German Fund Location Act — Part I

FLEXIBILITY FOR GERMAN FUND MANAGERS BOOSTED BY THE NEW GERMAN FUND REGULATION

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The law to strengthen Germany as a fund location will essentially come into force on 2 August 2021 (the Fund Location Act – *Fondsstandortgesetz*), and the asset management industry will then face a significant legislative package amending the existing German Capital Investment Code (KAGB – *Kapitalanlagegesetzbuch*).

The new Fund Location Act will result in the elimination of some of the downsides of more popular fund locations, such as Luxembourg and Ireland. Alongside tax relief for the management of venture capital funds, asset managers will be given more flexibility in terms of product range, including for example a new type of impact fund, investments in crypto-assets, as well as more flexible financing of real estate funds.

This client briefing gives an overview of the key points for the *German fund landscape*.

In addition, the Fund Location Act transposes the European Directive/2019/1160 on cross-border distribution of collective investment undertakings (CBDF Directive) into national law. The German legislator generally applies a one-to-one implementation, i.e. almost without gold plating the European rules. We will focus on this in a **separate Part II client briefing**.

1. Development Grant Fund (*Entwicklungsförderungsfonds*)

In the area of impact funds, a new product category was created in the form of the Development Grant Fund (DG Fund). This is a relatively unrestricted open-ended or closed-ended AIF for *institutional investors* (a non-retail, so-called special AIF) whose key feature is its contribution to the achievement of the *United Nations Sustainable Development Goals* in developing countries (the principle of "do no significant harm" shall apply).

DG Funds are not limited to the acquisition of specific assets, but can invest in a *flexible* way: for example in loan receivables, company shareholdings or other AIFs. In addition, a DG Fund can also be set up as an open-ended credit fund; this was not previously possible in Germany. Unlike closed-ended credit funds, the new DG Fund is liberal in that it is not subject to leverage restrictions and offers flexible refinancing options, e.g. issuing debt securities/notes. Fund managers of DG Funds are subject to additional risk and organisational requirements (in particular, the IFC Impact Principles) and their compliance with sustainability goals will be audited annually.

In the light of the current ESG boom, chances are good that the DG Fund will be perceived in practice as an interesting investment vehicle.

2. Investments in crypto-assets

Investments in crypto assets are already possible for funds that are general open-ended and closed-ended special AIFs. The new German Fund Location Act expands investment in crypto-assets for one type of fund that is very popular with German institutional investors: as of 2 August 2021, open-ended special AIFs with fixed investment conditions (sec. 284(3) KAGB) will also be permitted to *invest up to 20 per cent of fund assets in crypto-assets*. In Germany, the assets of open-ended special AIFs amount to more than EUR 1,843.1 billion, which highlights the potential for crypto-assets. Such investments can take very different forms, including token-based bearer bonds and rights to real estate or virtual currencies such as Bitcoin, Ethereum, XRP.

The expansion of the catalogue of eligible assets for such special AIFs will likely encourage market participants such as fund managers and custodians to more quickly develop expertise and *contribute to an innovative ecosystem for decentralised financial services (DeFi)*. For investor protection reasons, however, the direct acquisition of crypto assets for retail funds is not currently permitted by law.

3. Financing of real estate funds

The Fund Location Act has led to considerable relief in the real estate fund sector.

In particular, the Fund Location Act provides for more flexibility in the financing of special real estate funds for institutional investors, with the *limit for borrowings* raised from 50 to 60 per cent of the market value of the properties held in the fund.

In addition, the *financing of real estate companies* in a fund structure will be facilitated: if the fund manager directly or indirectly holds 100 per cent of the shares or voting rights of the real estate company for which the loan was granted, the statutory debt capital limits will not apply. As a result, such loans no longer have to be secured by 50 per cent of the property value held by the real estate company and by 25 per cent of the property value held by the real estate fund in total. This is generally to be welcomed since providing debt capital in cases of 100 per cent-participations is not riskier than providing equity capital.

The legislator has acknowledged the criticism voiced against the government draft and has clarified that *holding companies* that do not directly hold real estate themselves should also be privileged, i.e. the statutory debt capital limits will not apply here either. It must be noted, however, that any reduction of the 100 per cent participation in the holding company will result in the loan having to be repaid.

It is also to be welcomed that the maximum limit of 25 per cent for loans to *real estate companies held by the special real estate fund itself* has been deleted.

4. Amending investment conditions of real estate retail funds

Up until now, it has often been very difficult to amend the investment guidelines of real estate mutual funds. If, for example, the acquirable assets and investment limits were changed, investors had to be given the opportunity to exchange their fund units for those of a comparable fund. However, fund managers typically do not have such a "twin fund" at hand. As with other fund types, it will be *sufficient if investors are granted a free share redemption right*, which will facilitate the redemption process significantly. In a similar way, mergers with real estate investment funds in the same contractual form will also be facilitated.

5. Open-ended retail infrastructure funds

In Germany, open-ended infrastructure funds are making a comeback since having been introduced in 2007, but have not been incorporated into the current German KAGB. Their resurgence means reintroduction, the legislator is pursuing the goal of enabling small and *retail investors* to participate in infrastructure projects, which is becoming increasingly popular. Similar to investments in real estate, infrastructure projects, including for example the construction and management of energy plants, mobile communications networks and hospitals, promise a *stable cash flow* and attract investors by offering *high asset values.*

However, infrastructure projects are also associated with significant entry and exit costs, because such assets cannot be sold at short notice. It is therefore an *illiquid asset* class that will be subject to existing regulatory requirements for real estate funds. Evidently, the German legislator is attempting to channel private capital into infrastructure projects, while the operational risks mean that close attention will have to be paid to whether such an investment is indeed beneficial for small investors.

6. Facilitation of microfinance funds

For microfinance retail funds, it is a positive development that the scope for investment in microfinance institutions has been extended. They are no longer limited to granting loans to small and micro enterprises, but can choose from a variety of financing options with the cap raised from EUR 10,000 to EUR 30,000 per financing.

7. Closed-ended master-feeder structures

The new product range also includes *closed-ended master-feeder structures* in the area of retail AIFs. However, this will likely not be of great practical relevance since closed-ended retail feeder funds are still not permitted to invest in special master funds. The German legislator has *missed the opportunity for retail investors* to benefit from institutional asset management, especially in the areas of private equity and real estate.

8. Flexibility of legal forms

Until 2 August 2021 open-ended real estate funds were limited to the contractual legal form (*Sondervermögen*). In the future, funds in the form of *open-ended investment limited partnerships* are permitted to invest in real estate and infrastructure projects. It is expected that open-ended investment limited partnerships, which were originally intended for pension asset-pooling purposes, will become more attractive in the institutional sector.

Another positive aspect is that *closed-ended special funds* can now also be issued in the *contractual form* (*Sondervermögen*). In other EU fund jurisdictions, such as Luxembourg, this has been the practice for a long time (*fonds commun* *de placement*). Funds in the contractual form are considered advantageous since fund units can be held in custody more easily and, unlike company interests, can be issued, managed and transferred with less effort and cost; however, from a tax perspective, a corporate structure may eventually prove more appropriate. Despite the advantages associated with funds in the contractual form, the Fund Location Act does not yet permit this structure for closed-ended retail funds.

9. Tax reliefs for the start-up industry

The Fund Location Act also promotes the start-up industry: the German legislator acknowledges that young companies provide positive incentives for the economy as a whole with a great deal of risk-taking and commitment. They rely on highly qualified personnel, but are hardly in a position to pay high salaries during the start-up phase. *Employee participation programmes* are therefore considered to be an important additional compensation instrument for start-up companies. The problem here is that the equity participation of the employee generally triggers an income tax liability, even though liquidity has not yet flowed. The Fund Location Act tries to address this so-called dry income by means of a multi-year tax deferral.

Besides, the burden of value-added tax (VAT) on management fees is considered one of the biggest disadvantages of German funds compared with other fund domiciles such as Luxembourg. The Fund Location Act addresses this deficit only partially as the *VAT exemption for management services* for certain open-ended funds, e.g. UCITS and certain special AIFs, will be extended to *venture capital funds.* However, the scope of "venture capital funds" remains unclear. According to the German legislator, it will be determined by administrative practice and will not include all types of AIFs. Such selective preferential treatment of UCITS, certain special AIFs and now venture capital funds has been criticised as ineffective and a strain on European law. These VAT-related amendments apply from 1 July 2021.

10. Conclusion

The German Fund Location Act eliminates only some of the disadvantages associated with other jurisdictions, and thus falls short of its potential. In particular, all fund types of the KAGB should be allowed to be issued in all legal forms, e.g. closed-ended retail funds in the contractual form. In addition, mixed forms of public and special AIFs should also be permitted in master-feeder structures. In order to finally remove a serious obstacle, in short, all investment funds under the KAGB should receive the same preferential treatment for VAT purposes, as is the case in other fund jurisdictions.

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