YPOG Briefing:
Circular on VAT Exemption for Management of Venture Capital Funds published

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On June 24, 2022, the German Federal Ministry of Finance (BMF) published the long-awaited circular on the VAT exemption for the management of venture capital funds.

The VAT exemption was introduced by the legislator with the "Act to strengthen Germany as a fund location" as of July 2021 (FoStoG) (see YPOG Briefing: VAT exemption for the management of "venture capital funds": fulfillment of a wish for selected funds or aid contrary to EU law?). Until the FoStoG, the wording of the VAT exemption only covered the management of undertakings for collective investment in transferable securities (UCITS) and similar alternative investment funds (AIF), which, according to the – unconvincing and also inconsistently applied – opinion of the tax authorities, particularly excluded PE and VC funds in the form of closed-end special AIFs.

The FoStoG lacks a definition of the term "venture capital fund". As a result, there has been considerable legal uncertainty for PE and VC funds as to whether the fees payable for fund management are VAT exempt.

With the circular now published, the BMF has for the first time taken a binding position on the interpretation of the term "venture capital fund" and clears up several ambiguities that were raised by a draft circular of March 2022, but continues to lack clarification on the (core) question that VC funds managed by so-called "sub-threshold" managers are also subject to the VAT exemption, despite explicit announcements made in the course of the public consultation process:

- It is now clear that, from the perspective of the tax authorities, EuVECA funds that invest primarily in companies that are not older than 12 years can regularly benefit from the VAT exemption without further restrictions.

- In addition, the circular clarifies that the tax administration intends to limit the VAT exemption to managers of VC funds investing in startups, while other PE strategies should not be considered as "management of a venture capital fund".

- However, it is unclear whether the tax authorities – contrary to the announcements made during the public consultation process – assume that AIFs managed by so-called "small" fund managers with registration according to Section 2 (4) of the German Capital Investment Code (KAGB) and not qualifying as EuVECA funds can benefit from the exemption.

The tax authorities will apply the circular to service supplies after June 30, 2021, but will not object if management fees are treated as subject to VAT until June 30, 2022, and the fund manager claims input tax deduction on input services. Below we summarize the key aspects of the circular.

Regulatory Classification of the Fund as a Prerequisite for VAT Exemption

According to the BMF, the first prerequisite for the VAT exemption is that the fund either qualifies as a EuVECA fund or is "at least" subject to the same competitive conditions as UCITS and subject to special state regulation.

Unfortunately, this wording is only clear for EuVECA funds.

The circular lacks any hints on meaning of the prerequisites for AIFs to be at least subject to the same competitive conditions as UCITS (i.e. open-ended mutual funds) and to special state regulation. In order to concretize the requirements, the application letter merely refers to – also quite vague – parallel regulations of the VAT decree relating to the previous statutory wording of the VAT exemption. According to the VAT decree, all KAGB-regulated AIFs are in principle subject to "special state supervision" comparable to UCITS. Whether also the AIFs of "sub-threshold" fund managers (falling under significantly limited regulatory requirements according to Section 2 (4) KAGB), are therefore considered as such KAGB-regulated AIFs (rather than only AIFs of fully regulated managers, which have to comply with all KAGB requirements if their assets under management exceed EUR 500 million [or in case of leverage: EUR 100 million]), remains unclear, although this question is crucial for a considerable part of German VC funds, and thus for the effectiveness of the VAT exemption.

Moreover, the circular lacks a clarification that also "sub-threshold" fund managers (may) be subject to the "same competitive conditions" as UCITS. According to the referenced VAT decree, an AIF is subject to comparable competitive conditions with UCITS if the AIF is subject to "comparable duties and controls". Such comparability may lack due to the fact that a registration under Sec. 2 (4) KAGB comes with lower regulatory requirements than those applicable to UCITS. However, this would undermine the very purpose of the Section 2 (4) KAGB regime. The regulatory relief for "sub-threshold" fund managers is based on the legislator's intention to subject those managers to a lower regulatory standard, which should not be burdened with a VAT disadvantage for "sub-threshold" fund managers.

In our opinion, no straightforward conclusions can be drawn from the circular regarding the possible VAT exemption for "sub-threshold" fund managers. This result is questionable because it is contrary to the legislator's intention to strengthen Germany as a fund location and it is incomprehensible why VC funds managed by "sub-threshold" managers without (yet) the need for an EU-wide operating radius should be excluded from the VAT exemption (especially since, de facto, it can be assumed that the vast majority of these "sub-threshold" VC funds also meet the material requirements of the EuVECA Regulation). Besides, such limited interpretation of the term VC funds contradicts the principle of VAT neutrality, according to which the personal circumstances of the service provider are irrelevant when applying the VAT Act. It would therefore be desirable for the BMF to provide the clarification promised in the public consultation process as soon as possible. Until then, the VAT exemption for "sub-threshold" fund managers goes along with legal uncertainty. YPOG will continue to follow the development and keep you up to date. We recommend that affected funds contact us to discuss how this legal uncertainty can be dealt with in each individual case.

Requirements for the Investment Strategy of the Fund as a Prerequisite for VAT Exemption

In addition to the regulatory classification, the BMF circular imposes requirements on the fund's investment strategy as a second prerequisite for qualification as a venture capital fund.

According to the BMF, EuVECA funds benefit from the VAT exemption for fund management if they "exclusively or predominantly" invest in "growth companies". In any case, this clarifies that the management of typical PE funds, real estate funds or infrastructure funds is excluded from the VAT exemption and, in the view of the tax authorities, only VC funds investing in startups may benefit from the VAT exemption.

The circular further specifies the requirements for a beneficiary investment strategy and "growth companies":

1. **Investment Strategy - "Exclusive or Predominant" Investments in Growth Companies**

   Following the BMF, eligible VC funds, by virtue of their contractual investment terms, must be required to "exclusively or predominantly" invest in growth companies. The fund's investment strategy relevant for the VAT exemption may therefore be derived from its investment terms. According to the BMF, the fund's investment terms are proof for a corresponding investment strategy.

   In principle, the link to the investment terms is reasonable. However, it is not entirely clear whether actual compliance with the investment strategy criteria is sufficient, even if the investment terms do not expressly provide such strategy. In this respect, a clarification by the tax authorities would be helpful.

   Furthermore, compared to the draft, the circular contains a useful clarification of the term "predominant" investments in growth companies. According to the BMF, predominance means the obligation to invest more than 50% of the capital contributions or the uncalled capital commitments in growth companies. This requirement must be part of the fund's investment terms for the entire duration of the fund.

2. **"Growth Companies"**

   According to the BMF, growth companies must fulfill four requirements:

- The company is max. 12 years old at the time of the fund's initial investment. The growth stage of the portfolio company at the time of the initial investment is irrelevant. It is a positive development that the BMF has dispensed with the rather unclear restrictions to the "seed stage, early stage or expansion stage" or "young and innovative" growth companies still contained in the draft.

- The company meets, at the time of the fund's initial investment, the requirements of a "qualified portfolio company" within the meaning of the EuVECA Regulation. Accordingly, it must be an unlisted company with up to 499 employees (without regard to sales thresholds or balance sheet sizes) or listed on an SME growth market with an average market capitalization of less than €200 million over the last three years.

- The company is domiciled in the EU or in a third country that is not on the list of non-cooperative jurisdictions for tax purposes and that has committed to exchange tax information with the jurisdiction of the fund manager and all distribution states. The geographical requirements for the domicile of growth companies have been considerably lowered compared to the draft version, which contained a restriction to EU and EEA states.

- The company has profit-making intent.

  These restrictions will regularly be met in the case of EuVECA funds. The direct reference to the EuVECA Regulation creates legal certainty in this respect.

  Nevertheless, it remains questionable whether the limitations imposed by the BMF do justice to the statutory wording ("venture capital funds"). The legislator's goal of strengthening Germany as a fund location is hardly achieved due to excluding growth and continuation funds, let alone further PE strategies or innovative asset categories such as crypto funds. The restriction to companies with fewer than 500 employees and a maximum age of 12 years is also hardly reconcilable with the current federal government's goal of providing greater support for the financing of companies in more advanced growth stages.

  Besides, the risks under European law, which we already pointed out in our briefing on the introduction of the statutory regulation, remain or are even intensified by the restrictive interpretation of the statutory provisions.

Outlook and Possible Action Points

Given the circular, we recommend checking again on a potential need for concrete action and measures to improve the VAT situation or to achieve more legal certainty. Among other things, the following may be considered:

- EuVECA registration in order to benefit from the VAT exemption with legal certainty,

- Examination of the contractually defined investment strategy and, if necessary, its adjustment,

- Examination of whether current portfolio companies meet the requirements for "growth companies" as defined by the BMF circular,

- Analysis of the tax consequences of a VAT exemption for the capital management company (input tax deduction),

- Examination of the applicability of the VAT exemption in specific constellations, e.g. in the case of funds of funds or the outsourcing of fund management services to third parties.

Against the background of the uncertainties regarding the interpretation of the term "venture capital fund", which continue to exist even after the publication of the circular, it is a positive development that the BMF recently announced a future extension of the VAT exemption by means of statutory law.

We will closely follow these and other developments and inform you of any news. Please do not hesitate to contact us if you have any questions or the need for advice on how to deal with the VAT exemption in practice.