YPOG Briefing:
VAT Exemption for all Alternative Investment Funds – Draft Legislation of the German Government

On August 16, 2023, the German Government (*Bundesregierung*) passed a draft of the so-called Future Financing Act (*Zukunftsfinanzierungsgesetz*). The draft legislation provides, *inter alia*, for an extension of the value added tax (VAT) exemption for the management of certain funds to all alternative investment funds (AIF) within the meaning of the German Investment Code. The respective provision, which previously only applied to open-ended mutual funds (UCITS) and to certain, narrowly defined venture capital funds (so-called *Wagniskapitalfonds*), will now be extended to all venture capital, private equity and crypto funds.

An Important Step for Leveling the Playing Field

Unlike in the most important competitor countries (in particular Luxembourg, France and the UK), the management of private equity and venture capital funds is, as of today, only exempt from VAT in exceptional cases. The current VAT exemption only applies to so-called *Wagniskapitalfonds*. However, a legal definition for such term was missing and a decree by the German Federal Ministry of Finance (BMF) published last year seemed to raise more questions than it answered. A considerable degree of legal uncertainty remained.

According to the draft legislation now adopted by the German Government, the management of all alternative investment funds is to be exempt from VAT in the future. This includes all private equity, venture capital and crypto funds, regardless of whether the fund manager has a full license, is a so-called sub-threshold manager or is registered under the EuVECA regulation.

The draft legislation is good news, as it eliminates a major disadvantage for Germany as a business location for fund managers. It is now to be hoped that the law will be passed promptly in its current version.

What Does the new Provision Mean for Existing Funds?

Once the law has been passed by the German Parliament (*Bundestag*) and the German Council (*Bundesrat*), the VAT exemption comes into force for all sales from January 1, 2024. At the same time, there is no provision for a transitional arrangement for the management of funds already in operation, which are now subject to the VAT exemption for the first time.

The management of alternative investment funds is thus generally no longer subject to VAT. The fund manager may therefore invoice the agreed management fee without VAT, whereas tax exemption must be expressly referred to in the invoice (cf. Section 14(4) sentence 1 no. 8 UStG). If, as usual, a net amount has been agreed ("plus VAT, if any"), only this net amount may be charged. In exceptional cases, where a gross amount has been agreed, the previous amount may continue to be charged. In the latter case, however, the invoice must no longer show any such VAT. Otherwise, the fund manager may be held liable for VAT due to the unjustified tax display (cf. Section 14c(2) UStG).

Another direct consequence of the VAT exemption is that **the fund manager loses its right to deduct input VAT** to the extent that it now provides services that are exempt from VAT (Section 15(2) sentence 1 no. 1 UStG). As fund managers (especially when they are sub-threshold managers) typically do not provide any further services to third parties that are subject to VAT, the input tax deduction might therefore often be completely excluded. In practice, this may have a major impact on all costs of the fund manager that are not borne by the fund as fund expenses, such as any costs in connection with consulting services that are subject to VAT and which the fund manager obtains (e.g., general legal/tax consulting costs, fees of other consultants, including venture advisors or venture partners, travel expenses, outsourced services). **Fund managers should reflect the elimination of the input VAT deduction in their finance planning.**

It should also be noted that, according to the case law of the Court of Justice of the European Union (ECJ), the VAT exemption can also apply to investment advisors and outsourcing providers of the fund manager, but only if the service provided forms a 'package' and as such is specific and essential to the management of the funds. The latter must always be assessed in light of the circumstances of the individual case. While the investment advisor in standard advisor model should be covered by this, with respect to other (investment) advisors or the fund administrators the assessment will always depend on the specific activity. In addition, for assets acquired by the fund manager that are not only used once for the execution of sales, a (*pro rata*) input tax adjustment may also have to be made (Section 15a UStG), provided that the first use does not date back more than 5 years (for real estate: 10 years).

Further, fund managers should review their rental agreements and take action if necessary: Commercial leases regularly contain clauses according to which the tenant (in this case, the fund manager) is not entitled to use the leased office space for activities that exclude the deduction of input tax, as such use would exclude the landlord's right to opt for VAT (cf. Section 9 (2) sentence 1 UStG). If the tenant does not comply with this obligation, the landlord would not be entitled to deduct input tax (or only to a limited extent). In this respect, the rental agreements often provide for a (no-fault) **claim for damages or compensation for the landlord.** Fund managers that rent their office space could therefore find themselves exposed to substantial claims from their landlords. The input tax loss for the landlord can exceed the VAT on the rent very substantially (especially if the premises are in a new building or have been extensively renovated). **The risks associated should be clarified immediately to take any necessary measures**.

Before entering into negotiations with the landlord and possibly considering extraordinary termination or cancellation or adjustment of the rent agreement, it should, however, always be checked whether the clause in the specific lease agreement covers the situation of a legislative change at all (or whether the clause rather requires a change in the tenant's behavior) and whether the clause was effectively agreed.

Even in the absence of such clause in the lease agreement, however, it should be noted that a corresponding claim by the landlord to compensation for its input tax loss could also arise from the little-known provision of Section 29 UStG, which according to a widespread opinion applies in the event of a legislative change, such as the introduction of a VAT exemption. In this regard, it would have to be examined whether there are any indications in the lease agreement that such a statutory claim should be excluded. Finally, it may be possible in individual cases to avoid the severe consequences under the lease agreement by restructuring the service relationships among the group companies.

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