

VAT exemption for venture capital funds

SINCE THE INTRODUCTION OF THE FUND JURISDICTION ACT OF 1 JULY 2021, THE MANAGEMENT OF VENTURE CAPITAL FUNDS HAS BEEN EXEMPT FROM VAT. THE TERM “VENTURE CAPITAL FUND” HAS NOW BEEN DEFINED IN AN ADMINISTRATIVE DECREE ISSUED BY THE FEDERAL MINISTRY OF FINANCE DATED 24 JUNE 2022. THIS GSK UPDATE PRESENTS THE REQUIREMENTS FUNDS HAVE TO MEET.

Executive summary

- The definition of venture capital funds that qualify for the VAT exemption for management services is aimed in particular at closed-end venture capital funds.
- In order to be considered a venture capital fund in this sense, a fund must be able to demonstrate that it is subject to comparable competitive conditions to those of a UCITS¹ as well as special governmental supervision.
- In order for the venture capital fund management services to qualify for the VAT exemption, target companies must meet four requirements with regard to duration, company size, registered office and economic activity.

Starting position

In particular, private equity and venture capital funds are often not able to claim the VAT charged for the management of the fund as input tax if they themselves do not provide any services subject to VAT, for example because they are not entrepreneurs within the meaning of the VAT Act. Therefore, there is a fundamental economic interest in exempting such management services from VAT, since otherwise the VAT paid for management services becomes an economic cost factor for the fund.

For years, Germany's competitiveness as a location for funds has suffered due to a restrictive interpretation of the VAT exemption under Sec. 4 no. 8 h) of the Value-Added Tax Act (UStG), which for a long time only applied to the management of UCITS funds and comparable AIFs².

German legislators have tried to counter this by introducing an addition to this provision with the Fund Jurisdiction Act of 1 July 2021. This new provision extends the VAT exemption to include the management of “venture capital funds”. However, the amendment does not include a definition of the term “venture capital fund”.

The introductory administrative decree on the VAT exemption for the management of venture capital funds pursuant to Sec. 4 no. 8 h) UStG of the Federal Ministry of Finance (BMF) dated 24 June 2022 (“**BMF Decree**”) now provides taxpayers with an interpretation guideline.

General definition of a venture capital fund

A venture capital fund must be invested entirely or at least predominantly (i.e. more than 50%) in young, innovative growth companies, also known as “target companies”, which are defined in greater detail below. A key characteristic of a growth fund is the aim of seeing a significant increase in the value of the target company. This constitutes the main return on investment when the fund later exits from the investment. Financing is provided through equity participation or other forms of risk-bearing financing. A direct injection of capital into the target company is not required, but indirect capital flows via chains of ownership are permitted.

The BMF Decree clarifies that 50% of the aggregated capital contributed or not yet called in but committed is the key figure to be considered a venture capital fund. In addition, corresponding mandatory requirements must be included in the fund terms and conditions. The status as a venture capital fund is rescinded if subsequent changes to the fund terms and conditions compared to the date of the first venture capital investment result in the

¹ Undertakings for the collective investment in transferable securities.

² Alternative investment funds.



investment strategy no longer being permanently oriented towards the aforementioned target companies.

Competitive conditions and governmental supervision

The venture capital fund must be subject to the same competitive conditions as a UCITS (to be understood as comparable duties and controls) and to special governmental supervision and must be able to prove this. The wording of the BMF Decree does not completely rule out any further conditions from the list provided by the tax administration in Sec. 4.8.13 (8) of the Value-Added Tax Act Application Decree (UStAE) also being required, e.g. the same group of investors, issue of shares to multiple investors, investment according to risk spreading and risk diversification. In the case of registered qualifying venture capital funds under the EuVECA Regulation³, it is assumed that these conditions are already undeniably met, which should make it unnecessary for the fund to furnish any proof.

Requirements for target companies

In order for the venture capital fund management services to qualify for the VAT exemption, the fund's target companies must meet the following four requirements.

- The target company must not be more than twelve years old at the time of the first venture capital investment.
- There are no clear regulations on the required size of the target company at the time of the first venture capital financing. The references to other statutory provisions suggest that targeted companies generally have an average market capitalisation based on the year-end listing of less than EUR 200 million in the last three calendar years.
- Target companies must also have their registered office in an EU member state. Target companies in a

third country may only qualify if further conditions regarding the third country's anti-money laundering requirements and the effective exchange of tax information are met.

- Furthermore, target companies must be actively engaged in ongoing economic activity with the intention of making a profit.

Proof that the aforementioned conditions are met must be provided to the tax authorities, with particular reference to the fund terms and conditions. These fund terms and conditions must therefore be drawn up accordingly.

Transition period and required action

The interpretation according to the BMF Decree is to be applied to transactions carried out after 30 June 2021. During the transition period for transactions carried out until 30 June 2022, no objections shall be raised if transactions subject to VAT under the previously applicable regulations continue to be treated as subject to VAT by mutual agreement between the parties involved.

Therefore, market participants have to agree with their contractual partners on how to treat such transactions in the transition period and, if necessary, initiate changes on the basis of this new BMF Decree. However, once the transition period expires, market participants are required to apply the new interpretation from 1 July 2022.



³ Qualifying venture capital funds pursuant to Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds, as amended.



Conclusion

The BMF Decree will enable market participants qualifying as venture capital funds to obtain the much desired VAT exemption for management services.

A few days after the publication of the BMF Decree, the Federal Ministry of Finance published a key issues paper for a “Future Financing Act” on 29 June 2022. The objective of this legislation is to strengthen Germany as a fund location by extending the VAT exemption for venture capital funds to the extent permissible under EU law. It remains to be seen whether this merely refers to the BMF Decree described above⁴ or whether the intention is to pursue a more far-reaching reform towards more competitive taxation of AIFs in line with EU law.

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⁴ As well as the similar statements on the VAT exemption for venture capital funds in the draft for a “Start-up Strategy for the Federal Government” by the Federal Ministry for Economic Affairs and Climate Action dated 1 June 2022.



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