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Alternative Funds 2021

Germany: Law & Practice
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GERMANY

Law and Practice

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1. GENERAL

1.1 General Overview of Jurisdiction

Germany is not a typical funds jurisdiction, such as, Luxembourg or the Channel Islands. Nevertheless, Germany has a sizeable alternative funds sector with German-based funds and managers in place, for both direct investment funds as well as fund of funds. Besides domestic fund structures, many fund managers offer cross-border fund structures (such as a German master fund with non-German feeder funds for certain non-German investors). Some German fund managers also use pure non-German fund structures (mostly based in Luxembourg).

As for investors, Germany is a top jurisdiction in Europe with regard to large institutional investors, such as insurance companies, pension funds and pension schemes, as well as family offices and high net worth individuals (HNWIs).

2. FUNDS

2.1 Types of Alternative Funds

Private equity funds (buyout, venture capital, and growth capital) and real estate funds are the most commonly established funds in Germany. Renewable energy funds and private debt funds are also noteworthy.

2.2 Fund Structures

German limited partnerships (GmbH & Co KG) are typically used for closed-end alternative investment funds. The German limited partnership is structurally comparable to the US, UK or Luxembourg limited partnership. It offers limited liability to its limited partners and has as a corporate type, general partner with unlimited liability (though the general partner's liability is limited to its assets, typically EUR25,000, and thus, effectively, also limited).

The German limited partnership offers the benefits of being tax-transparent and allowing legal flexibility for its governance. It is the market standard for registered fund managers, ie, Alternative Investment Fund Managers Directive (AIFMD) sub-threshold fund managers.

Contractual funds with no legal personality (*Sondervermögen*) are typically used for open-end funds. Contractual funds can only be established by alternative investment fund managers (AIFM) that are fully authorised under the German implementation of the AIFMD (Directive 2011/61/EU). The contractual fund is often established for real estate funds and non-UCITS securities funds. It is also often used for separate managed accounts as an investment platform for institutional investors.

2.3 Regulatory Regime

The German regulatory regime for alternative investment funds (AIFs) is based on the AIFMD. Germany implemented the AIFMD into the German Capital Investment Act (*Kapitalanlagesetzbuch*, KAGB). The KAGB contains the AIFMD manager-related rules and the AIFMD funds marketing-related rules. It further sets out German-specific "product rules" applicable to AIFs. This overlay of product rules for the AIF, however, applies in general only to fund managers that are fully authorised under the AIFMD.

Smaller-Fund Managers

Smaller fund managers, ie, sub-threshold managers under the AIFMD, are only subject to a registration requirement. The funds of sub-threshold managers are not regulated and no investment restrictions for such funds exist (except for debt funds). Most German-based fund managers in the alternative assets space are still sub-threshold managers (as opposed to fully licensed fund managers).

Large-Fund Managers

Large fund managers, ie, fund managers that need to be fully licensed under the AIFMD, are subject to a regulatory regime very much based on the AIFMD. Their funds are also subject to product rules, ie, investment and borrowing limitations.

Investment Limitations

The German Financial Supervisory Authority (BaFin) is in charge of overseeing the regulatory regime for fund managers and funds. The applicable product rules for a fund, ie, the investment limitations, depend on the category of the fund and on whether the fund is a retail fund or a non-retail fund. Non-retail funds (so-called *Spezialfonds* or specialised investment funds) are open only to professional and semi-professional investors.

Open-end and closed-end funds

The investment limitations for open-end alternative retail funds are based on the UCITS Directive, but provide for variations and deviations from a UCITS. Deviations are, for instance, broader eligibility of investments in other AIFs or investments in loans or non-listed equity. For open-end real estate funds, the deviations are most profound, ie, real estate funds may only invest in real estate and in vehicles that invest in real estate (in addition to holding liquidity).

The investment limitations for closed-end alternative retail funds are not based on the UCITS Directive. Accordingly, they are more in line with alternative asset classes. The reason for this is that closed-end funds have traditionally been used for alternative investments. Therefore, closed-end funds can invest in real assets, such as real estate, ships, aeroplanes and infrastructure, or in non-listed equities.

With regard to open-end and closed-end special funds, the only investment limitation is that the assets must have a market value (in addition to the fund being risk-diversified). However, the KAGB also provides for a so-called "special fund with fixed investment guidelines". The special fund with fixed investment guidelines is popular with institutional investors as an investment platform as it offers the possibility of being tax-transparent. Closed-end special funds can grant loans to non-consumer borrowers.

The EuVECA, EuSEF and EU-ELTIF regimes

In addition to the above regimes, the European Venture Capital Funds (EuVECA) regime and European Social Entrepreneurship Funds (EuSEF) regime are directly applicable in Germany, as well as the European Long-Term Investment Funds (EU-ELTIF) regime.

2.4 Loan Origination

Closed-end special funds can originate loans in Germany. This applies to both German funds as well as EU funds with an EU-AIFM. German funds may, however, grant loans only to non-consumer borrowers, leverage of the fund itself is restricted and certain diversification rules apply. Also, detailed rules on risk management apply (KAMaRisk rules). EU funds with an EU-AIFM may grant loans to German non-consumer borrowers based on the rules of such AIFM's home jurisdiction.

Non-EU funds may grant loans in general only if the loan is granted on a reverse solicitation basis or if the loans are subordinated to almost-equity level in the case of insolvency or financial difficulties on the part of the borrower.

2.5 Non-traditional Assets

Cryptocurrencies

Funds managed by sub-threshold managers may invest in cryptocurrencies and non-traditional assets.

With regard to fully licensed managers, a special fund can in theory also invest in cryptocurrencies and non-traditional assets. The practical problem is that the mandatory depositaries for such funds oppose the holding of such assets. That said, new regulatory rules for acting as a depositary for cryptocurrencies and other digital assets were recently implemented in 2020, although those rules will still face the test of time. As a result, it is expected that specialist depositaries will develop and that traditional depositaries will delegate their activities with regard to digital assets to these new "fintech" service providers. At the time of writing, one depositary for cryptocurrencies had been licensed by BaFin.

Special funds (ie, non-retail funds) can invest in cryptocurrencies without any limitation. But special funds managed by fully licensed managers have to appoint a depositary for their crypto-investments.

Consumer Credit and Loan Portfolios

In general, German investment funds cannot originate consumer credit loans.

Closed-end special funds are allowed to originate loans of up to 30% of the already paid-in capital minus the fees and costs borne by the investors. Additionally, closed-end special funds can only lend 20% of the already paid-in capital minus the fees and costs borne by the investors, to a single borrower in order to minimise the credit default risk.

Furthermore, these funds can borrow up to 50% as shareholder loans of the already paid-in net capital to portfolio companies that the fund holds directly.

Open-end special funds can originate loans of up to 50% of their invested capital.

The AIFMs which manage loan-originating AIFs are required to have adequate liquidity and risk management systems in place.

Lastly, the AIFs are also allowed to restructure existing loans.

Litigation Funding

Funds which are allowed to grant loans are also mostly allowed to fund litigation. However, there is a limitation with regard to the funding of litigation. AIFs which are managed by fully licensed AIFMs are only allowed to invest in assets which can be valued at any time. This is challenging with respect to financing of litigation, as the risk of the loan depends on the legal risk of the respective financed lawsuit, which is difficult to assess independently. Therefore, significant practical challenges remain when setting up litigation funding AIFs under the German fund regime.

Cannabis and Cannabis-Related Investments

Funds can invest in cannabis or cannabis-related portfolio companies, as long as the portfolio company's activity is legal or it has the necessary licence to do so. In other words, German funds are not allowed to invest in an activity which is illegal. Other than that, there are no restrictions with regards to cannabis or cannabis-related investments.

2.6 Regulatory Approval Process

For retail funds, it takes about four weeks to get approval to market the fund. For special funds (ie, non-retail funds) of fully authorised managers, approval is only necessary if the fund is being marketed. Such approval also takes about four weeks. Special funds of sub-threshold managers are not regulated and therefore do not need approval to be marketed.

2.7 Requirement for Local Investment Managers

Germany requires either a German-based fund manager or a fund manager with an AIFMD passport.

The fund manager can, however, outsource portfolio management to an investment manager abroad. Such outsourcing is, for instance, quite common with regard to special funds established as a separate managed account for a specific German institutional investor.

2.8 Other Local Requirements

The fund manager (AIFM) needs to have sufficient substance in Germany, both from a regulatory and tax perspective. This basically translates into having sufficient physical presence of senior management and staff in Germany. On the regulatory side, BaFin follows the ESMA Brexit guidelines with regard to substance requirements (ESMA34-45-344).

Directors of a corporate fund may not need to be German residents. However, foreign directors must make sure that corporate decisions are made in Germany (this can happen on a well-documented fly-in basis).

A local general partner is required for German partnership funds. Germany follows the "seat-theory" with regard to the applicable law in the case of partnerships.

Funds are not expected to maintain business premises or hire local employees in Germany.

2.9 Rules Concerning Other Service Providers

A fund depositary is necessary if the fund is managed by a fully licensed manager – based on the AIFMD. For German-based funds, the depositary must be German-based as well.

A money-laundering officer must be German-speaking and German-resident. BaFin does not accept a money-laundering officer on a fly-in basis. It is usually sufficient for the money-laundering officer to be employed by the fund manager and not by the fund.

A compliance officer and other internal control functions usually require a local presence as well. It is also usually sufficient for the compliance officer to be employed by the fund manager and not by the fund.

Fund administrators can provide their services from outside Germany. This is useful for offshore fund administrators who would like to access the German market, but for whom it does not make business sense to have a local presence.

2.10 Requirements for Non-local Service Providers

There is, in general, no registration or regulation requirement for non-local service providers. A depositary, however, must be subject to sufficient regulatory supervision.

An outsourcing delegate must be authorised or registered in their home country, if the outsourcing concerns portfolio or risk management. Furthermore, if an outsourcing delegate provides services that fall under the Markets in Financial Instruments Directive II (MiFID II), the delegate will be subject to a licence requirement under the German Banking Act (KWG) if the delegate actively solicited the relationship with the manager (as opposed to reverse solicitation).

2.11 Tax Regime

Overview

The applicable tax regime depends on the legal form of the fund in question. For funds structured as partnerships (eg, German KG), the German general tax rules apply. This is typically the case for closed-end AIFs. For funds structured

in other legal forms (corporations or contractual-type funds), special tax regimes are applicable under the German Investment Tax Act. This is mostly applicable to open-end UCITS, certain open-end AIFs, as well as closed-end AIFs (if structured as corporations or contractual-type funds).

Funds as Partnerships

According to German general tax rules, partnerships are not subject to German income tax, ie, they are tax-transparent. However, funds structured as partnerships may be subject to German trade tax. If the fund is structured as a partnership, the main issue under the German general tax rules is whether the fund is conserved to be engaged in trade or business, or whether such activity is considered investment activity (also called private asset management status). If the fund is considered to be engaged in investment activities only, it is not subject to German trade tax (ie, it is fully "transparent" for tax purposes).

Any income derived by a partnership is immediately allocated to its partners and taxed at the level of the partners, in accordance with the rules of the tax regime applicable to the respective partners. On the other hand, if the fund vehicle qualifies as being engaged in a trade or business, the fund itself is not subject to German income tax, but it is subject to German trade tax.

There are no withholding tax implications at the level of a partnership itself. However, withholding tax implications can arise from the underlying investments made by the fund.

Funds as Corporations or Contractual-Type Funds (Investment Funds)

The German Investment Tax Act applies to all funds other than partnerships. Thus, it covers so-called "investment funds", ie, funds that are structured as corporations or contractual-type funds (*Sondervermögen*). The Act generally applies to UCITS and AIFs (both retail AIFs and special AIFs). Also covered are certain other entities that do not qualify as "investment funds" under the KAGB (in particular, "single-investor funds").

Prior to the 2018 revision of the Act, the German Investment Tax Act provided for a tax regime known as the "restricted transparency" regime. This has been replaced by two different concepts, the "opaque regime", which is the general regime under the revised Act, as well as the "restricted transparency option" regime, to which only special funds may opt in.

Under the opaque tax regime, there are two levels of taxation: the fund and the investors. This tax regime is applicable to all retail funds. Furthermore, it also applies to all other investment funds (including non-retail funds) that do not satisfy the specific criteria for specialised investment funds, or specialised investment funds that do not use the transparency option.

Opaque regime

Under the opaque regime, the fund itself is subject to taxation. However, the fund is only subject to taxation with respect to certain types of income: certain domestic German income (in particular, dividends and real estate income, but not capital gains from the sale of securities unrelated to real estate and unrelated to a permanent establishment in Germany). In respect to such income, a 15% tax rate (ie, German corporate tax rate) applies to the fund. The exemption for dividends (Section 8b of the German Corporation Tax Act) is not applicable at fund level even if the relevant threshold (ie, 10%) is exceeded. In addition, German trade tax may apply at fund level if the fund itself is engaged in trade or business in Germany (subject to a potential exemption if the fund does not engage in "active entrepreneurial management" in relation to its assets). Investment funds are required to withhold tax for the

taxable income of their (domestic) investors, but not for the income from the sale of fund units.

In general, there are no tax exemptions at the level of the fund. In return, at the level of the investor, proceeds received from the fund are subject to partial exemptions depending on the respective fund type (equity fund, mixed fund or real estate fund).

At the investor level, there is lump-sum taxation (designed for the needs of retail funds with a large number of investors, but applicable to all funds covered). In particular, distributions from the fund, predetermined tax bases and capital gains realised upon sale or redemption of the fund interests are covered. The objective of the predetermined tax base is to subject the retained income of the investment fund to tax.

Different investor types

For individual investors, the actual rate of investor level taxation depends on whether the investor holds the fund interests as part of their "non-business" or "business" assets. If individuals hold their investment fund interests as part of their non-business assets, such items are subject to flat income tax. If individuals hold their investment fund interests as part of their business assets, generally, the full amount of such items is subject to income tax at their personal rate.

For corporate investors, the full amount of such items is subject to corporation tax. In addition, German trade tax may be triggered at the corporate investor level. The partial income taxation and the exemption pursuant to Section 8b of the German Corporation Tax Act do not apply. In return, investment fund proceeds (ie, distributions, predetermined tax bases and capital gains from dispositions or redemptions) are now subject to partial exemptions depending on the respective fund type.

Partial exemptions in respect of certain types of funds

With respect to "equity funds", the partial exemption is:

- 30% of such proceeds for individuals who hold their investment fund interests as part of their non-business assets;
- 60% for individuals who hold their investment fund interests as part of their business assets; and
- 80% for corporate investors.

With respect to mixed funds, half of the partial exemption rate applicable to equity funds is available to investors. With respect to real estate funds, the partial exemption is 60% or 80% of the proceeds, depending on whether the fund invests at least 51% of its value in German or non-German real estate and real estate companies. In return, income-related expenses and operating expenses may not be deducted to the extent of the available partial exemption percentage. With regard to trade tax at investor level, half of the applicable partial exemption rate applies.

Non-resident investors

Domestic and foreign investors in investment funds are treated equally on a formal basis. However, the partial exemption rates provided in the German Investment Tax Act only benefit German investors, because foreign investors are generally not subject to any tax obligation in Germany at the level of investment fund investor.

In the case of non-resident investors of a German investment fund subject to the German Investment Tax Act, the distributions to such non-resident investor will not be taxable in Germany and will not be subject to withholding tax. As a result, non-resident investors who make German investments via (domestic or foreign) investment funds only have to bear a German

tax burden, as far as there is taxation at fund level (fund input side). The German non-taxation of distributions to non-resident investors (fund output side) is completely independent of which assets the fund holds, in which country the investor is domiciled and whether a double-taxation agreement is applicable.

Specialised investment funds: "restricted transparency" regime (optional)

If the investment fund qualifies as a specialised investment fund, the fund may opt to be treated transparently for tax purposes. As a result, the fund itself will not be subject to taxation, ie, it will effectively be transparent (though not as fully transparent as a partnership). This "restricted transparency option" regime is similar to the tax regime for investment funds under the German Investment Tax Act which was in force before 2018, but with certain amendments.

Specialised investment funds may only have a maximum of 100 investors. Unlike the prior law (in force before 2018), there is a look-through approach with respect to partnerships as investors (ie, each partner of such partnership is counted as one investor of the fund). However, individuals may now invest directly in a specialised investment fund, provided that they hold such fund interests as part of their business assets (previously, only the indirect participation of investors was possible).

To qualify as a specialised investment fund, a fund must satisfy certain criteria with respect to regulation, redemption rights, eligible assets and investment restrictions. These are substantially similar to the criteria under the law in place before 2018 (though certain changes with respect to the definition of "securities" apply).

If the specialised fund opts to apply the restricted transparency regime, at fund level, there is no taxation for domestic participation income and domestic real estate income. At the investor level, "special investment income" is subject to tax (ie, distributed income, deemed distributed income and capital gains realised upon the disposition or redemption of fund interests). The flat income tax rate is not applicable, even if an individual holds its investment fund interests as part of its non-business assets. Foreign withholding tax is still creditable.

2.12 Double-Tax Treaties

Germany has a vast network of double-tax treaties with a large number of countries (including most OECD states and with many other states). The applicability of such double-tax treaties will depend on the legal form of the fund in question. Most German alternative funds are structured as partnerships. As such, they are tax-transparent. As a result, double-tax treaties typically do not apply directly to a fund, but rather to the investors (ie, the partners of the partnership) instead. One of the main issues with income received from a German alternative fund is whether the activities of the fund qualify as a trade or business that is related to a permanent establishment in Germany. No special exemptions exist for funds in this regard in German domestic laws (unlike in Luxembourg).

If the alternative fund is structured as a corporation, or as a contractual-type fund, the specific double-tax treaty may be applicable to the fund itself, but will have to be analysed for each specific treaty and legal form of the fund on a case-by-case basis. In certain cases, domestic laws may override double-tax treaties.

2.13 Use of Subsidiaries for Investment Purposes

The use of subsidiaries is common, in particular, with regard to private equity funds and real estate funds. The advantages are often structural reasons, such as creating different tiers of structural subordination (not just contractual subordi-

nation) of lenders or making use of leverage (in this case, private equity funds). From a tax and regulatory perspective, the use of subsidiaries is also relevant, as leverage should ideally be used at the subsidiary level, since leverage at the fund level may trigger both qualification of the fund as being engaged in a trade or business for German tax purposes, as well as triggering the lower EUR100 million assets-under-management threshold requiring full authorisation for the fund manager under the AIFMD. In addition, real estate funds tend to use subsidiaries to better handle real estate transfer tax issues and make shareholder loans tax-deductible at the subsidiary level (to a certain extent).

2.14 Origin of Promoters/Sponsors of Alternative Funds

Promoters/sponsors of alternative funds are typically established in Germany.

2.15 Origin of Investors in Alternative Funds

Investors in German funds typically come from Germany.

2.16 Key Trends

Tax

Reporting of certain cross-border arrangements (DAC 6)

Effective as of 2020, Germany implemented Directive 2018/822/EU of 25 May 2018, amending the Directive on Administrative Co-operation (DAC 6). As a result, funds, fund managers, investors as well as their respective legal and tax advisers can be subject to new reporting obligations for certain cross-border arrangements. These new cross-border arrangements must be reported to the German Federal Central Tax Office (BZSt) as from 1 July 2020. Also, prior existing arrangements (ie, where the first step of implementation was realised after 24 June 2018) had to be reported retroactively within two months of 30 June 2020. Most European jurisdictions provided some relief due to the COVID-19 situation, in the form of postponement of the starting date for reporting, sometimes until 2021. However, Germany was one of only two countries that did not implement such reporting relief (the only other jurisdiction being Finland). As a result, the structuring of the private equity fund itself and its portfolio investments may, in certain cases, constitute a cross-border arrangement.

The reporting obligation is relevant for "intermediaries" (including fund managers and their legal and tax advisers) as well as for relevant taxpayers (including fund investors). If a structure is considered to qualify as a cross-border arrangement (ie, the fund or one of its investments) and is subject to the fulfilment of one of certain hallmarks (in some cases, a tax advantage may be one of the main advantages of a cross-border arrangement, the "main-benefit test"), a reporting obligation is triggered. The report of such arrangement has to be filed with the BZSt. In this case, fund managers will have to provide the registration number and disclosure number assigned by the BZSt to the investors, which then have to be included in the investors' tax returns. If a waiver of professional privilege of confidentiality is provided, the legal or tax advisers involved can also report to the BZSt on behalf of the fund manager or investor. The guidance provided by the German tax authorities in a circular on 29 March 2021 is rather limited, which may, in the light of the potential fines in case of non-compliance, result in over-reporting. The fund industry is hopeful, however, that over time, certain best practices will develop and the German tax authorities will clarify which structures do not trigger a reporting obligation (eg, by expressly adding such structures to a tax authorities' white list). Until then, some uncertainty remains.

Investment Tax Act

The German Investment Tax Act has been revised over the years. Although the latest main revision came into effect in 2018, certain aspects of interpretation are still not resolved. In the last three years, the German tax authorities issued several, mostly helpful, administrative clarifications. A draft guidance issued in mid-December 2019 had raised concerns and suggested restrictions on the ability of German special investment funds (often set up as managed accounts by certain German institutional investors) to invest in target funds organised as a corporation or in a contractual form. The final version of the circular with respect to special investment funds (Section 26 of the Investment Tax Act) was published on 20 January 2021. This version clarifies many points, but leaves certain others still unresolved. However, the final circular is welcome news overall, as investments by German special investment funds in target funds (structured as corporations or partnerships) are generally possible, in particular, if such target funds qualify as "securities".

Corporate Income Tax Modernisation Act

The new Modernisation of the Corporate Income Tax Act takes effect as of 1 January 2022. It offers a new "check the box" regime with an irrevocable option for partnerships to be treated as corporates for tax purposes. This will effectively result in a third form of tax treatment for AIFs under German tax laws. In addition to the options mentioned above (AIF in the form of a partnership treated according to the general rules of German taxation for partnerships or AIFs formed as corporations treated as investment funds or specialised investment funds under the Investment Tax Act), there would be the option to treat an AIF formed as a partnership-like taxable corporate entity without falling into the scope of the German Investment Tax Act. This might be helpful to prevent foreign investors from tax declaration obligations in Germany and to retain the possible application of the taxation privilege for capital gains under Section 8b of the German Corporation Tax Act (KStG) for German corporate investors, as well as the fund entity itself. This will limit the tax leakage at the fund level. However, certain withholding tax issues make this option less attractive.

Anti-tax Avoidance Directive

A new ATAD (Anti-tax Avoidance Directive) implementation law came into force on 1 July 2021. ATAD splits into the ATAD I Directive (EU) 2016/1164 of 12 July 2016 concerning, in particular, interest barriers, rules on exit taxation, general abuse avoidance rules and CFC Rules, and the ATAD II Directive (EU) 2017/952 of 29 May 2017 concerning hybrid arrangements, both resulting in several restrictions for companies operating cross-border. A positive clarification for AIFs in a corporate form is that the specialised CFC rules do not apply to income received in respect of a foreign intermediate company that falls within the scope of the Investment Tax Act. The new law provides for a limitation of the taxation privilege on capital gains in certain cross-border cases (Section 8b of the German Corporation Tax Act).

Regulatory

Regulatory key trends are currently the sustainable finance initiative of the EU, the introduction of electronic securities and investment fund units, as well as the handling of cryptocurrency funds, and the newly implemented EU (pre)-marketing regime.

The new German law on investment firms (*Wertpapierinstitutsgesetz*) implements the Directive 2019/2034 (Investment Firm Directive – IFD) and seeks to lighten the burden of prudential supervision on small and medium-sized investment firms. The new regime came into effect on 26 June 2021 and has a lighter touch on small and medium-sized investment firms regarding

internal governance, remuneration policies and risk management. In terms of the IFD, small and medium-sized investment firms have, inter alia, total balance assets under EUR100 million and less than EUR1.2 billion assets under management. Bigger investment firms fall under the traditional Capital Requirements Regulation (CRR) regime.

2.17 Disclosure/Reporting Requirements

Prospectus

In respect of special funds, ie, non-retail funds, Article 23 AIFMD disclosures must be provided if the fund is marketed in Germany or in the EU. In any case, a private placement memorandum (PPM) is commonly produced for all special funds, to protect fund sponsors from liability.

Key Information Document

If the fund is marketed to semi-professional investors, a key information document must be produced.

Annual Reporting

There are annual reporting requirements for both managers of retail funds and managers of non-retail funds. In addition, there are semi-annual report requirements for contractual funds and investment stock corporations (AG) with variable capital. The reports must be published.

Partnership Structures

With regard to a German partnership, its limited partners need to be registered with the local commercial register. The records maintained at the commercial registry are publicly available via the internet. This includes the identity of the investors as limited partners and their liability amounts (typically expressed as a small percentage of the capital commitment). Such disclosure can be avoided by interposing a nominee as direct limited partner, to hold and manage its limited partner interest for and on behalf of the investors as beneficiaries.

Filing of the partnership agreement is not required, thus the fund terms remain confidential.

AML Transparency Register

In 2018, Germany introduced the transparency register under the EU anti-money laundering (AML) law. The transparency register must include all beneficial owners. The law was recently revised, effective from 1 August 2021, by the Transparency Register and Financial Information Act. As a result, almost all legal entities in Germany will be required to notify the Transparency Register of all beneficial owners, regardless of the information already contained in other registers.

2.18 Anticipated Changes

Overhaul of Marketing Rules for Investments

German lawmakers implemented the recent EU amendments of the AIFMD with regard to pre-marketing and marketing communications of collective investment funds (Directive (EU) 2019/1160) with effect from 2 August 2021. In this context, Germany reviewed its Capital Investment Act for drafting errors and practical amendments. The new regime leads to a slightly stricter regulation in Germany compared to the current regulation on pre-marketing. It needs to be noted that Germany extended the new EU pre-marketing regime to non-EU managers. In consequence, non-EU managers are required to notify BaFin about their pre-marketing activities in Germany.

3. MANAGERS

3.1 Legal Structures Used by Fund Managers

Managers almost always use a corporate entity for the managing entity (GmbH or AG).

3.2 Regulatory Regime

The German regulatory regime for AIFs is based on the AIFMD. Germany implemented the AIFMD into the German Capital Investment Act (*Kapitalanlagesetzbuch*, KAGB). See **2.3 Regulatory Regime** for details.

3.3 Tax Regime

Overview

With respect to the tax regime applicable to income received from the fund by fund managers, several income streams need to be distinguished. Fund managers typically invest their own money (usually through a separate team commitment vehicle organised as a German limited partnership considered to be engaged in private asset management). With respect to income in relation to such capital commitment, the fund managers are treated like normal investors, ie, no special rules apply. In addition, fund managers may receive, according to the so-called distribution waterfall in fund agreements, additional income which does not correspond to their capital commitment, ie, which is capita disproportionate – so-called "carried interest". In Germany, special tax rules apply – with certain requirements and qualifications – to carried interest received by fund managers (see **3.5 Taxation of Carried Interest**). The third type of income stream that fund managers may receive from the fund is the management fee. From an income tax perspective, all management fee income is taxable as income received for services provided, ie, no special tax exemptions are applicable. In practice, the greatest issue in relation to management fees arises in relation to the value added tax (VAT) treatment.

Management Fee and VAT

The issue of the VAT treatment in relation to the management fee in Germany has changed over the years, but is still a hot topic. Until the end of 2017, the management fee payable to the fund manager of an AIF was subject to German VAT (unlike in respect of UCITS funds, where there has been a specific exemption for many years). The German VAT Act has been revised since early 2018. According to this revision, the management of UCITS and of certain AIFs that are comparable to UCITS, is exempt from VAT. The law does not provide guidance on which types of AIFs are comparable to UCITS but the German tax authorities have issued guidance on this point. Accordingly, certain criteria must be fulfilled in order to benefit from the VAT exemption (in particular, the AIF has to offer shares to the same group of investors and be subject to similar obligations and controls as UCITS). In practice, the German tax authorities try to argue that AIFs which target professional investors (and semi-professional investors) are not comparable to UCITS, thus denying the VAT exemption. The situation has not been settled and certain German local tax authorities have confirmed the application of the VAT exemption in individual cases, or, if disputed, have agreed to a compromise (partial exemption, eg, up to 90% in some cases). Effective as of 1 July 2021, the Funds-Jurisdiction Strengthening Act extended the VAT exemption on management fees for certain types of AIFs (venture capital funds). Though a positive development, the legislative wording is rather narrow and potentially excludes a number of AIF categories (eg, buyout funds, infrastructure funds, private debt funds, real estate funds, etc) from the benefits of the VAT exemption and creates potential issues under European state aid rules. This point remains an issue that is seen as a potential negative factor when comparing German funds with funds in other European jurisdictions.

3.4 Rules Concerning "Permanent Establishments"

Germany does not have an exemption ensuring that alternative funds with a German manager do not have a "permanent establishment" or other taxable presence in Germany. This is due to the fact that for funds structured as limited partnerships, the German general tax rules apply. The German Investment Tax Act, ie, the special tax regime applicable to funds structured other than partnerships (ie, funds in the form of a corporation or a contractual-type fund), does provide certain special rules that deviate from the general German tax rules, but, in effect, it does not provide special rules to substantially limit the permanent establishment risk of foreign investors.

3.5 Taxation of Carried Interest

Overview

The tax treatment of carried interest for fund managers will depend on the legal form and tax status of the fund. The tax treatment of funds structured as partnerships that are not engaged in a trade or business, ie, that are considered to be engaged in private asset management activities, is well established. These rules apply to the majority of German funds. The rules applicable to other types of funds, in particular, funds structured as partnerships that are engaged in a trade or business, or structured as a corporation or contractual-type fund are less settled, although certain recent developments are encouraging.

Carried Interest Taxation

Funds structured as partnerships engaged in private asset management

Most German funds, in particular direct investing funds, are set up as partnerships and carefully structured to qualify as private asset management activities. Often, fund managers will apply for an advance tax ruling with the German tax authorities to confirm this point prior to the first closing of the fund. Funds that are partnerships engaged in private asset management activities are fully tax transparent, ie, the fund itself is not subject to German trade tax. In addition, a special German tax regime applies to carried interest income received by fund managers, subject to certain technical qualifications (Section 18 paragraph 1 number 4 German Investment Tax Act). As a result, a certain tax exemption (ie, 40% income tax exemption) applies, which results in an effective rate of income tax of around 28.5% at the level of the individual tax managers (as opposed to the highest personal income tax bracket of 45% otherwise applicable). One of the technical requirements is that the carried interest must be paid only after the investors have received all their invested capital back from the fund. If the specific requirements and qualifications of the special carried interest tax regime are not met, the fund managers' income in relation to carried interest received could potentially be fully taxable at the respective German personal income tax rate (up to 45%).

Funds structured as partnerships engaged in a trade or business

Some funds are structured as partnerships that are engaged in a trade or business. This might be the case because some institutional investors prefer that the fund is engaged in a trade or business, or because the respective fund strategy is seen to be more active than a typical private equity fund (eg, turnaround funds or venture capital funds acting as incubators). In such cases, the German tax authorities have taken the position that the carried interest received by fund managers is subject to the respective German personal income tax rate (up to 45%), ie, that the special tax exemption for funds qualifying as private asset management is not applicable. This is due to the fact that the tax authorities consider the carried interest to be a "hidden payment" for services provided by fund managers to the fund rather than a capital-disproportionate

participation in the distribution waterfall among partners of the fund.

However, the German highest tax court issued a ruling in a recent case from late 2018, which disagrees with this tax treatment. According to the court, the waterfall distribution rules in fund agreements that set out the distribution of profits received by the fund among all partners of the fund have to be respected. In other words, the court considers that carried interest received should not be characterised as a "hidden payment" for services provided by fund managers to the fund. Rather, the court ruling qualifies such payment received by fund managers as (capital-disproportionate) share of the profits. Therefore, the so-called partial income rule, which exempts 40% of the income and makes only 60% of the income received subject to the normal individual tax rate, will also be applied by the court in cases where the fund qualifies as being engaged in a trade or business. This results in a tax rate of around 28.5% at the level of the individual tax managers. This ruling greatly reduces the risk for fund managers that a changing assessment by the tax authorities of the fund activities (trade or business versus private asset management) would negatively affect their tax position with respect to carried interest. However, the long-term implications of the ruling will have to be closely monitored, as the German tax authorities have not yet indicated whether they will accept this ruling or whether they will try to amend the tax laws to implement their position in the law.

3.6 Outsourcing of Investment Functions/Business Operations

Outsourcing by fund managers is possible and commonly used. If portfolio management or risk management is outsourced, the delegate must have a licence (as required by the AIFMD). Outsourcing agreements are often based on a sample agreement published by a German investment lobby-group called BVI. Outsourcing agreements must ensure specific control and supervisory rights by BaFin and by the fund manager's internal control functions.

3.7 Local Substance Requirements

See **2.7 Requirement for Local Investment Managers** and **2.8 Other Local Requirements**.

3.8 Local Regulatory Requirements for Non-local Managers

See **2.7 Requirement for Local Investment Managers** and **2.8 Other Local Requirements**.

4. INVESTORS

4.1 Types of Investor in Alternative Funds

The spectrum of investors ranges from retail investors to highly sophisticated institutional investors.

4.2 Marketing of Alternative Funds

Retail funds can be marketed to all types of investors. Special funds may only be marketed to professional investors and to semi-professional investors. The definition of a professional investor is in line with the AIFMD definition. A semi-professional investor is – broadly speaking – an investor who commits at least EUR200,000 and who has shown certain investment experience and understanding of risk.

4.3 Rules Concerning Marketing of Alternative Funds

Marketing by an Intermediary

In the absence of reverse solicitation, if a firm would like to market an alternative investment fund in Germany, the firm would require either a MiFID licence or a MiFID passport. It is also possible to get a local financial intermediary licence under the German Commerce Act (GewO). The local financial intermediary licence is a non-

MiFID licence and is based on the optional exemption from MiFID II in Article 3 of MiFID II.

In the case of both licence holders (MiFID firms and local financial intermediary firms), Germany considers the prospective investor as the regulatory client of the firm. Accordingly, the firms have to adhere to the MiFID II rules of good conduct towards the prospective investor (eg, requiring compliance with suitability or appropriateness checks). The MiFID application further means here that marketing materials provided by the fund manager must comply with the MiFID II requirements on marketing materials (eg, with regard to past or simulated performance). The same applies for firms licensed under the Investment Firm Directive (Directive 2019/2034).

Marketing by the Fund Manager

The fund manager itself can always market its "own" funds. If the fund manager is fully licensed under the AIFMD, it can also market the investment funds of other managers. Pursuant to the new EU cross-border distribution of funds regulation (Regulation 2019/1156) fund managers are obliged to provide marketing materials to their prospective investors, which are "fair, clear and not misleading". Additionally, marketing materials have to be labelled as such.

Marketing Approval for Fund Interests

The fund interests themselves generally require a licence prior to the fund interests being marketed in Germany. This is either a marketing licence granted by BaFin or an AIFMD marketing passport (or, as the case may be, a EuVECA or EuSEF passport).

German-based sub-threshold managers are an exception. They can market their funds on a private placement basis in Germany. However, sub-threshold managers can only approach professional investors and semi-professional investors and there is no AIFMD passport available.

Marketing of EU AIFs by EU AIFMs

With regard to the marketing of non-German EU AIFs by EU AIFMs, the AIFMD marketing passport is available. The AIFMD marketing passport allows for the marketing of EU AIFs to professional and semi-professional investors in Germany.

Marketing of Non-EU AIFs or EU AIFs by Non-EU AIFMs

Germany allows for the marketing of non-EU AIFs managed by non-EU AIFMs to professional investors under the German implementation of Article 42 of the AIFMD. However, Germany has gold-plated Article 42 of the AIFMD, which still requires the appointment of a "depositary light". Furthermore, Germany also applies the Article 42 AIFMD regime to non-EU sub-threshold managers. Registration under Article 43 of the AIFMD requires fund managers to submit a so-called Annex IV report under the AIFMD to BaFin, as well as paying a current annual fee of EUR1,270.

Reverse Solicitation

Germany recognises a reverse solicitation concept. Reverse solicitation requires that the offer or placement is genuinely initiated by the investor. In addition, the prospective investor must be a professional or semi-professional investor.

4.4 Local Investors

Local investors may invest in alternative funds established in Germany. This is, in particular, true for German institutional investors (typically qualifying as "professional investors" according to MiFID II) as well as other investors (eg, family office investors and HNWIs) qualifying as so-called "semi-professional" investors under German law. Special requirements and restrictions apply to funds targeting retail investors.

4.5 Regulatory Regime

It is necessary to make regulatory filings in respect of marketing fund interests in Germany

(see **4.3 Rules Concerning Marketing of Alternative Funds**).

4.6 Disclosure Requirements

Particular disclosure requirements apply with respect to German investors (see **2.17 Disclosure/Reporting Requirements**).

4.7 Tax Regime

Overview

Different investor groups trigger different tax regimes with respect to their investments in German funds. Also, the taxation differs based on whether the general tax rules apply (in the case of funds in the form of a partnership) or whether the special tax regime of the German Investment Tax Act applies (in the case of funds in the form of a corporation or a contractual-type fund).

The following is a short summary of the tax effects at investor level under the German general tax rules in the case of partnerships (see **2.11 Tax Regime** for the tax effects at investor level in the case of the applicability of the German Investment Tax Act).

There is no special treatment of income from a fund in the form of a partnership. The income is taxed at the level of German-resident investors in accordance with the general rules applicable to the respective investor and the respective type of income.

German Investors

In the case of German-resident investors, the taxation rules will depend on the type of investor as well as whether the fund (ie, the partnership) is treated as being engaged in a trade or business, or engaged in private asset management.

Individual investors

For individual investors, the actual rate of investor-level taxation depends on whether the investor holds the fund interests as part of their non-business or business assets. For individuals that hold their investment fund interests as part of their non-business assets, such items are subject to flat income tax (effectively at 25%, plus solidarity surcharge, in aggregate effectively around 26.5%) if the fund qualifies for treatment as private asset management. For individuals that hold their fund interests as part of their business assets, principally, the full amount of such items is subject to income tax at their personal rate (up to 45%). The same would be true for individuals (irrespective of whether they hold their investment fund interests as part of their non-business assets or business assets), if the fund is engaged in a trade or business. The partial income tax regime (40% of income is exempt) would apply to capital gains and dividends. The full tax rate is applicable to interest income.

Corporate investors

For corporate investors, both corporate income tax (ie, German corporate tax rate, generally at 15%, if no exemptions apply) as well as (potentially) trade tax (the trade tax rate will depend on the tax residency of the corporate investor, as the trade tax rate differs based on municipality, but typically the general tax rate is around 15–18%, if no exemption applies) is applicable at their level, if such corporate investor is not tax-exempt. For corporate taxable investors, the general rule is that the full amount of such items is subject to corporation tax. In addition, German trade tax may be triggered (in particular, if the fund is treated as private asset management). For certain corporate investors (in particular, property insurance companies as well as general corporate entities), the partial income taxation and the exemption pursuant to Section 8b of the German Corporation Tax Act may be applicable to both corporate tax as well as trade tax. In particular, this applies in the case of capital gains as well as dividends (in the latter case, only if certain holding percentages are satisfied, 10% in

the case of corporate tax applicable to dividends and 15% in the case of trade tax applicable to dividends).

Non-German Investors

In general, non-resident investors of a fund structured as a partnership will be subject to taxes in Germany pursuant to the German general tax rules for non-residents. If the fund is structured as a partnership having asset management status (ie, it is not deemed to be in business and is not engaged in business activities for German tax purposes), non-resident investors are generally (if holding less than 1% indirect share in such portfolio company) not taxed on capital gains realised by the fund from the sale of a portfolio company and they are not required to file tax returns in Germany. However, the income of non-resident investors may be subject to German withholding tax (eg, with regard to dividend distributions from a portfolio corporation held by the fund). A refund, an exemption or a reduction of withholding tax may depend on certain filing procedures. This may also apply with regard to certain double-taxation treaties.

4.8 FATCA/CRS Compliance Regime

Regarding FATCA (Foreign Account Tax Compliance Act), Germany has signed an intergovernmental agreement (IGA) with the USA based on the Model 1 IGA. As a result, German funds are "deemed compliant" but require certain information to be provided to German tax authorities. Germany has transposed the agreement with the USA into German national tax law and the German tax authorities have issued a clarifying FATCA ordinance. Germany has also implemented the CRS (Common Reporting Standard) rules into German tax laws. The German tax authorities issued further administrative guidance on both FATCA and the CRS in late 2017.

Both FATCA and the CRS oblige all German funds and their fund managers to comprehensively screen their investors, collect information about non-residents among investors (and their ultimate beneficial owners), and report this information to the BZSt, together with information about the participation of such persons/entities. This information will be passed on to the US (in the case of FATCA) or to other European countries (in the case of the CRS).

POELLATH (formerly known as P+P Pöllath + Partners) has approximately 150 P+P professionals who contribute to one of the largest and most experienced fund structuring practices in continental Europe, with locations in Berlin, Frankfurt and Munich. The firm is a market leader in the structuring of private equity funds in Germany and maintains strong relationships with German law firms in jurisdictions abroad. The firm advises initiators of and investors in private equity funds and worldwide fund participations in the area of alternative investments. The team has extensive expertise in fund structuring; advice regarding the Alternative Investment Fund Managers Directive (AIFMD), the German Capital Investment Code (KAGB) and the Markets in Financial Instruments Directive II (MiFID II); asset management; and secondary transactions. This includes all relevant fund structures in private equity (buyout, venture capital), private debt, distressed debt, real estate, infrastructure, natural resources, education, hybrid funds, hedge funds, digital assets funds, captive funds, master-feeder structures, separate accounts, annex funds as well as primary and secondary fund of funds.

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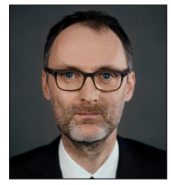

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