessment must take an overall view of the activity and consider the characteristics of the economic goods. Applying the relevant principles – not included here – developed in case law and by the German fiscal authorities to the activities of loan originating funds, such activities typically should qualify as asset management.

Advantages and disadvantages of the tax status

Whether a partnership's status as "non-business" or "business" is advantageous for an institutional investor depends on the kind of investor and on whether the debt fund is German or non-German.

For example, it is not advisable for a tax-exempt pension fund (*Pensionskasse*) to (directly) invest in a business-type partnership. The reason is that on the basis of older case law of the German Federal Fiscal Court it cannot be excluded that such pension fund's tax personal exemption would be adversely affected as a result of such investment.

Under the applicable investment tax product rules, (specialized) investment funds may invest in business partnerships only under exceptional circumstances, for example if the partnership interests qualify as securities.

For other taxable institutional investors (e.g. property insurers) the business status of a debt fund established as a non-German partnership is usually advantageous. This is because for such investors, proceeds derived from business-type partnerships are effectively exempt from German trade tax (Sec. 9 no. 2 German Trade Tax Law, *GewStG*). This also applies in cases where – as is typically the case with non-German funds – the fund is not subject to German trade tax at all at the level of the fund.

Corporate Investment Companies

Currently, debt funds which are neither investment funds nor partnerships qualify as corporate investment companies (*Kapital-Investitionsgesellschaften*, Sec. 19 InvStG). Due to the corporate tax and trade tax burden at the fund level, German corporate investment companies (e.g., a closed-ended specialized investment stock corporation with fixed capital (*Spezial-Investmentaktiengesellschaft*) or a closed-ended specialized special fund [*Spezial-Sondervermögen*]) are currently generally not suitable as fund vehicles.

By contrast, investments by institutional investors in non-German corporate investment companies are for the most part unproblematic from a tax perspective. For taxable investors the taxation rules regarding German controlled foreign corporations (*Hinzurechnungsbesteuerung*) can be applicable. This typically does not lead to an increased tax burden, however, only to certain tax declaration obligations (Sec. 18 AStG).

Investment Funds pursuant to InvStG-E

InvStRefG-E aims at extending the scope of application of investment taxation. From 2018 on, all UCITS and AIFs, including all debt funds, are to fall under the new investment tax act (InvStG-E). The only exception will be partnerships that are not UCITS. Compliance with the product regulation currently in effect will generally (i.e., for retail investment funds) no longer play a significant role.

Retail Investment Funds

The currently applicable principle of semi-transparency is to be replaced by an intransparent tax regime for retail funds (i.e., all investment funds which are not specialized funds [*Spezialfonds*]). Under this new tax regime, income derived by investment funds (including both German and non-German retail funds) from German dividends, German real estate and other German income will be subject to German corporate tax (15%).

With respect to debt funds, (only) income from profit-linked debt or similar debt instruments (such as profit-participating loans or profit sharing rights) or from debt secured by German real estate should be subject to German corporate income tax; in this regard, taxation applies definitively at the fund level (i.e., is not deductible at the investor level), thereby burdening both taxable and tax-exempt institutional investors. Income from other debt remains tax-exempt at the fund level.

Specialized Investment Funds

The intransparent tax regime is not to apply to specialized investment funds. For specialized investment funds the investment tax principle of semi-transparency is to remain in force. It will be significantly modified from the current legal situation, such that its application will largely be restricted to withholding taxes. However, the tax consequences for debt funds qualifying as specialized investment funds within the meaning of the InvStG-E will ultimately be similar to the favourable or “acceptable” tax consequences applicable to investment funds within the meaning of the currently applicable InvStG; see above.

Specialized investment funds within the meaning of the InvStG-E are investment funds which

- have no more than 100 investors that are not natural persons; in contrast to the current legal situation, not only direct participations by natural persons but also indirect participations by natural persons investing through partnerships will adversely affect the status as a specialized investment fund;

- comply with the investment tax product regulation currently applicable to all investment funds (see above); being listed on a stock exchange will no longer suffice in lieu of granting redemption rights. Consequently, while investment regulatory law requires loan-originating funds to be structured as closed-ended specialized funds (Spezialfonds), this would hinder the classification of such funds as specialized investment funds for tax purposes.

Conclusion: Positive developments which unfortunately fall short of expectations

The new regulatory environment is without a doubt a positive development. At a time when banks as traditional lenders are restricting their lending policies and demand for debt funds is increasing, the admission of debt funds in Germany is good news. It represents an important step towards harmonization of the European market. BaFin's approach towards non-German funds is regrettable, however. In an international investment environment it is not appropriate to include only German funds. Investments in non-European funds represent an extremely important area for institutional investors. We hope that the German and the European legislature will address this issue. Ideally, tax implications would also be considered.

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