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CHAMBERS GLOBAL PRACTICE GUIDES

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# Investment Funds 2024

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**Germany: Law & Practice**

Amos Veith, Dr Jens Steinmüller, Ronald Buge  
and Dr Stephan Schade  
POELLATH



# GERMANY



## Law and Practice

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**POELLATH** has one of the largest and most experienced fund structuring practices in continental Europe, with locations in Berlin, Frankfurt and Munich, and around 60 professionals. It is a market leader in the structuring of private equity funds in Germany, and maintains strong relationships with local law firms in jurisdictions outside the country. 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 Di-

rective (AIFMD), the German Capital Investment Act (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, mezzanine/private debt, distressed debt, real estate, infrastructure, natural resources/energy, education, hybrid funds, hedge funds, crypto/digital assets funds, captive funds, master-feeder structures, separate accounts, annex funds and specialised funds, as well as primary and secondary funds of funds.

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# POELLATH+

## 1. Market Overview

### 1.1 State of the Market

Germany is frequently used by advisers and managers for the formation of venture capital, private equity and similar closed-end alternative investment funds, as well as for retail funds wherever the manager of the respective investment fund is located in Germany – ie, Germany is generally not used as a domicile for structuring alternative investment funds or retail funds by non-German advisers or managers. Typically, German private equity or venture capital funds are structured as limited partnerships that are transparent for German tax purposes.

German resident institutional investors and German family offices are frequent targets of fundraising activities for venture capital, private equity and similar alternative investment funds located in Germany or various other jurisdictions around the world.

## 2. Alternative Investment Funds

### 2.1 Fund Formation

#### 2.1.1 Fund Structures

The typical legal forms of investment funds used in Germany are limited partnerships, investment stock corporations and contractual funds with no legal personality of their own (*Sondervermögen*). The most frequently used legal form for private funds is the limited partnership, whereas retail funds, undertakings for the collective investment in transferable securities (UCITS) funds and real estate funds are more often structured as contractual funds. A key difference is that a limited partnership is transparent for German tax purposes, whereas the rules of the German Investment Tax Act apply in respect of corporate fund

structures and contractual funds treating such funds as opaque entities.

#### 2.1.2 Common Process for Setting Up Investment Funds

The process for setting up an investment fund in Germany differs for registered sub-threshold managers and fully licensed managers of alternative investment funds. The regulation of investment funds in Germany is primarily exercised through the regulation of the respective manager, who is required to apply for a full licence or to be registered with the German supervisory authority for financial services (BaFin) under the German Investment Code (KAGB). The KAGB implements the European Alternative Investment Fund Managers Directive (AIFMD) rules into German law.

#### Registered Managers – Registration Process Availability

This registration process is available to certain small or medium-sized managers only. The most important category of these small to medium-sized managers is known as a “sub-threshold manager” under the AIFMD and KAGB. In practice, most German alternative investment fund managers outside the real estate area still fall within this category.

Sub-threshold managers under the KAGB are managers with assets under management of not more than EUR500 million with no leverage at fund level, or not more than EUR100 million if there is leverage at fund level, and who manage so-called special alternative investment funds (“Special AIFs”) only. Special AIFs are AIFs whose interests or shares may only be acquired by professional investors or semi-professional investors (ie, non-retail funds).

## *Registration procedure*

The registration process is relatively simple. It requires the submission of a registration request together with certain documents on the manager and the investment fund(s) the manager intends to manage (such as the fund's limited partnership agreement and the manager's articles of association). In addition, a Special AIF may not require the investors to pay in capital in excess of their respective original capital commitment.

## *Ongoing compliance issues*

An advantage of the registration is that only a few provisions of the KAGB apply to "registered-only" managers – mainly the provisions on the registration requirements, some ongoing reporting requirements and the general supervisory powers of BaFin. However, fund-specific requirements do not apply to "registered-only" managers and their funds. In particular, the depository requirements and marketing requirements do not apply, and nor do the additional requirements of the KAGB for fully licensed managers, except that certain additional internal governance and reporting obligations apply to the extent that any debt funds are managed.

In exchange for such light regulation, "registered-only" managers do not benefit from the European marketing passport under the AIFMD. A registered manager can, however, opt to become a fully licensed manager (or upgrade to an EU European venture capital fund (EuVECA) manager). Since 2021, "registered-only" managers have been required to audit their annual financial statements. Such audit must include a review of compliance with the KAGB and German anti-money laundering law.

## *Fully Licensed Manager – Licensing Process Availability*

Fund managers who do not qualify for a registration or who opt to upgrade must apply for a full fund management licence with BaFin under the KAGB. A full fund management licence opens a door for managers to market funds to retail investors, and also gives access to the marketing passport under the AIFMD. Retail investors are neither professional nor semi-professional investors.

## *Licensing procedure*

The licensing procedure is a fully fledged authorisation process with requirements equivalent to the requirements for granting permission under Article 8 of the AIFMD or Article 6 of the UCITS Directive. The licensing procedure checks requirements such as sufficient initial capital or owned funds, adequate experience of the directors, sufficiently good repute of the directors and shareholders, and organisational structure of the manager.

## *Ongoing issues*

The licensing of the manager results in the manager being subject to the entirety of the KAGB, which entails the following in particular:

- the appointment of a depository for the funds;
- access to setting up contractual funds;
- adherence to the corporate governance rules for funds set up as investment corporations or investment limited partnerships (so-called Investment KGs);
- adherence to the fund-related requirements of the KAGB;
- adherence to the pre-marketing and marketing rules of the KAGB;
- access to the marketing passport under the AIFMD or UCITS Directive;

- access to the managing passport under the AIFMD or UCITS Directive; and
- adherence to the reporting requirements of the KAGB.

### 2.1.3 Limited Liability

Investors admitted to investment funds in Germany typically benefit from limited liability. As limited partners of a limited partnership, which is the most frequently used structure for alternative investment funds in Germany, their liability in relation to third parties for obligations of the fund is limited to their respective liability amount registered with the commercial register of the respective fund partnership. The liability amount is typically a small portion (ie, 0.1%) of their capital commitment or a small fixed amount. Once this portion of their capital commitment has been contributed to the alternative investment fund, their liability in relation to third parties ceases to exist.

Regarding the relationship of the investors to the alternative investment fund itself, the liability is restricted to the unpaid portion of the investor's capital commitment. For fund structures other than limited partnerships, an even stricter limitation of liability applies. Legal opinions are commonly issued to confirm such limitation of liability.

### 2.1.4 Disclosure Requirements

For the usual AIFs that are marketed to non-retail investors, there is no legal requirement to issue a private placement memorandum (PPM); however, all fund managers are subject to the SFDR disclosure obligations and disclosures under Article 23 of the AIFMD must be provided if the fund is marketed under the AIFMD. In any case, a PPM is commonly produced for all AIFs to ensure that the investors are informed – completely and correctly, and in a non-misleading

manner – about the respective AIF, its management, its investment strategy, the risks associated with an investment and the expected tax consequences of the investment. These disclosures are recommended in order to avoid the liability of the sponsor or managers under general prospectus liability rules.

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

There are annual reporting requirements for managers of retail funds and managers of non-retail funds. There are also semi-annual reporting requirements for contractual funds and investment stock corporations (AG) with variable capital. The reports need to be published.

Furthermore, new notification requirements implementing Council Directive (EU) 2018/822 for cross-border tax arrangements have applied for intermediaries of funds (usually the fund manager) since 1 July 2020.

## 2.2 Fund Investment

### 2.2.1 Types of Investors in Alternative Funds

During the last two decades, alternative funds have experienced a considerable and increasing capital inflow from German institutional investors. A significant portion of the institutional investors are professional pension schemes (*berufsständige Versorgungswerke*), insurance companies, tax-exempt or taxable pension funds (*Pensionskassen*, *Pensionsfonds*) and, increasingly, banks. Furthermore, industrial companies can be found as investors in alternative investment funds, especially in specialised private equity or venture capital funds, which promise strategically interesting investment opportunities. Finally, public investors (*öffentlich-rechtliche Geldgeber*) invest in alternative funds, often motivated by

reasons of broader structural economic policy. Rather than investing directly, institutional investors often invest through managed accounts set up as single or group investor funds.

## 2.2.2 Legal Structures Used by Fund Managers

Legal structures depend on investors' specific requirements and preferences. The legal structures for private funds in which most types of investors are usually prepared to invest are limited partnerships and, particularly regarding real estate, contractual funds. However, specific structural requirements apply for certain types of investors.

For example, certain non-taxable or tax-exempt investors, including pension funds (*Pensionskassen*), can only invest in business-type partnerships if certain conditions and thresholds are met. Investments by investment funds intending to be treated as tax-transparent (*Spezial-Investmentfonds*) have to check the eligibility of investments in closed-end funds on a case-by-case basis. Generally, feasible ways exist for *Spezial-Investmentfonds* to invest in partnerships as well as corporate or contractual fund structures, subject to certain restrictions and thresholds.

Based on applicable product requirements, investments by *Spezial-Investmentfonds* via corporate funds or holding vehicles might be challenged, depending on the respective *Spezial-Investmentfond's* share in such fund or holding vehicle. Statements by the Federal Ministry of Finance confirm that interests in alternative funds in general can be treated as eligible investments for *Spezial-Investmentfonds* if they qualify as transferable securities under the UCITS Directive.

German pension funds that are subject to German domestic insurance regulation (Solvency I investors) usually prefer investment funds that are managed by a regulated manager. Requirements regarding the provenance and regulatory status of the fund depend on the classification of the fund. For private equity funds, fund vehicles and managers that have their seats within an EU/EEA country or Organisation for Economic Co-operation and Development (OECD) member state and that have a manager regulation that is at least comparable to the regulation of a sub-threshold alternative investment fund manager (AIFM) are sufficient. For a fund to qualify as a private equity fund, it needs to be closed-ended and may only invest in certain types of corporate finance instruments. Funds with investment policies covering instruments beyond equity and equity-like instruments require special scrutiny in this respect. For all other types of funds, only EU/EEA vehicles with full-scope AIFMs with an EU/EEA seat are eligible as AIF investments.

Interests in closed-end funds held by Solvency I investors or Solvency II investors need to be transferable without the prior consent of the general partner, manager or any other investor, as long as the interests are transferred to another institutional (or other creditworthy) investor. At the same time, the fund documents might need to contain specific language clarifying that an interest can only be transferred upon the prior written consent of a trustee appointed by the investor to safeguard the investor's assets, dedicated to covering a client's claims against the insurer.

## 2.2.3 Restrictions on Investors

There are no general restrictions for investors investing in investment funds. However, certain restrictions apply to specific types of investors – eg, Solvency I investors may not invest in invest-



ment funds that directly invest in working capital or consumer credits.

German insurance companies (Solvency II investors) have certain transparency requirements due to the prudent person principle under Solvency II. Investors usually require look-through information on the basis of a standardised tripartite reporting template. Moreover, Solvency II investors are subject to capital requirements, which are determined by risks in connection with investments, among other factors. Unleveraged closed-end funds are privileged in that respect.

Due to rules implementing further Basel III rules in 2021, fund managers must also accommodate the increasing transparency requirements of the growing group of banks reaching out for investments in AIFs – eg, in order to avoid investing banks having to fully back their investments with regulatory own funds.

Last but not least, ESG concerns are on the agenda of an increasing number of investors. Some institutional investors are already subject to statutory ESG obligations – eg, pension funds have to consider ESG aspects in connection with their business organisation and risk management, and are obliged to be transparent with regard to their handling of ESG factors. Solvency II investors have to consider sustainability aspects as part of the prudent person principle.

## 2.3 Regulatory Environment

### 2.3.1 Regulatory Regime

BaFin is responsible for regulating funds and fund managers.

In Germany, the management of investment funds is regulated by the KAGB, which implements the AIFMD and the UCITS Directive. The law requires that the manager is fully licensed or

registered with BaFin under the KAGB. If a fund is internally managed, then the fund itself needs a licence or registration.

For details on investment limitations and other rules applicable to alternative funds, see **2.4 Operational Requirements**.

### 2.3.2 Requirements for Non-local Service Providers

There is, in general, no registration or regulation requirement for non-local service providers such as administrators, custodians and director services providers. However, when a German manager outsources portfolio or risk management, the delegate must be authorised or registered in their home country. In addition, any delegate domiciled outside of the EU must appoint a domestic authorised agent to whom notifications and service of process can be effected by the respective German authority.

An outsourcing delegate who provides services falling under the Markets in Financial Instruments Directive (MiFID) will be subject to a licence requirement under the German Banking Act (KWG) or the recently introduced German Securities Institutions Act (WpIG) if they actively solicited the relationship with the manager (as opposed to reverse solicitation).

If German regulatory law requires a depositary for a German AIF, the depositary – or at least a branch of the depositary – must be domiciled in Germany.

### 2.3.3 Local Regulatory Requirements for Non-local Managers EU Fund Managers

EU fund managers are allowed to perform fund management services under the AIFMD passport regime with regard to German Special AIFs.

They may also use the AIFMD passport to provide other services and ancillary services (such as MiFID investment advice or discretionary individual portfolio management).

## Non-EU Managers

Non-EU managers are currently not allowed to perform fund management services in Germany. This might change in the future with regard to AIFMs in those countries for which the passporting regime under the AIFMD for third-country managers will eventually become effective.

Outside of providing fund management services (eg, managed account solutions), non-EU managers may provide certain regulated services in Germany, such as investment advice or discretionary individual portfolio management. This requires either that the services are in the scope of an existing relationship with the German manager or that the relationship is established at the initiative of the German client (reverse solicitation). As an alternative, such service providers may apply to BaFin for an exemption from the German licence requirements (which is a lengthy process).

### 2.3.4 Regulatory Approval Process

The registration procedure for a sub-threshold manager is comparatively simple and takes about one month. A full licensing procedure varies between six and 12 months, or even more. For the details on registered and fully licensed managers, see **2.1.2 Common Process for Setting Up Investment Funds**.

### 2.3.5 Rules Concerning Pre-marketing of Alternative Funds

A stricter regulation of pre-marketing activities and of the content of marketing materials has applied since the harmonised European regime for pre-marketing of alternative investment

funds came into force in August 2021 (Directive (EU) 2019/1160 and the related Regulation (EU) 2019/1156)). The European marketing regime provided by the EU Directive only applies to marketing activities by, or on behalf of, EU managers.

The German Implementation Act, however, extends the EU pre-marketing rules to non-EU managers. The commencement of pre-marketing of an AIF in Germany by a German or non-German manager (except for “registered-only” managers) needs to be notified to BaFin directly or through the respective regulator of an EU manager, and any subscription by German investors within 18 months following the commencement of pre-marketing will require adherence to the formal marketing notification and, thus, precludes reverse solicitation.

### 2.3.6 Rules Concerning Marketing of Alternative Funds

Germany understands marketing activities to be any direct or indirect offering or placement of units or shares in an investment fund. Reverse solicitation is currently not regarded as marketing, but its scope is further limited due to the pre-marketing regime.

Marketing materials must be in line with the European Securities and Markets Authority (ESMA) guidelines on the fair and not misleading standard of the content of marketing materials. These guidelines mirror the rather strict rules under the MiFID regime.

For placement activities in Germany by EU “registered-only” or non-EU managers, the BaFin FAQs maintain the position that placement by a manager, in particular, takes place with regard to a fund if:

- the fund has been established (ie, first closing with investors); or
- the terms of the fund are ready to be sent for acceptance to investors.

Such FAQs also stipulate that reverse solicitation – ie, the approach of a manager by a German investor on its own initiative – will be permissible even on the basis of general advertisement activities of such manager if unrelated to particular funds.

### 2.3.7 Marketing of Alternative Funds

AIFs can basically be marketed to retail and non-retail investors. However, alternative funds that are closed-end Special AIFs can only be marketed to professional and semi-professional investors. The EU EuVECA regime and the European long-term investment funds (ELTIF) regime apply to the marketing of EuVECA funds and ELTIF funds in the EU and in the EEA.

### 2.3.8 Marketing Authorisation/Notification Process

The marketing of alternative funds requires an authorisation by BaFin or at least a European marketing passport under the AIFMD, except for marketing by German sub-threshold managers.

Depending on the type of investment fund and whether retail investors are targeted, the notification process and the materials to be presented to BaFin vary.

To the extent an EU-AIFM has notified the marketing of an AIF in Germany to its local regulator, BaFin generally only reviews whether the notification and materials provided by such local regulator are complete, and marketing may already commence when such local regulator has informed the EU-AIFM of the submission to BaFin.

### 2.3.9 Post-marketing Ongoing Requirements

As explained in 2.1.4 Disclosure Requirements, there are annual reporting requirements for managers of retail funds and managers of non-retail funds. There are also semi-annual reporting requirements for contractual funds and AG with variable capital. The reports need to be published.

### 2.3.10 Investor Protection Rules

As explained in 2.3.1 Regulatory Regime, Germany recognises the concept of Special AIFs, which are AIFs whose interests or shares may only be acquired according to the fund documents by professional investors within the meaning of the AIFMD or by semi-professional investors. Special AIFs themselves are either subject to a lighter regulatory regime than retail funds (in the case of fully licensed managers) or are not subject to a regulatory regime at all (in the case of a German sub-threshold manager, except for debt funds).

### 2.3.11 Approach of the Regulator

In the authors' experience, BaFin is generally co-operative and open to discussions. Expected timeframes can sometimes be an issue, particularly where BaFin is requested to answer questions on new issues.

BaFin regularly takes enforcement actions, with enforcement usually being a proportionate, step-by-step approach. Often, BaFin just issues a request for explanations as a warning and takes further actions only if the answers are not satisfactory.

## 2.4 Operational Requirements

The investment-type restrictions for regulated general special funds translate only into assets that can be valued at fair value and risk diversification. In practice, regulated special funds are

often set up under a specific fund category (eg, special funds with fixed investment guidelines). Accordingly, for these funds, investment-type restrictions apply based on the chosen fund category and individualised investment guidelines (eg, real estate focus or debt fund).

Borrowing restrictions depend on the chosen fund category. For instance, special funds with fixed investment guidelines allow short-term borrowing of up to 30% of their net asset value and, for real estate, up to 60% of the real estate value. For German debt funds, the borrowing restriction is 30% of the capital available for investment.

If the fund manager is fully licensed, they must appoint a depository or special private equity custodian for each of its funds (as required by the AIFMD).

The valuation and pricing of the fund's assets must be in line with the AIFMD requirements – ie, fair value.

The operational requirements of a fully licensed manager are in line with the AIFMD. In addition, fund managers must adhere to rules that apply to all market participants, such as the EU-based rules on insider dealing and market abuse, transparency, money laundering and short selling. Special manager-internal rules apply to the manager as regards debt funds.

Sub-threshold managers are only subject to a light-touch regulatory regime. Accordingly, no operational requirements apply, in principle, from a regulatory perspective (except as regards debt funds).

## 2.5 Fund Finance

### Accessibility to Borrowing for Funds

Funds that are eligible for non-trading treatment from a tax perspective (see also 2.6 Tax Regime) are generally not permitted to raise debt at fund level nor to provide guarantees or other forms of collateral for the indebtedness of portfolio companies. As an exception, tax authorities have accepted that funds can enter into a capital call facility subject to certain restrictions, and the number of funds making use of this concession has increased, as has the number of financial institutions offering capital call facilities to German funds. Leverage is not permitted for tax reasons and is restricted for regulatory reasons.

### Restrictions on Borrowings

The criteria for non-trading treatment from a tax perspective do not allow borrowings at fund level. As an exception, short-term borrowings to bridge capital calls are accepted by tax authorities. While “short-term” has not been defined, borrowings cannot remain outstanding for more than 270 calendar days. Fund managers need to first issue the capital call and can thereafter draw down the amount under the capital call facility. The amount so borrowed is then repaid out of the capital contributions.

### Lenders Taking Security

Under German law, the investors' commitment to the capital of a fund is not an asset that can be pledged in favour of the capital call facility provider. As a consequence, capital call facility agreements entered into by German funds typically provide that payments of capital contributions shall be made to a bank account maintained with the facility provider that is pledged in its favour. In addition, the facility provider reserves the right to claim payment of capital contributions directly from investors when due, and to enforce the fund's rights under the fund

agreement in the event of default. Assets and investments held by the fund are typically not pledged as collateral.

## Common Issues in Relation to Fund Finance

Common issues include the following:

- financial covenants regarding excused investors in respect of an investment by reference to the number of excused investors and the total amount; and
- default situations pending at the time of a drawdown under the facility agreement by reference to the number of defaulting investors and the total amount.

Investors typically object to the requirement to provide financial information unless publicly accessible.

Because of the general restriction on providing guarantees and other forms of collateral for the indebtedness of portfolio companies, equity commitment letters are very often used as an alternative. They should not interfere with the general restrictions on providing guarantees if structured as an agreement between the fund and its portfolio company whereby the fund undertakes to provide additional capital in the event that the portfolio company is in payment default or in breach of financial covenants. Such undertaking, however, should not be pledged by the portfolio company in favour of its creditors, in order to avoid being treated as a guarantee of the fund. The portfolio company can undertake in the agreement with its creditors not to change, amend or waive the fund's equity commitment letter other than with the consent of its creditors.

## 2.6 Tax Regime

The tax regime applicable to fund structures depends on whether a fund is organised as a corporate entity or a partnership.

### Funds Organised as Partnerships

The tax regime applicable to funds organised as partnerships is as follows.

#### *Fund structures*

Consistent with international standards, German funds are typically structured as partnerships that are eligible for non-trading treatment and avoid their investment activities constituting a trade or business attributable to a permanent establishment. The non-trading requirements for private equity and venture capital funds are set out in an administrative pronouncement and include the following:

- no borrowings and guarantees on fund level (other than fund finance, as described in 2.5 Fund Finance);
- no reinvestment of proceeds, subject to two exceptions:
  - (a) proceeds up to an amount previously drawn down to fund management fees and fund expenses can be reinvested to ensure that an amount representing 100% of the total capital commitments can be invested in portfolio companies; and
  - (b) an additional amount not exceeding 20% of the total capital commitments can be reinvested to fund follow-on investments;
- a weighted average holding period of investments of at least three years; and
- no involvement in the operating management of portfolio companies whereby representation on the supervisory or advisory board of portfolio companies in a non-executive, monitoring capacity is permitted.

While the administrative pronouncement has recently been questioned by the courts, it is still applied by the fiscal authorities.

Management of private equity and venture capital funds by German managers used to be subject to VAT in Germany. However, a general exemption in line with European laws was introduced in 2023, and fund management services are generally no longer subject to VAT.

### *Allocations and distributions to investors*

Funds structured as partnerships are treated as transparent for German tax purposes, so taxable income allocated to the investors is subject to tax regardless of whether or not the fund made distributions. Non-resident investors of funds that are eligible for non-trading treatment are generally not subject to a German tax filing obligation in respect of their allocable share of the fund's taxable profit. The fund files a partnership return showing the items of taxable income received by the fund partnership and each investor's allocable share thereof. Non-German investors are included in the partnership return only for information purposes. They are subject to tax in their country of residence in accordance with their personal tax status.

Distributions by the fund to investors are not subject to German withholding tax. Dividends received by the fund from German portfolio companies as well as payments by German portfolio companies on certain German-source profit-linked debt instruments (such as silent partnership interests, *jouissance* rights and profit-sharing loans) are subject to withholding tax at the rate of approximately 26.4% (including solidarity surcharge) at source. Generally, the withholding agent (German portfolio companies or a German issuer of a profit-linked debt instrument) is not permitted to apply a reduced rate of

withholding (eg, under an applicable tax treaty). Non-German investors that are entitled to treaty benefits with respect to such items of income must file a refund application with the German federal tax office, which is awarded subject to the fulfilment of certain procedural requirements.

### *Carried interest participants*

The German fiscal authorities characterise carried interest payments as a compensation for professional services, and carried interest payments are not taxed in accordance with the rules applicable to the source from which such payments are derived. Carried interest payments by private equity funds and venture capital funds that are eligible for non-trading treatment are eligible for a partial tax exemption of 40%, and the remaining 60% is subject to tax at the marginal income tax rate of the carried interest participant.

According to German fiscal authorities, carried interest payments by funds that are treated as trading are fully subject to tax at the marginal income tax rate of the carried interest participant. According to a decision rendered by the German federal tax court in December 2018, carried interest payments by funds that are treated as trading are subject to tax in accordance with the tax rules applicable to the source from which the carried interest payments are derived. It is an open issue whether this favourable court decision will be generally applied by the German fiscal authorities.

Carried interest payments are not subject to VAT.

### **Taxation of Investors of Domestic and International Partnership-Type Funds**

The following description is limited to funds organised as partnerships.

## *Domestic funds eligible for non-trading treatment*

Partnership-type funds are treated as transparent for German tax purposes. Therefore, taxable income allocated to the investors is subject to tax at its level and in accordance with its tax status, regardless of whether or not the fund made distributions.

## *Resident corporate investors*

95% of a resident corporate investor's allocable share of equity capital gains is exempt from tax; the remaining 5% and all other items of income (interest, dividends) are subject to German corporate income tax and trade tax. The 95% exemption does not apply to life and healthcare insurance companies.

## *Non-resident corporate investors*

A non-resident corporate investor's allocable share of German equity capital gains is exempt from German tax. Dividends received from German portfolio companies and payments on certain profit-linked debt instruments by German issuers are subject to German withholding tax at the rate of approximately 26.4%. Tax treaty-protected investors may file an application with the German federal tax office for a refund of German withholding tax under the applicable tax treaty. Income derived from non-German portfolio companies is not taxable in Germany for non-resident corporate investors.

## *Non-German funds*

Regardless of the qualification of their investment activities, non-German funds are typically deemed to be trading from a German tax perspective due to their legal structure.

## *Resident corporate investors*

The allocable share of a non-German (deemed) trading fund's taxable profits is subject to Ger-

man tax. 95% of equity capital gains is exempt from corporate income tax and 100% is exempt from trade tax. These exemptions do not apply to life and healthcare insurance companies. The full amount of interest and dividends is subject to corporate income tax, but trade tax is levied only on interest and on dividends where the fund holds less than 10% of the company paying the dividend.

## *Non-resident corporate investors*

The deemed trading status of non-German funds does not affect their taxation in Germany. Their allocable share of German equity capital gains is exempt from German tax. However, they may be required to file a German tax return where they have held 1% or more of the share capital of the German company, the shares of which were sold or disposed of (determined on a look-through basis) during the last five years prior to such sale or disposition. They are only subject to tax in Germany in respect of items of income derived from German sources that are subject to German withholding tax at a rate of approximately 26.4% – ie, German dividends and payments on certain profit-linked debt instruments by German issuers. Tax treaty-protected investors may apply to the German federal tax office for a refund under an applicable tax treaty.

## **Corporate-Type Funds**

The taxation of corporate-type funds (including funds of a contractual type such as the German *Sondervermögen* and non-German fund vehicles that resemble a German *Sondervermögen*, including trusts) and their investors is governed by the German Investment Tax Act.

## *Fund level*

A corporate-type fund is a taxpayer in and of itself. Regardless of whether its place of business management is located in or outside Ger-

many, only certain items of German-source income are subject to tax at the level of the fund:

- German-source dividends;
- income derived from German real estate (not dealt with herein); and
- trading income attributable to a German permanent establishment, but excluding capital gains realised upon the sale of shares of companies. However, if such shares form part of a trade or business and are attributable to a German permanent establishment, the full amount of capital gains from the sale of such shares by a corporate-type fund and any other trading income attributable to such German permanent establishment is subject to German tax at the level of such corporate-type fund.

## *Investor level*

### *Non-resident corporate investors*

Distributions by corporate-type German or non-German funds to non-resident investors are not subject to (withholding) tax in Germany.

### *Resident corporate investors*

Resident investors are subject to German tax on the following three items of income derived from a corporate-type fund:

- all distributions;
- a lump-sum advance amount that represents a minimum yield and is only subject to tax if the corporate-type fund does not make distributions equal to, or exceeding, the lump-sum advance amount; and
- capital gains realised upon the sale of shares of the corporate-type fund either in a secondary transaction with a third party or in connection with a redemption of shares or a share buy-back by the corporate-type fund.

These three items of income subject to tax at the level of resident investors are eligible for a partial tax exemption in order to mitigate double taxation at fund and investor level if the corporate-type fund qualifies as a so-called equity fund or mixed fund. An equity fund is a corporate-type fund whose binding investment guidelines provide that more than 50% of the total net assets is directly invested throughout the entire fiscal year in equity instruments issued by companies. For a mixed fund, the relevant threshold for direct equity investments is at least 25%.

For equity funds, the partial tax exemptions for taxable resident corporate investors (other than life or healthcare insurance companies) amount to 80% for corporate income tax purposes and 40% for trade tax purposes. In respect of mixed funds, the partial tax exemptions amount to half of the exemptions applicable to equity funds.

## **Germany's Tax Treaty Network and Its Impact on the Funds Industry**

Germany's tax treaty network is extensive and covers, among others, all member states of the EU and the OECD. German tax treaties generally follow the OECD Model Convention. German corporate-type funds should be eligible for protection by German tax treaties regardless of the fact that their tax bases only include certain items of German-source income. Because distributions by German corporate-type funds to non-resident investors are not taxable in Germany under German domestic tax law, non-resident investors need not rely on treaty benefits in this regard.

Funds organised as partnerships are transparent for income tax purposes. German investors benefit from Germany's tax treaty network because the geographic focus of funds typically relates to tax treaty countries. Funds investing in Ger-



many benefit from Germany's tax treaty network because their fundraising very often relates to investors resident in tax treaty countries.

## FATCA and CRS Regimes in Germany

Germany has entered into a Model-1 intergovernmental agreement (IGA) with the USA and has incorporated the reporting and disclosure requirements under the Foreign Account Tax Compliance Act (FATCA) as modified by the IGA into German domestic law. Accordingly, German fund managers have to file information under FATCA with the German federal tax office, which exchanges such information with the US Internal Revenue Service (IRS). As a consequence, German fund managers do not have a direct obligation towards the IRS regarding FATCA reporting and disclosure.

Germany has also incorporated the Common Reporting Standard (CRS) into domestic law. As a result, German fund managers have an obligation under German domestic law to file information under the CRS with the German federal tax office, which exchanges this information with the competent tax authorities of the participating countries of the CRS.

## DAC 6

The tax treatment and tax structure of partnership-type funds is typically not subject to filing requirements under DAC 6 (EU Council Directive 2011/16 in relation to cross-border tax arrangements). In particular, the trading or non-trading status of a partnership-type fund should not give rise to filing obligations under DAC 6. Moreover, the German tax authorities have provided guidance that the PPM or a similar document that outlines the risks and benefits of an investment does not constitute standardised documentation within the meaning of Hallmark A 3 of Part II of Annex IV to DAC 6.

Currently, there are discussions to extend filing requirements similar to DAC 6 to merely domestic tax arrangements. Respective legislation is still pending and it is not entirely clear if and when such filing requirements will enter into force.

## The Anti-Tax Avoidance Directive (ATAD)

As Germany, like most other countries, treats partnerships as being tax-transparent, an investment in a partnership-type fund should not give rise to hybrid mismatches. However, if an investor is residing in a country that treats partnerships as opaque, any income of a German partnership-type fund attributable to such investor is subject to German tax to the same extent as if such investor were resident in Germany.

Investments in funds of a contractual type, such as the German *Sondervermögen* or non-German fund vehicles that resemble a German *Sondervermögen*, may give rise to hybrid mismatches, particularly in situations where the home jurisdiction of a non-German fund of a contractual type treats this fund as tax-transparent while Germany treats such funds as opaque under the German Investment Tax Act.

## 3. Retail Funds

### 3.1 Fund Formation

#### 3.1.1 Fund Structures

As a starting point, retail investors are neither professional nor semi-professional investors (see 2.3.1 Regulatory Regime).

Retail funds are typically set up as UCITS funds or as so-called Public AIFs (as opposed to Special AIFs). Legal vehicles are mostly contractual-type funds (*Sondervermögen*) for open-end structures, and investment limited partnerships

for closed-end retail funds. Corporate structures are less common in the retail sector as they are more complicated.

The choice of the vehicle is, in principle, dependent on whether an open-end fund or a closed-end fund is desired.

### Arrangements and Vehicles for Open-End Funds

For open-end funds, the contractual fund and the investment corporation with variable capital structures are available. They can have different classes of units or shares, and can also establish sub-funds (umbrella structure). For open-end funds, most fund managers prefer a contractual fund to a corporation as the setting up and operation are easier.

### Vehicles for Closed-End Funds

For closed-end funds, the only available vehicles for retail funds are the investment corporation with fixed capital and the closed-end investment limited partnership. Managers can only set up a closed-end fund in the form of a contractual fund for non-retail investors.

Both vehicles can issue different classes of shares or interests and establish sub-funds (umbrella structure).

### 3.1.2 Common Process for Setting Up Investment Funds

The contractual fund is established by the fund manager on a contractual basis with the investor. The contractual fund is a pool of assets separated by statute and contract from the (other) assets of the fund manager. The investment guidelines for contractual funds set out the details of the contractual relationship between the fund manager and the investors, particularly the applicable investment restrictions.

Investment corporations and investment limited partnerships are basically corporations and limited partnerships, with some modifications required by investment law. They are established in accordance with the applicable procedures for establishing corporations and partnerships (with some modifications because of investment law). In addition to the articles of incorporation or the limited partnership agreement (LPA), separate investment guidelines are necessary.

The investment guidelines and marketing of retail funds need BaFin approval. BaFin also has to approve the selection of the depositary for the respective retail fund. The approvals are usually obtained in parallel with each other.

Depending on the type of fund, the process can be rather short in the case of a standardised fund product, or it can be rather lengthy and expensive in the case of a bespoke alternative asset retail fund (in particular, a closed-end fund).

### 3.1.3 Limited Liability

As further described in 2.1.3 Limited Liability, investors admitted to investment funds in Germany benefit from limited liability.

### 3.1.4 Disclosure Requirements

An extensive disclosure document (prospectus) is required if an AIF is marketed to retail investors. The prospectus must contain the following minimum information, where applicable:

- general information on the investment fund;
- the investment policy of the investment fund;
- risks and investor profile;
- the manager, depositary and auditor;
- outsourcing;
- the issue, redemption and conversion of units; and
- past performance.

There are also specific minimum information requirements for the prospectus of closed-end Public AIFs.

In addition to the prospectus, so-called key investor information must also be provided. The key investor information was supplemented by the key information document (KID) in accordance with the European PRIIP (packaged retail and insurance-based investment products) Regulation.

For UCITS, Germany follows the disclosure rules of the UCITS Directive, and since 2 August 2021 has required that the UCITS prospectus informs the investors about the “facilities” established for local investors under the EU Directive on cross-border distribution of investment funds (Directive (EU) 2019/1160).

As described in **2.1.4 Disclosure Requirements**, there are annual reporting requirements for managers of retail funds and managers of non-retail funds. There are also semi-annual reporting requirements for contractual funds and AG with variable capital. The reports need to be published.

## 3.2 Fund Investment

### 3.2.1 Types of Investors in Retail Funds

Retail funds can be subscribed by retail investors as well as by professional and semi-professional investors.

### 3.2.2 Legal Structures Used by Fund Managers

For open-end funds, the contractual fund and the investment corporation with variable capital structures are available.

For closed-end funds, the only available vehicles for retail funds are the investment corporation

with fixed capital and the closed-end investment limited partnership.

For details concerning operational requirements regarding retail funds, please see **3.1.1 Fund Structures** and **3.1.2 Common Process for Setting Up Investment Funds**.

### 3.2.3 Restrictions on Investors

There are only a few restrictions for investors investing in retail funds – eg, German Solvency I investors may not invest in retail open-ended real estate investment funds.

## 3.3 Regulatory Environment

### 3.3.1 Regulatory Regime

The main law governing retail funds is the KAGB, which is based on the AIFMD and the UCITS Directive and which is supplemented by German-specific rules for retail funds. In addition, several lower-level ordinances apply (the Derivative Ordinance, the Organisational and Rules of Conduct Ordinance and the Mediation Ordinance).

This set of laws is supplemented by self-regulatory standards, mainly the Rules of Good Conduct issued by the German Investment Funds Association and the Association’s sample investment guidelines.

As described in **2.3.1 Regulatory Regime**, a full fund management licence opens the door for a manager to market funds to retail investors.

### 3.3.2 Requirements for Non-local Service Providers

Please see **2.3.2 Requirements for Non-local Service Providers**.

### 3.3.3 Local Regulatory Requirements for Non-local Managers

The management of a retail AIF is not permitted for non-local managers.

For UCITS, management by non-local UCITS managers is possible via the cross-border passport under the UCITS Directive.

### 3.3.4 Regulatory Approval Process

The licensing procedure can take from six to 12 months, or sometimes longer.

### 3.3.5 Rules Concerning Pre-marketing of Retail Funds

The rules concerning pre-marketing only apply to AIFs, as noted in **2.3.5 Rules Concerning Pre-marketing of Alternative Funds**.

### 3.3.6 Rules Concerning Marketing of Retail Funds

Retail funds can be marketed only by the following three categories of “marketers”.

- The fund manager itself can always market its “own” funds and, if fully licensed (ie, not only registered as a sub-threshold manager), may also market investment funds of other managers.
- MiFID firms are entitled to market investment funds (provided they have a MiFID licence or passport for investment advice and the transmission or receipt of orders).
- Firms or individuals with a financial intermediary licence under the German Commerce Act (GewO) may also market retail funds. The financial intermediary licence is a non-MiFID licence and is based on the optional exemption from MiFID II stipulated in Article 3 of MiFID II. However, since 2 August 2021, these firms or individuals may no longer engage in pre-marketing on behalf of a manager.

If the retail fund is marketed by the fund manager itself, the fund manager must make the fund documents and the latest semi-annual and annual fund reports available to the prospective investor. In addition, certain ongoing publication requirements apply (such as the publication of fund documents and fund reports on the manager’s website).

For MiFID firms, Germany considers the prospective investor as the regulatory client of the MiFID firm. Accordingly, MiFID firms have to adhere to the MiFID II rules of good conduct towards the prospective investor (requiring items such as suitability or appropriateness checks). This applies in a broadly similar fashion to the above-mentioned GewO firms. The MiFID application further means 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). As mentioned in **2.3.6 Rules Concerning Marketing of Alternative Funds**, since 2 August 2021, managers have been subject to similar requirements on the content of their marketing materials as MiFID firms.

### 3.3.7 Marketing of Retail Funds

Retail funds can be marketed to any investor in Germany (regardless of whether the investor is professional, semi-professional or retail).

### 3.3.8 Marketing Authorisation/Notification Process

The marketing of alternative funds or UCITS to retail investors requires either an authorisation by BaFin or, with respect to UCITS, a European marketing passport under the UCITS Directive.

### 3.3.9 Post-marketing Ongoing Requirements

There are annual and semi-annual reporting requirements for managers of retail funds. The

reports need to be published. Furthermore, the redemption price must be published as well as any disclosures made in the home country of such manager.

### 3.3.10 Investor Protection Rules

In addition to as previously discussed in **2.3.10 Investor Protection Rules**, civil law prospectus liability rules offer effective protection for retail investors. Basically, civil law prospectus rules impose a liability on the manager and initiator of the fund. The measuring stick is whether the prospectus is incomplete or misleading in aspects that are material for the investment decision of a typical investor.

### 3.3.11 Approach of the Regulator

As noted in **2.3.11 Approach of the Regulator**, BaFin is generally co-operative and open to discussions.

## 3.4 Operational Requirements

Germany offers different types of retail funds – eg, UCITS, real estate funds, funds of hedge funds, closed-end funds and infrastructure funds. The fund types are based on the UCITS investment and borrowing restrictions as the default rules. The investment and borrowing restrictions are then modified to fit each fund type.

The KAGB contains a catalogue of assets in which a closed-end Public AIF may invest. The investment in other funds by a closed-end Public AIF is restricted (ie, the structuring of a fund of funds or feeder fund as a retail fund).

For a further overview, see **2.4 Operational Requirements**.

## 3.5 Fund Finance

The explanations given in **2.5 Fund Finance** (regarding alternative investment funds) also apply to fund finance for retail funds.

## 3.6 Tax Regime

German tax law does not provide for a specific tax regime applying to funds targeting retail investors. However, for taxation at investor level, different tax rules apply to institutional corporate investors and retail individual investors. The rules for retail individual investors are as follows.

### Funds Organised as Partnerships

#### *Domestic funds eligible for non-trading treatment*

##### *Resident retail individual investors*

A resident retail individual investor's allocable share of interest, dividends, capital gains relating to debt instruments and equity capital gains of shareholdings representing an indirect interest of less than 1% are subject to German income tax at a flat rate of approximately 26.4% (including solidarity surcharge) plus church tax, if applicable. Equity capital gains of shareholdings representing an indirect interest of 1% or more are subject to German income tax levied at the marginal tax rate, but 40% of such capital gains are exempt from income tax.

##### *Non-resident retail individual investors*

A non-resident retail individual investor's allocable share of interest (other than profit-linked), dividends from non-German portfolio companies, capital gains relating to debt instruments and equity capital gains aside from shareholdings in German portfolio companies representing an indirect interest of less than 1% are not subject to German income tax.

Equity capital gains of shareholdings in German portfolio companies representing an indirect

interest of 1% or more are subject to German income tax at the marginal tax rate, but 40% is exempt from income tax. Tax will be levied by way of assessment, based upon a German tax return to be filed by the non-resident retail individual investor. Such German tax-paying obligation does not apply to non-resident retail individual investors who are entitled to tax treaty benefits.

A non-resident retail individual investor's allocable share of dividends from German portfolio companies is subject to German withholding tax at the rate of approximately 26.4%, and investors who are entitled to tax treaty benefits can file an application with the German federal tax office for a refund of the excess of the German withholding tax over the amount permitted under the applicable tax treaty.

### **Non-German funds**

#### *Resident retail individual investors*

As set forth in **2.6 Tax Regime**, non-German funds are typically trading from a German tax perspective. Accordingly, a resident retail individual investor's allocable share of a non-German fund's taxable profits is subject to German income tax as follows: 60% of equity capital gains and dividends, and the full amount of interest is subject to German income tax at the marginal tax rate.

#### *Non-resident retail individual investors*

While non-German funds are typically trading from a German tax perspective, they typically do not operate a German permanent establishment to which their income would be attributable. Accordingly, a non-resident retail individual investor's allocable share of the taxable profits of a non-German fund is subject to German tax only on German-source items of income, in accordance with the rules explained above for

German funds that are eligible for non-trading treatment.

### **Corporate-Type Funds**

#### *Non-resident retail individual investors*

Income derived from German or non-German corporate-type funds (including funds of a contractual type such as the German *Sondervermögen* and non-German fund vehicles that resemble a German *Sondervermögen*) is not subject to tax in Germany.

#### *Resident retail individual investors*

The three items of income described in **2.6 Tax Regime** and derived by them from a German or non-German corporate-type fund are subject to German income tax at a flat rate of approximately 26.4% (including solidarity surcharge) plus church tax, if applicable. The partial tax exemptions for which they may be eligible amount to 30% in respect of equity funds and 15% in respect of mixed funds. Resident retail individual investors are not subject to trade tax.

## **4. Legal, Regulatory or Tax Changes**

### **4.1 Recent Developments and Proposals for Reform**

Germany is constantly implementing any EU directives and modernising its rules, by a number of amendments to the KAGB. Recent changes have already been discussed throughout this article, where relevant. In addition, BaFin reviews and updates its administrative pronouncements and FAQs on a regular basis.

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