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Alternative Funds 2022

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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, it 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. As well as 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).

With regard to large institutional investors, Germany is one of the top jurisdictions in Europe for 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

A German limited partnership (GmbH & Co KG) is typically used for closed-end alternative investment funds. In terms of structure, the German limited partnership is comparable to the US, UK or Luxembourg limited partnership. It offers limited liability to its limited partners and has as a corporate type, a general partner with unlimited liability (although the general partner's liability is limited to its assets, typically EUR25,000, thereby also being 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 Funds: Regulatory Regime

The German regulatory regime for alternative investment funds (AIFs) is based on the AIFMD. The German Capital Investment Act (*Kapitalanlagesetzbuch*, KAGB) incorporates the AIFMD. 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). The vast majority of German-based fund

managers in the alternative assets sector are still sub-threshold managers (as opposed to fully licensed fund managers).

Large-Fund Managers

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

Investment Limitations

The German Federal 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. Both German funds and EU funds with an EU-AIFM are subject to this rule. However, German funds may only grant loans to non-consumer borrowers, their leverage is restricted, and they are subject to certain diversification rules. Furthermore, detailed risk management rules (KAMaRisk rules) apply. EU funds with an EU-AIFM may grant loans to German non-consumer borrowers subject to the rules of that AIFM's home jurisdiction.

In general, non-EU funds may grant loans only under reverse solicitation conditions or if the loans are subordinated to almost-equity level in the event 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. Despite this, new regulations for acting as a depositary for cryptocurrencies and other digital assets were recently implemented in 2020. These regulations will need to stand the test of time. It is expected that specialist depositaries will develop, and traditional depositaries will delegate their responsibilities regarding digital assets to these new “fintech” service providers. As of the time of writing, BaFin had licensed four depositaries for cryptocurrencies.

Special funds (ie, non-retail funds) can invest in cryptocurrencies without any restrictions. However, special funds managed by fully licensed managers are required 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, less the fees and costs borne by the investors, to a single borrower in order to minimise the risk of credit defaults.

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 managed by fully licensed AIFMs can only invest in assets that can be valued at point in time. This is challenging with respect to financing of litigation since the risk of the loan depends on the legal risk of the respective financed lawsuit, which is difficult to assess independently. Due to this, there remain significant practical challenges when it comes to 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 so long as the portfolio company’s activity is legal or it has the necessary licences. Therefore, German funds are not permitted to invest in an activity that is illegal. Apart from that, there are no restrictions with regard to investments in cannabis or cannabis-related businesses.

2.6 Regulatory Approval Process

In the case of retail funds, the process of getting approval to market the fund takes about four weeks. In the case of special funds (ie, non-retail funds) managed by fully authorised managers, approval is only necessary if the fund is being marketed. An approval of this kind also takes about four weeks. Special funds managed by sub-threshold managers are not regulated and therefore do not require prior approval for marketing.

2.7 Requirement for Local Investment Managers

The German fund management regime requires either a German-based fund manager or a fund manager with an AIFMD passport.

However, the fund manager can outsource portfolio management to an investment manager abroad. Outsourcing of this nature is 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 the country. 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. In the case of funds based in Germany, the depositary must also be based in Germany.

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.

If portfolio or risk management is being outsourced, the outsourcing delegate must be authorised or registered in their home country. Moreover, 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) or the German Investment Firm Act (WpIG) if the delegate actively solicited the relationship with the manager (as opposed to reverse solicitation).

2.11 Funds: Tax Regime

Overview

The tax regime applicable to a fund depends on its legal form. The German general tax rules apply to funds structured as partnerships (eg, German KGs). It is typically the case for closed-end AIFs. Under the German Investment Tax Act, funds structured in other legal forms (corporations or contractual-type funds) are subject to special tax regimes. The rules apply primarily to open-end UCITS, to certain open-end AIFs, as well as closed-end AIFs (if they are structured as corporations or contractual 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 is whether such activity is considered an investment activity (also known as private asset management status) or whether it is considered trade or business. 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 their respective levels according to the rules of the respective tax regime applicable to the relevant partner. 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. Withholding tax implications can, however, 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. It covers so-called "investment funds", ie, funds that are structured as corporations or contractual funds (*Sondervermögen*). The Act generally applies to UCITS and AIFs (both retail AIFs and special AIFs). Certain other entities that do not qualify as "investment funds" under KAGB are also covered (in particular, "single-investor funds").

Prior to its 2018 revision, the German Investment Tax Act provided for a tax regime called "restricted transparency" regime. It 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, which is available to only special funds.

There are two levels of taxation under the opaque tax regime: those that apply to the funds and those that apply to the investors. This tax regime is applicable to all retail funds. It also applies to all other investment funds (including non-retail funds) that do not meet 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 taxed only on 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). For such income, the fund is subject to a 15% tax rate (ie, German corporate tax rate). 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 on the taxable income of their (domestic) investors, but not on 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). Specifically, distributions from the fund, predetermined tax bases and capital gains realised upon redemption or sale of 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 they hold fund interests as part of their "non-business" or "business" assets. Individuals who hold their investment fund interests as part of their non-business assets are subject to a flat income tax on such items. Generally, when individuals hold their investment fund interests as part of their business assets, 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 provided by 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. The partial exemption rates provided in the German Investment Tax Act, are, however, only available to German investors, as foreign investors are generally not subject to any tax obligations in Germany at the level of investment fund investors.

In the case of non-resident investors in 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 through (domestic or foreign) investment funds only have to pay German taxes in the event that there is taxation at the 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, it may opt to be treated transparently for tax purposes. The fund, therefore, will not be subject to taxation, ie, it will effectively be transparent (although 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 that was in effect prior to 2018, but with certain amendments.

Specialised investment funds may only have a maximum of 100 investors. In contrast to the previous law (in force before 2018), there is a look-through approach with respect to partnerships as investors (ie, each partner of such a partnership is regarded 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 indirect investor participation was allowed for individuals).

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 an extensive network of double-tax treaties with a large number of countries (including most OECD member states and as well as many other states). The applicability of such double-tax treaties depends on the legal form of the fund in question. Most German alternative funds are structured as partnerships. As such, they are tax-transparent. Consequently, double-tax treaties typically do not apply directly to funds, but rather to investors (ie, the partners of partnerships). 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. In most cases, the advantages come from structural factors, such as the creation of different tiers of structural subordination of lenders (not just contractual subordination) and the application 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, but German funds also attract a significant number of foreign investors.

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. As of 1 July 2020, these new cross-border arrangements must be reported to the German Federal Central Tax Office (BZSt). Also, prior existing arrangements (ie, where the first step of implementation was realised after 24 June 2018) were required to be retroactively reported within two months from 30 June 2020. Due to the COVID-19 situation, most European jurisdictions provided some relief by delaying the reporting deadline, sometimes until 2021. Germany, however, was one of only two countries that did not imple-

ment this reporting relief (the only other jurisdiction being Finland). Consequently, the structure of the private equity fund itself and its portfolio investments may, in certain cases, constitute a cross-border arrangement.

The reporting obligation applied to both "intermediaries" (including fund managers and their legal and tax advisers) and 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 (circulars dated 29 March 2021 and 26 July 2022) 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. Despite the fact that the latest main revision took effect in 2018, certain aspects of interpretation remain unclear. Over the past three years, the German tax authorities have issued several, mostly helpful, administrative clarifications. A draft guidance issued in mid-December 2019 had raised concerns and suggested restrictions on the ability for 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 arrangement. 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. Overall, however, the final circular is a welcome development because investment by German special investment funds in target funds (structured as corporations or partnerships) is generally possible, especially, if such target funds qualify as "securities".

Corporate income tax modernisation act

The new Modernisation of the Corporate Income Tax Act becomes effective from 1 January 2022. It provides a new "check the box" regime with an irrevocable option for partnerships to be treated as corporates for tax purposes. As a result, AIFs will be subject to a third form of tax treatment under German tax law. In addition to the options mentioned above (AIFs formed as partnerships are treated in accordance with the general rules of German taxation for partnerships and AIFs formed as corporations are treated as investment funds or specialised investment funds under the Investment Tax Act), an AIF could also be treated as a partnership-like taxable corporate entity without being subject to German Investment Tax Act. This may be useful to prevent foreign investors from tax declaration obligations in Germany and to maintain the possibility of applying the taxation privilege for capital gains under Section

8b of the German Corporation Tax Act (KStG) to German corporate investors, as well as the fund entity itself. This will limit the tax leakage at the fund level. Withholding tax issues, however, make this option less attractive.

Anti-tax avoidance directive

A new Anti-tax Avoidance Directive (ATAD) implementation law came into force on 1 July 2021. This covers both 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). Currently, ATAD III relating to shell companies is discussed at European level and not to be implemented by EU member states before 2024.

Regulatory

Key regulatory trends include 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.

Sustainable finance disclosure regulation / ESG-reporting

Additionally, Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector and Regulation (EU) 2020/852 on establishing a framework to facilitate sustainable investments came into effect. As of January 2022, funds that seek to contribute to the achievement of an environmental goal (Article 9 of the SDFR) or which advertise environmental features (Article 8 of the SDFR) are now subject to further disclosure obligations according to the Taxonomy Regulation. There are, however, still many questions of detail and the implementation of the Regulatory Technical Standard (RTS) through the Delegated Regulation (EU) 2022/1288 by the European Commission came into effect on 1 January 2022. During BaFin's annual press conference in May 2022, it was announced that the planned Guidelines for Sustainable Investment Funds have been placed on hold due to the dynamic regulatory, energy and geopolitical environment. At present, it is unclear which requirements - set forth in the Guidelines - BaFin will apply in its administrative practices to prevent greenwashing.

New law on investment firms

The new German law on investment firms (*Wertpapierinstitutsgesetz*) implements the Directive 2019/2034 (Investment Firm Directive – IFD) and seeks to reduce the burden of prudential supervision on small and medium-sized investment firms. The new regime came into effect on 26 June 2021 and is designed to be more lenient when it comes to small and medium-sized investment firms' internal governance, remuneration policies and risk management. As defined by the IFD, small and medium-sized investment firms have, inter alia, assets under management that are less than EUR1.2 billion and total balance sheet assets under EUR100 million. Bigger investment firms fall under the traditional Capital Requirements Regulation (CRR) regime.

New structuring options for domestic investment funds

The new German Fund Jurisdiction Act (*Fondsstandortgesetz*, or FoStoG) came into force in August 2021. It expanded the options available to fund managers with respect to the permissible structuring options. The new range of permitted products includes, for instance, a master-feeder structure for closed-ended funds and the introduction of an open-ended infrastructure fund for special AIFs in the corporate form of an *Investmentkommanditgesellschaft* (investment limited partnership).

Markets in crypto-assets regulation (MiCAR)

In 2020, the EU Commission proposed a Regulation on Markets in Crypto Assets (MiCAR) as part of a new, standardised regulatory framework for EU crypto-assets, their service providers and issuers.

The MiCAR proposal covers the regularity subjects of authorisation and supervision of both issuers of crypto-assets as well as crypto-asset service providers. It also covers and defines the corresponding obligations for the token types covered by the regulation (value-referenced tokens (so-called stablecoins), e-money tokens and, as a catch-all, crypto-assets). Among the main features of the proposal is its comprehensive consumer protection regime for crypto-assets, including notification requirements for cross-border distribution of crypto-assets within the EU or the requirement to publish a white paper. At the same time, issuers and service providers of crypto-assets are to benefit from EU passporting regime.

At present, Germany provides a legal framework for crypto commerce due to the fact that different types of crypto token are classified as financial instruments under national law. The definition of crypto-assets in MiCAR, however, is not congruent with the term in the German Banking Act (KWG), so changes are to be expected on the German market.

MiCAR is expected to enter into force in the third quarter of 2022 with an 18-month transitional period (Art. 126(2) MiCAR).

Act to Strengthen Investor Protection

Financial audit for sub-threshold AIFM

The 2019 Act to Strengthen Investor Protection (*Anlegerschutzstärkungsgesetz*) introduced a package of measures to protect investors from losses incurred through capital investments, which have already been implemented over the last years. However, some provisions became applicable in 2021 and 2022, such as a new provision in the German Investment Code (Section 45a KAGB) concerning financial audits. Now, sub-threshold AIFM (not the AIF itself) are also required to instruct a qualified independent third party (eg, an auditor) to audit how funds are being used. The AIFM must notify the BaFin of the appointed auditor. In the audit report, the auditor must state separately whether the AIFM has complied with its obligations under the KAGB and the Money Laundering Act (*Geldwäschegesetz*, or GWG). The report is to be submitted to BaFin by the auditor. In the event that the AIFM does not provide the auditor with sufficient information, or does not provide it correctly, completely or in a timely manner, a fine of up to EUR1 million may be imposed; in the case of legal entities, a fine of up to 2% of the total annual turnover may be imposed additionally.

Management of mutual funds requires full authorisation

The special regulations according to which sub-threshold AIFM were allowed to manage retail funds pursuant to Section 2 (4a) and (5) KAGB

have been abolished. Thus, all AIFM must be fully licensed (Section 20 KAGB) to manage retail funds.

Blind pool prohibition; regulatory powers

An amendment to the German Investment Act (*Vermögensanlagegesetz*, or VermAnlG) prohibits investments in so-called blind pools, ie, where the investment objects have not yet been determined. However, units in investment funds within the meaning of the KAGB, and in particular AIFs, are explicitly not an asset investment within the meaning of the VermAnlG (Section 1 (2) VermAnlG), so the blind pool prohibition does not apply to AIFs.

The supervisory powers of BaFin were also expanded. For example, the prospectus approval process is now to be interlinked with the product intervention process. Until August 2021, BaFin had to approve a prospectus if it met the legal requirements, regardless of possible material deficiencies, such as grounds for considerable investor protection concerns or incompleteness (which was corrected by the offeror on the first day of the public offering at the latest). In accordance with the new regulation, the approval procedure will be suspended the moment BaFin has grounds to concern itself with investor protection (Section 8 of the VermAnlG). In addition, the sales prospectus may only refer to one single asset. Starting in 2022, BaFin will be legally required to publish approved prospectuses on its website and ensure that they are retrievable for a period of 10 years.

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.

The partnership agreement is not required to be filed, therefore the fund 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

With effect from 2 August 2021, German legislators have incorporated the recent EU amendments of the AIFMD regarding pre-marketing and marketing communications for collective investment funds (Directive (EU) 2019/1160). As a result, Germany has reviewed its Capital Investment Act in order to identify drafting errors and make practical amendments. The new regime leads to a slightly stricter regulation in Germany compared to the current regulation on pre-marketing. A point to note is that Germany has extended the new EU pre-marketing regime to non-EU managers. As such, non-EU managers are required to inform BaFin about their pre-marketing activities in Germany.

3. Managers

3.1 Legal Structures Used by Fund Managers

As a rule, managers almost always use a corporate entity to serve as their managing entity (GmbH or AG).

3.2 Managers: Regulatory Regime

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

3.3 Managers: Tax Regime

Overview

There are several income streams to be distinguished with regard to the tax regime applicable to income received from the fund by fund managers. Fund managers typically invest their own money (usually through a separate team commitment vehicle structured as a German limited partnership that is considered to be engaged in private asset management). With respect to income related to such capital commitments, fund managers are treated as normal investors, ie, no special rules apply. According to the so-called distribution waterfall in fund agreements, fund managers may also receive additional income that 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. In terms of income tax, all management fee income is taxed as income received for the provision of services, ie, no special tax exemptions will apply. In practice, the greatest issue in relation to management fees comes in the form of value added tax (VAT) treatment.

Management Fee and VAT

Despite the fact that the VAT treatment of management fees in Germany has changed over the years, it remains a hot topic. As of the end of 2017, the management fee payable to the fund manager of an AIF was subject to German VAT (in contrast to UCITS funds, which have enjoyed a specific exemption for many years). Since early 2018, the German VAT Act has been revised. As a result of 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, cer-

tain criteria must be met in order to qualify from the VAT exemption (in particular, the AIF must offer shares to the same investor group and be subject to similar obligations and controls as UCITS). It is common practice among German tax authorities to argue that AIFs intended for professional investors (and semi-professional investors) are not comparable to UCITS, and, therefore, do not qualify for VAT exemption. The situation has not been resolved and some German local tax authorities have either confirmed the application of the VAT exemption in individual cases, or, if it was disputed, have agreed to a compromise (partial exemption, for instance, up to 90% in some cases). With effect from 1 July 2021, the Funds-Jurisdiction Strengthening Act extended the VAT exemption on management fees for certain types of AIFs (venture capital funds). While the legislation is a positive development, its 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 VAT exemption benefits, creating potential issues under European state aid rules. When comparing German funds with funds in other European jurisdictions, this issue remains a potential negative factor. In June 2022, the German Federal Ministry of Finance published a final version of the long-awaited supplement to the German VAT Regulations and clarified the conditions under which a fund qualifies as a venture capital fund within the meaning of the Act. It is the definition's linchpin that a minimum capital contribution of at least 50% of the funds aggregated investments is required to support young, innovative growth-companies that are located in the EU or EEA (target companies) and meet specific criteria (eg, no more than 12 years since the company was founded). The fund must also demonstrate that it is subject to similar comparative conditions as UCITS as well as special governmental supervision. As a result, the decree has increased legal certainty for VC funds in regard to VAT.

3.4 Rules Concerning Permanent Establishments

There is no exemption available in Germany ensuring that alternative funds with German managers do not have a "permanent establishment" or other taxable presence within the country. The reason for this is that German general tax rules apply to funds structured as limited partnerships. As a result of the German Investment Tax Act, the special tax regime applicable to funds structured other than partnerships (ie, funds structured as corporations or contractual funds), there are a number of special rules that deviate from the general German tax rules. However, in effect, there are no special rules to substantially limit foreign investors' risk of permanent establishment.

3.5 Taxation of Carried Interest

Overview

The tax treatment of carried interest for fund managers depends on the fund's legal form and tax status. There is a well-established tax treatment for 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. The majority of German funds are subject to these rules. There is less certainty regarding the rules applicable to other types of funds, namely those structured as partnerships engaged in trade or business, or structured as corporation or contractual funds, although certain recent developments are encouraging.

Carried Interest Taxation

Funds structured as partnerships engaged in private asset management

The majority of German funds, in particular direct investing funds, are set up as partnerships and carefully structured to qualify as private asset management activities. Fund managers often apply for an advance tax ruling with the German tax authorities in order to confirm this point prior to the first closing of their fund. Partnership funds engaged in private asset management activities are fully tax transparent, ie, the fund itself is not subject to German trade tax. Moreover, 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). In accordance with technical requirements, carried interest must be paid only after the investors have received their entire 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 from 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

There are some funds that are structured as partnerships that are engaged in a trade or business. The reason for this may be that some institutional investors prefer that the fund is engaged in a trade or business, or because the respective fund strategy is seen as more active than that of 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%), which means that the special tax exemption for funds qualifying as private asset management does not apply. 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 share of the distribution waterfall among fund partners.

However, in a recent case from late 2018, the German highest tax court issued a ruling in which it disagreed with this tax treatment. Consequently, the court ruled that the waterfall distribution rules in fund agreement that determine the distribution of profits received by the fund among the fund's partners must be respected. In other words, the court considers that carried interest received should not be viewed as a "hidden payment" for services provided by fund managers to the fund. Rather, the court ruled that such payments 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 when the fund qualifies as being engaged in a trade or business. At the level of individual tax managers, this results in a tax rate of around 28.5%. This ruling greatly reduces the risk for fund managers that a change in assessment by the tax authorities of the activities of the fund (trade or business versus private asset management) would negatively impact their tax position with regard 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 the ruling or whether they will attempt to amend the tax laws in order to implement their position.

3.6 Outsourcing of Investment Functions/Business Operations

The practice of outsourcing by fund managers is possible and common. If portfolio management or risk management is outsourced, the delegate must hold a licence (as required by the AIFMD). Often, outsourcing agreements are based on sample agreements published by a German investment lobby group called BVI. An outsourcing agreement must ensure that BaFin and the fund manager's internal control functions have specific control and supervisory rights.

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 Investors 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 wishes to market an alternative investment fund in Germany, it would require either a MiFID licence or a MiFID passport. Additionally, it is possible to obtain 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). In addition, the MiFID application means here that marketing materials provided by the fund manager must comply with the MiFID II requirements on marketing materials (eg, with regard to the past or simulated performance of the fund). Firms licensed under the Investment Firm Directive (Directive 2019/2034) must comply with the same requirements.

Marketing by the Fund Manager

The fund manager can always market its "own" funds. If the fund manager is fully licensed under the AIFMD, then it can also market the investment funds of other managers. Under the new EU cross-border distribution of funds regulation (Regulation 2019/1156), fund managers are

required to provide their prospective investors with marketing materials that are "fair, clear and not misleading". Additionally, marketing materials must be labelled as such.

Marketing Approval for Fund Interests

The fund interests themselves generally require a licence before they can be marketed in Germany. It may either be a marketing licence granted by BaFin or an AIFMD marketing passport (or, as the case may be, a EuVECA or EuSEF passport).

The exception is German-based sub-threshold managers. In Germany, they are able to market their funds on a private placement basis. 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

To facilitate 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, it has gold-plated Article 42 of the AIFMD, which still requires the appointment of a "depositary light". Furthermore, the country 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 particularly true for institutional investors in Germany (ie, those that qualify as "professional investors" under MiFID II) as well as other investors (eg, family offices and HNWIs) who qualify as "semi-professional" investors according to German law. In the case of funds targeting retail investors, there are specific requirements and restrictions.

4.5 Investors: 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 Investors: Tax Regime

Overview

Different investor groups trigger different tax regimes with respect to their investments in German funds. Furthermore, the tax treatment differs depending on whether the general tax rules apply (in the case of funds established as partnerships) or whether the special tax regime of the German Investment Tax Act applies (for

funds organised as corporation or contractual funds).

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 Funds: 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%). If the investment fund is engaged in a trade or business, the same would apply to individuals (irrespective of whether they hold their investment fund interests as part of their non-business assets or business assets). 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, since the trade tax rate differs by municipality, but typically the general tax rate is around 15–18%, if no exemptions apply) 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 Foreign Account Tax Compliance Act (FATCA)/Common Reporting Standard (CRS) Compliance Regime

With regard to 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. There has been a transposition of the agreement with the USA into German national tax law and a clarification of the FATCA ordinance has been issued by the German tax authorities. Additionally, Germany has implemented the CRS (Common Reporting Standard) rules into its tax laws. In late 2017 and in June 2022, the German tax authorities issued further administrative guidance on both FATCA and the CRS.

The FATCA and the CRS require all German funds and their fund managers to comprehensively screen their investors, collect information about non-resident investors and their ultimate beneficial owners, and report this information to the BZSt, along with information regarding 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) comprises approximately 170 professionals, of whom 50 are affiliated with the firm's fund structuring practice, which is one of the largest and most experienced in continental Europe, with offices in Berlin, Frankfurt and Munich. Among the firm's strengths are the structuring of private equity funds in Germany, as well as its strong relationships with German law firms abroad. It advises investors and initiators of private equity funds and participations in global funds in the area of alternative investments. Among the team's extensive skills are 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 asset funds, captive funds, master-feeder structures, separate accounts, annex funds as well as primary and secondary funds of funds.

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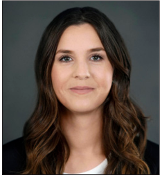

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