VENTURE CAPITAL IN GERMANY: A SUMMARY

The innovative strength of German inventors as well as the importance of innovation for Germany as a business location are widely recognized. Despite of that and although Germany ranks itself among the big economies in the world, it still has only a middle ranking, even within Europe, with respect to fund-raising and investments in technology enterprises. Unfortunately, the attempt to reconcile the tax disadvantages of the deletion of losses carry forward in case of a change in the shareholders' structure, including in case of capital increases, § 8 c Corporate Income Tax Act, through a legislative bill on the modernization of the framework for investment companies (the "MoRaKG"), which was enacted in August 2008, has been a non-starter, just as the cautious attempt to support the engagement of Business Angels by increasing the allowable deduction in case of a sale of shares. These well-intentioned approaches, the only purpose of which has been to moderate the excessive tax burden for VC-financed businesses and private VC-investors, failed since the European Commission decided on September 30, 2009 that these rules were an illicit governmental aid forbidden under EU law. However, according to a further legislative amendment, losses carry forward are now at least allowed up to the amount of silent reserves which are taxable in Germany, in case of all share acquisitions after December 31, 2009.

Fund-raising for German funds is impeded by the fact that reimbursement for management services is subject to turnover tax in Germany although the fund itself does not receive any taxable income. The transparency of VC funds (asset management or commercial activity?) remains subject to ambiguities. Legislative action seems necessary in this respect. Additional incentives for VC-investments, namely for family offices, could help to achieve the intended risk reduction for participation in funds.

But also the direct investment of Business Angels, who not only contribute their experience in addition to their money but often serve as intermediary between investors and founders, requires appreciation (beyond the fact that 2010 was proclaimed to be a "Business Angel Year"), not only through tax incentives but also through the agreement to more moderate investment conditions. Founders and seed investors are quite often adversely affected by excessive liquidation preferences which are standard practice in favor of later stage investors. But their engagement must ultimately be profitable.

The initiative of the Federal Ministry of Economics to correct the discovered market failure in seed financing by establishing the High-Tech Founders' Fund ("*High Tech Gründerfonds*"), was successful and acknowledged even abroad. However, this success is undermined by the inflexible present approach of the German Federal Cartel Office that requires application for seed investments to the antitrust agencies, especially for first round investments of public investors, which regularly have to insist on strategic supervisory rights (since they are subject to public auditing). VC investments by a syndicate including Corporate Venture Capitalists and public funds are, thus, burdened with unnecessary bureaucratic barriers and costs.

Financial institutions have received generous support by the government in the financial crisis. But instead of the well intended regulatory attempt of the above mentioned new legislation (the *MoRaKG*), its counterpart, the Act on the Limitation of Investment Risks (the *RisikoBegrG*) has survived, which was intended to limit the activities of hedge funds and private equity funds. For example, the RisikoBegrG prescribes the information of the workers' council about the potential buyer and his economic intentions prior to a change of control. The self-inflicted crisis of the financial markets in autumn 2008 has not only hit providers of debt-financing but indirectly also affected the VC-branch. Fund investors became risk-averse, potential clients of VC-enterprises postponed their intended investments. But young seed-enterprises need further funds through their development stage. The focus, thus, has to be on the availability of moneys for follow-up financing. This requires a stable regulatory environment, which is competitive throughout Europe, and which does not discriminate VC-investments against other forms of investment.

To this end, recent European legislative initiatives may be helpful, such as the *Directive on the Regulation* of *Alternative Investment Fund Managers* (AIFM) which will come into force during the first quarter of this year and shall be implemented in all member states within further two years. This implementation will lead to a uniform regulatory regime for all sorts of investment management companies in Europe and will supplement the already existing *Directive on Undertakings of Collective Investments in Transferable Securities* (UCITS). The UCITS – Directive has been implemented in Germany in the Investment Act (*InvG*) which only covers funds with unlimited capital in the structure of a corporation where the investors may trade in their shares ("*open*" funds). In contrast, the AIFM directive aims at all kinds of investment fund managers which will then all need authorization under certain conditions by the competent authorities of their home member state (in Germany the *Federal Bureau on the Supervision of Financial Services*). An authorized EU-AIFM may market any EU alternative investment fund in other member states and may also manage EU-AIFs established in another member state ("EU pass"). The AIFM directive in addition contains specific third country rules. AIFMs will have to comply with certain operating and organizational requirements as well as with certain transparency requirements (annual report and further disclosure obligations for leveraged funds or funds acquiring major holdings or control of non-listed companies). If these provisions of the AIFM directive are implemented in Germany, consequently all alternative investment funds would enjoy the tax privileges which funds falling under the InvG already enjoy, such as the exemption from trade tax and corporate tax and exemption from value added tax for fund management.

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