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by Lorenz Jarass and G.M. Obermair

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This article was translated from German by R. Moore.

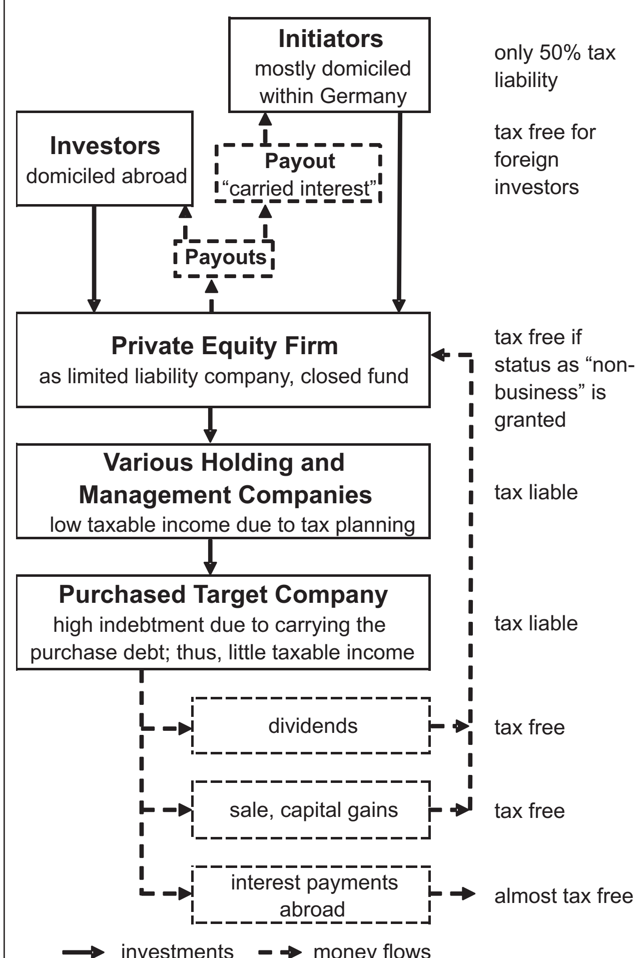
What are funds and what do they do, particularly the much-discussed private equity and hedge funds? Does the German economy need such equity investors because of a shortage of capital? Are investors so critical that they must be provided with huge tax benefits at the expense of other taxpayers? And which target group — if any — should receive tax benefits to promote the formation of start-up enterprises in the technology sector?

Hedge funds, largely domiciled in tax havens, protect the money entrusted to them by spreading the risk for the investors by, for example, arranging purchases of goods secured against currency exchange rate volatility. It is high-risk speculation with futures contracts and currency. Often it works, but sometimes it does not. Because billion-dollar collapses in recent years have shaken not only the international banking system but also banking regulators in major countries, international regulation of these funds is called for. The taxation of their yields generated in Germany is, in principle, possible through their German financial partners.

Private equity funds have a branch in the target country in order to use the mostly foreign money of anonymous investors to purchase firms with high cash flow; the purchased firm is then burdened with debt in order to refinance the original purchase. The diagram shows a typical business model. It results in a double tax advantage — the taxable profits of the purchased firm are driven down to zero by interest payments on debt, high consulting costs, and loss carryforward. If the firm can no longer support the debt costs, it is restructured, meaning it is sold off piece by piece and employees are fired. And the funds attempt, usually successfully, to attain the tax status of administrators of property so that all of the income from within Germany and the resale gains are tax free and can be paid out tax free to the mostly foreign investors.

The German Private Equity and Venture Capital Association (BVK) argues that the German economy needs the money from equity funds and that without tax exemptions for the cash flow of the funds transferred abroad, foreigners will not invest in Germany. Considering the questions and answers in the accompanying box, one must conclude that providers of financing who offer additional financing to a German economy that is not suffering from a shortage of capital should in no way be privileged over investors who domestically finance factories or install production machinery.

Figure 1. Business Model of Private Equity Funds



According to the proposals of the BVK and their associated institutes, the extensive tax exemptions should be secured by legislative regulations, which define the funds as asset managers, in contrast with their actual business activities, which consist of mostly foreign-financed company takeovers, short-term holding of the companies, consulting, and actual control of the targeted company. The desired result of the proposals would be no business tax, no tax on resale gains, and, from 2009 on, for domestic investors only a 25 percent lump sum tax instead of the 45 percent top income tax rate, and for foreign investors no taxation at all in Germany.

The German government on September 12 published a proposal for a venture capital law that will be delivered to the Bundestag this month. Unfortunately, because of pressure from the CDU/CSU Bundestag faction and the Economics Ministry, the proposal does not eliminate the possibility of "tax planning and free riding" feared by the Finance Ministry. The proposal sets limits on the equity and age of the enterprise to be financed by the venture capital fund — at most €20 million equity and not more than 10 years old — such that any larger enterprise can be structured by splitting or founding new follow-up companies and creating debt that fits the criteria for venture capital financing. The resulting annual revenue loss is estimated at €20 billion. It is also highly doubtful that the founder of an innovative technology firm should be supported through tax privileges not for his firm, but for its financing equity fund. If a venture capital law is passed, the opportunities for tax avoidance and free riding must be minimized. The support must be strictly focused according to the size and age of the firm. The enterprise must be innovative, high-tech, recommended by experts, not more than five years old, and with an equity below €2 million when the fund buys the enterprise. This guarantees fair competition for all other financing enterprises not engaged in the risky business of venture financing. ◆

Five Questions and Answers

(1) Is there a need for more finance capital that only the funds can fill?

Answer: As often emphasized by the German Bundesbank, there is no shortage of finance capital within Germany.

(2) Do the funds generate benefits that clearly compensate for the social costs?

Answer: There is no statistically significant proof for this.

(3) Does the special status of the funds cause a competitive disadvantage?

Answer: Yes. Due to privileges, they can pay higher prices for their targets than the regulated tax-obligated competition.

(4) Are other financial service providers treated unequally in terms of taxation?

Answer: Yes, other financial service providers are not given such tax privileges for the same services.

(5) Does the funds branch provide an important and irreplaceable contribution for the promotion of new innovative companies, for instance, in the high-tech area?

Answer: No, most financing is covered by government development banks or specialized large companies; for the funds, such investments are a small side business.