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# Fund Jurisdiction Act – News for Private Equity and Real Estate

**According to the explanatory memorandum to the Act, the primary objective of the Fund Jurisdiction Act was to improve Germany's international competitiveness as a location for employee share ownerships, particularly with regard to start-ups. In addition, the disadvantage for Germany as a fund location, caused by VAT levying on the administrative services of venture capital funds, was to be eliminated as well. Almost unnoticed and shortly before its adoption by the Bundesrat, a significant improvement in the so-called extended trade tax reduction for real estate companies also found its way into the law. This article will briefly introduce the latter two topics with a view to practical applications.**

## I. Co-letting of operating equipment – all's well that ends well?

If let properties located in Germany are held by a property company, usually a limited liability company (GmbH), or a deemed commercial partnership with management based in Germany, the letting profits of these companies are generally subject to trade tax in full. An exception is the so-called extended trade tax reduction if these companies – exclusively – manage and use their own real estate or, in addition, their own capital assets. In addition to other pitfalls, a major problem here is the exclusivity requirement, which in the end means that even minor sideline activities result in the de facto trade tax exemption being dropped. Classic examples of such tax-detrimental sideline activities are, for example, the operation of photovoltaic systems for feeding electricity into the public grid or the co-letting of so-called operating equipment, such as freight elevators, air-conditioning systems in server rooms, as well as cold storage rooms or kitchen systems and grease separators in restaurants and canteens, but so-called kitchenettes in office buildings as well.

In this regard, the Federal Fiscal Court (Bundesfinanzhof = BFH) most recently ruled in 3 landmark rulings on 11/04/2019 that:

- in the case of a hotel, co-letting a beer cellar refrigeration system, refrigerated rooms as well as refrigeration units for counters and buffet systems in the volume of approx. EUR 134,000 or approx. 1.14% of the total acquisition or production costs of the building (III R 36/15), or
- in the case of a car dealership, co-letting paint booths with associated supply air and exhaust air facilities (III R 5/18), or
- in the case of a car dealership with a workshop, co-letting a gantry car wash, lifting platforms, compressed air refrigeration dryers as well as advertising facilities and an advertising tower (III R 6/18),

applying the extended reduction is to be refused for violation of the exclusivity requirement.

In a further ruling on 18/12/2019 (III R 36/17) regarding the letting of a department store and a filling station, the BFH also qualified the filling station technology belonging to the latter (roadway, petrol pump, pipelines and tanks) as harmful operating equipment.

What was new in all the above decisions was the specification of the exclusivity requirement. Contrary to the previous case law of individual tax courts, the extended trade tax reduction is not applicable to any co-letting of operating equipment, irrespective of the scope of the co-transferred operating equipment. According to the BFH, the law expressly does not provide for a de minimis limit. This very restrictive case law was thus to be applied in all still pending cases. In our article in FYB 2021, we pointed out the persisting problem, in particular the fact, which has long become common practice, to hold domestic real estate via real estate companies domiciled abroad and also to exercise the management functions at the foreign registered office of the company, as a result of which the domestic permanent establishment is missing as a connecting factor for trade tax.

**In this respect, the current Fund Jurisdiction Act has resulted in significant regulations that are advantageous for real estate owners.**

If real estate companies have so far been operating the generation of electricity from renewable energy systems in terms of sect. 3(21.) EEG (Renewable Energies Act) or from the operation of charging stations for electric vehicles as well, they lost the possibility of claiming the extended reduction altogether.

Currently, the regulation of sect. 9(1.) sentence 2 GewStG (Trade Tax Act) has been extended in a new sentence 3 by an exemption for the supply of electricity and the operation of charging stations. This requires that it can be shown that the income generated in this way does not exceed 10% of the income from the transfer of use of the real estate in the business year. In addition, the electricity may only be fed into the grid or supplied to the tenants of the property company, but not to final consumers who are not tenants of the system operator (e.g. to the owner or the tenants of a neighbouring residential or office building). Operating charging stations for the public, in turn, remains an activity not eligible for tax relief, just like the operation of a combined heat and power plant (as a result of the explicit reference to sect. 3(21.) EEG).

Almost at the last minute, a further benefit with considerable practical significance was included in the law. According to the new sect. 9(1.) sentence 3, letter (c) GewStG, the extended reduction for real property will also be retained in future if the income from other activities in the financial year does not exceed 5% of the income from the transfer of use of the real property *and* originates from direct contractual relationships with the property tenants.

In plain English, this means that co-letting previously financially detrimental operating equipment, such as freight elevators, exhaust air systems and grease separators as well as kitchen equipment in the catering trade, but also cold storage rooms in supermarkets or kitchenettes in offices or air-conditioning systems in server rooms, is now possible without any problems in principle, provided that the limit of 5% of the income is complied with.

**This regulation is most welcome, as it brings to an end the long-running dispute in the courts over the exclusivity requirement for letting.**

It should be noted, however, that even if the income in question is exempt, no tax exemption applies in this respect. The exemption continues to apply only to direct letting income; the income from sideline activities must be determined separately and is subject to trade tax. As a rule, the profit attributable to the letting of the business equipment and thus the trade tax will probably be manageable in most cases.

In addition, the new regulation is also consistent with sect. 15 (3) InvStG (Investment Tax Act), which provides for a trade tax exemption for investment funds holding real estate since the InvStG 2018, if the share of the income generated from active entrepreneurial real estate management in a financial year is less than 5% (de minimis threshold) of the total income of the investment fund (for details, see the BMF letter dated 21 May 2019 on application issues relating to the Investment Tax Act in the version applicable as from 1 January 2018). The previous unequal treatment or preferential treatment of investment funds for trade tax purposes has now also been eliminated and equal treatment has been established irrespective of the legal form.

The bill was passed by the Bundesrat on 28 May; the new regulation on the extended reduction will apply as from the 2021 assessment period.

**Practical Tip:**

As much as the new regulation is to be welcomed, there is currently still no regulation as to how the limits of 10% or 5% of the "income from the transfer of use" are to be determined, here in particular whether it is the cold rent or whether apportionments for operating costs are to be included. In addition, it is unclear whether proceeds from the sale of operating equipment are still covered by the new regulation as well, which is doubtful when focusing on income from the mere transfer of use. Last but not least, it is also questionable how the agreed rent for a partial area or an entire building is to be used to determine the proportion of the rent that is attributable to the letting of the operating equipment included in the rent, especially as this is often not recorded separately in the fixed assets, particularly in the case of existing

buildings, and data on historical acquisition and production costs are often not available, which means that the "valuation discussion" with the tax office is sure to follow here as well – as is so often the case in tax law, the pitfall is again in the detail.

In practical application, it must therefore continue to be ensured that

1. the relevant percentage is not exceeded, even if the building is partially vacant,
2. relevant income is subject to trade tax,
3. equipment must therefore continue to be clearly identified, in particular at the time of purchase, and, where appropriate, the corresponding pro rata purchase prices must be shown in the purchase contract and
4. operating facilities continue to be spun off to separate companies if the relevant limits are exceeded or if they are to be sold, separately or together with the real estate.

**Conclusion:** Further developments in this area therefore remain to be seen; especially transactions should continue to be handled with a sense of proportion and, in case of doubt, with caution. Previous models will probably not lose their validity completely.

### II. VAT on management fees for private equity funds

The basic problem dates back to 2003, which in retrospect may well be called the "fateful year" of the venture capital and private equity industry. The then private equity decree on the distinction between private asset management and commercial operations set not inconsiderable income tax hurdles for the management of PE funds, for example with regard to the effect on the management of the portfolio companies, but also with regard to the use of borrowed capital or the granting of sureties by the fund. As a result, PE funds originally managing assets were exposed to a considerable trade tax risk. In addition, the carry-holders were also exposed to a trade tax risk, which, however, was largely eliminated with the introduction of sect. 18 (1)(4.) EStG (Income Tax Act) in 2004. As a flanking measure, the BMF interpreted this in a letter dated 23/12/2003, based on a

ruling by the BFH in 2002, to the extent that the advance payment of profits to the managing partner of a PE fund should also constitute special remuneration subject to VAT. As a result, subsequent generations of funds have often "emigrated" to foreign jurisdictions such as Luxembourg, Guernsey, Jersey or Malta, and German asset-managing fund limited partnerships have since led a shadowy existence, even leading to a loss of jobs for those previously involved in the management of fund limited partnerships.

With the Fund Jurisdiction Act, the German legislator has recognised this apparently self-inflicted shortcoming and has remedied it, at least as far as VAT is concerned. This is also against the background that the ECJ already ruled in 2015 in the Fiscale Eenheid case that the management of real estate funds subject to special state supervision is exempt from VAT. This is also the wording of the current Art. 135(1)(g) VAT System Directive. Despite all efforts towards a European harmonisation of VAT, this tax exemption has not been consistently implemented in Germany to date, with the result that in other European countries, such as Luxembourg, the management of private equity and venture capital funds has long been regularly exempt from VAT, while in Germany VAT has continued to be charged.

## VAT under the old law

The central VAT regulation is sect. 4(8)(h) UStG (VAT Tax Act), which provides for the VAT exemption of the management of certain fund companies. Until now, however, this VAT exemption was limited to Undertakings for Collective Investment in Transferable Securities (UCITS) and comparable Alternative Investment Funds (AIF). There has also been some dispute as to when an AIF can be considered comparable to a UCITS. Contrary to the aforementioned ECJ case law, the tax authorities have so far interpreted this loophole very restrictively in the VAT Application Decree (section 4.8.13), and as a result have regularly assumed that private equity and venture capital funds are subject to VAT.

Since private equity funds qualify as non-entrepreneurs for VAT purposes due to their mere asset management nature, they do not have the right to deduct input tax, which leads to an additional cost burden for investors and, in a European comparison, to a disadvantage for Germany as a fund location.

## New VAT regulation under the Fund Jurisdiction Act

The main change is the extension of the tax exemption from VAT to the management of "venture capital funds". The bill was passed by the Bundesrat on 28/05/2021 and came into force on 1 July 2021.

Although the Act lacks a definition of the term of "venture capital fund" and this term is not used in any other legislation either, there is reason to suggest that both private equity and venture capital funds are covered by the term. This assumption is based on the fact that, on the one hand, the term was used in the 2004 Act on the Promotion of Venture Capital for the purpose of reorganising the carry taxation and no differentiation was made between private equity and venture capital funds. In addition, in the ruling of the Magdeburg Regional Finance Office of 05/04/2016 on doubts and questions regarding the so-called PE decree, the tax authorities also use the terms venture capital funds/venture capital companies and subsumes both PE and VC funds under them.

Thus, portfolio management and risk management, but also the legally required fund accounting and the preparation of annual reports and other reports and activities in connection with the distribution of profits are regularly exempt from tax. Among other things, the preparation of tax returns, consultancy services without specific purchase or sales recommendations and activities in connection with the actual management of real estate held, in particular its letting, the management of existing tenancies, the engagement of third parties to carry out servicing measures as well as their monitoring and inspection (for further details, see section 4.8.13, paragraphs 18, 20 and 21 of the VAT Application Decree) are not exempt.

**Practical Tip:**

**I.** The VAT exemption of the management fee is very welcome and eliminates a significant competitive disadvantage vis-à-vis other international and European jurisdictions, in particular Luxembourg. In principle, German legal forms, in particular the typical asset-managing, commercially oriented GmbH & Co.

KG, could regain importance, not least because fund providers based in Germany would once again be operating on familiar legal terrain and administrative barriers abroad, often caused by geographical distance and language barriers, can be reduced.

From 1 July onwards, fund management companies will be allowed to issue the management fee to the venture capital fund without any VAT being shown, together with an explicit reference to the VAT exemption, if a net amount agreement is in place. In the case of a gross amount agreement, the management company may continue to invoice the gross amount, but then without showing VAT, as otherwise the VAT still incorrectly shown will continue to be owed under sect. 14c(2) UStG. Further invoicing should therefore be reviewed in a timely manner on the basis of the statutory agreements on the management fee.

For the management company itself, this means that it is no longer entitled to deduct input tax if it only renders tax-exempt services. If, in addition, services subject to VAT are performed in the own name and for the account of fund companies, e.g. from service purchases and onward invoicing as part of the so-called service commission, the input tax deduction is retained in this respect. Where appropriate, the input tax deduction, in particular from purchased overhead costs, such as for accounting, administration, office rent etc., is to be apportioned at the level of the management company.

**II.** Last but not least, existing tenancy agreements of the management company for renting office space should be reviewed. Landlords letting their office premises regularly assert the input tax deduction both for the acquisition or construction of the building and for its ongoing operation. This presupposes that the landlord himself opts for VAT when letting, which is in principle only possible if the tenant – in this case the management company – also only effects transactions subject to VAT. Office tenancy agreements therefore usually provide for compensation clauses at the expense of the tenant in the event that the latter, for whatever reason, loses the right to deduct input tax in whole or in part as a result of performing tax-exempt transactions. If discovered years later, often in the course of tax audits of the tenant's or

landlord's business operations, this can lead to substantial additional tax payments by the landlord, which the landlord will pass on to the tenant in the context of the compensation clauses in the tenancy agreement.

If the management company itself is the owner of the owner-occupied office property, it should be examined whether, with the entry into force of the VAT exemption as of 1 July, any adjustment of the input tax deduction from the acquisition or production of the property or also from major maintenance measures within the 10-year adjustment period pursuant to sect. 15a UStG is to be made. The same applies to landlords to the extent that the adjustment period of 10 years since the acquisition or construction of the property or performance of certain maintenance measures has not yet expired; here, too, the tenant will have to pay for the loss of the input tax deduction by the landlord if corresponding tenancy agreement clauses exist.

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***Thomas Jäger*** *is German tax advisor and managing director (Private Equity & Real Estate) at LM. LM Audit & Tax GmbH are focussed on international clients in the field of Real Estate and Private Equity with services ranging from Tax Due Diligence to Tax Compliance and day-to-day Tax Consulting including support during Tax Audits and – if necessary – representation at Tax Court. In the field of Real Estate all asset classes are involved from office- and logistics buildings up to hotels, car park facilities and shopping centers, The field of Private Equity comprises drafting of financial statements and tax declarations including complex partnerships income tax declarations and CFC (AStG) declarations for German investors invested in international fund vehicles.*

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