Framework conditions for venture capital in Germany

A 5

Venture capital is an important source of financing for young innovative enterprises. Yet, Germany's venture capital market is much smaller than markets in the United States and many European countries (cf. C 4-2). If young innovative companies do not have access to enough capital, they cannot realise and market their innovative products or business models. Germany as an innovation-based economy thus squanders potential for growth and productivity.

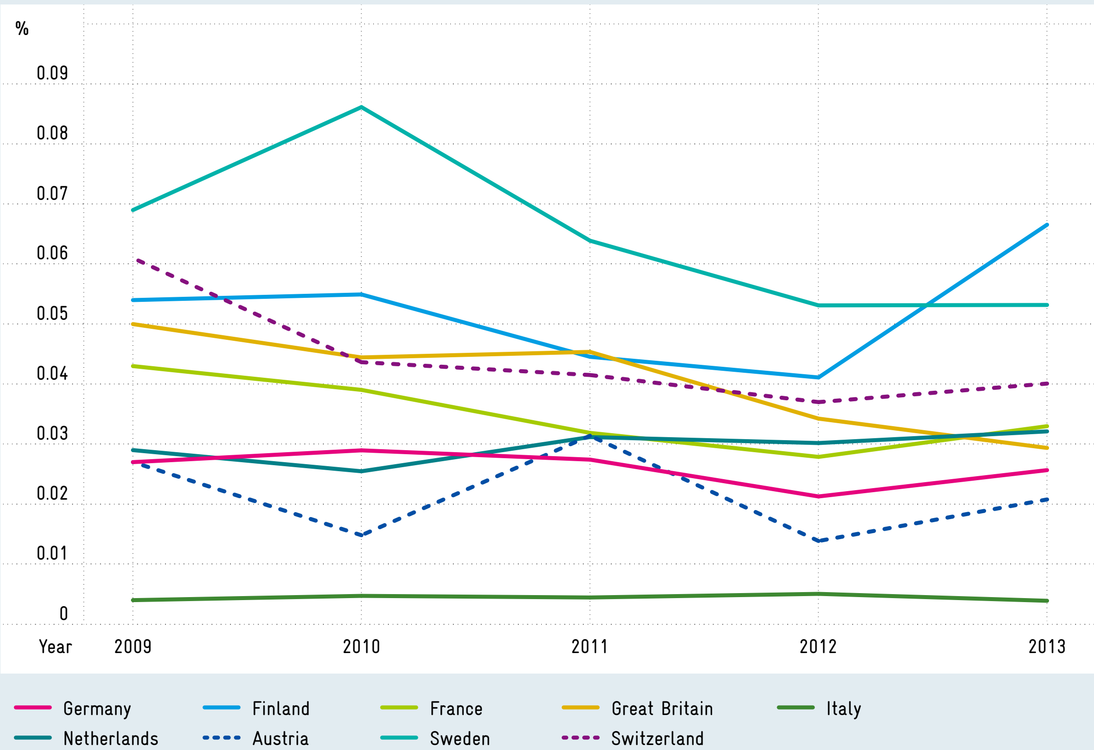
An analysis of venture-capital investments in Germany over the last few years (cf. Figure 1) shows that it has been stagnating and is relatively low compared to innovation pioneers like Finland and Sweden.

Against this background, the Commission of Experts welcomes the intention stated in the Federal Government's coalition agreement to "make the legal and fiscal framework conditions for venture

Fig 01

Data Download

Development of venture-capital investment as a percentage of national gross domestic product, 2009 to 2013



Investments according to registered office of the portfolio companies.
Source: EVCA, Eurostat. Own calculations.

capital in Germany internationally competitive [...]. This requires a separate set of rules. Similarly, new forms of financing, such as crowdfunding, need a reliable legal framework."[83] Different proposals and measures have been discussed by the Federal Government in recent months and are presented and evaluated here.

Tax exemption for INVEST grant decided

Under the programme entitled "INVEST – grant for venture capital" (INVEST – Zuschuss für Wagniskapital), which was introduced in 2013, 20 percent of equity-capital investments by private investors (business angels) is reimbursed (up to a maximum of EUR 250,000), if they invest at least EUR 10,000 in young innovative enterprises and hold onto their stake for at least three years. More than 1,000 investors applied for subsidies from the start of the programme in May 2013 until December 2014. Grants worth a total of EUR 11.7 million were approved, corresponding to a total investment sum of EUR 58.6 million.[84]

However, only a quarter of the envisaged funds was disbursed in the first two years. The recipients' uncertainty about the tax treatment of the grant was seen as the biggest obstacle to higher demand for the programme.[85] For this reason, in September 2014 the Federal Cabinet decided to exempt the subsidy from taxation – also retroactively for 2013.[86]

The Commission of Experts had already called for better conditions for venture-capital funds and business angels in its 2011 and 2012 reports. In view of the growing importance of private investors for financing young companies, the Commission of Experts welcomes the decision on tax exemption.

Easier transfer of carried-over losses needed

In addition, the Federal Government has announced its intention to revise the restrictive tax regulations for the treatment of carried-over losses (section 8 of the corporate tax law KStG).[87] At present, carried-over losses are lost when an investor acquires shares in a company. Yet, innovative companies in particular spend large sums on research and development (R&D) in the first few years, which can then be posted as carried-over losses. If these carried-over losses for R&D expenditure can no longer be deducted from tax after a takeover, this makes the company less attractive for potential investors. The current restrictive treatment of carried-over losses therefore has a detrimental effect on the willingness of venture-capital investors to invest in innovative start-ups in Germany.[88] Yet, the law passed by the Bundestag in 2008 to facilitate the transfer of carried-over losses (Law on the Modernisation of the Framework Conditions for Venture Capital and Equity Investments, MoRaKG) was rejected in Brussels because of concerns relating to state aid; it is currently before the European Court of Justice. Depending on the case's outcome, it is important to find new solutions quickly here.

Taxation of capital gains and the remuneration of fund initiators in discussion

In the context of tax law, it is not enough to create regulations that explicitly increase incentives for venture-capital investors in Germany; it must also be taken into account that undesirable side effects on venture-capital investment can also be caused by changes in the law that do not actually target venture capital. For example, the Bundesrat initiative entitled "Close Loopholes – Reduce Tax Breaks – Stimulate Investment" (Steuerschlupflöcher schließen – Steuervergünstigungen abbauen – Investitionen ankurbeln) called for a general taxation on capital gains realised upon the sales of free-floating shares.[89] This would have a negative impact on the start-up scene in Germany, however. Small-scale investment by venture-capital investors and business angels would be affected by this tax liability, making their investments less attractive and reducing incentives to invest in young innovative firms. Therefore, the potential that is generated – in the form of innovative products and business models – by venture-capital investments in young companies should be given precedence over short-term increases in tax revenues.

The repeated calls for higher taxes on the remuneration of fund initiators – known as "carried interest" – have a similarly damaging effect.[90] The Federal Government has rejected such an increase up to now. Even so, the ongoing discussion reduces long-term planning certainty for the initiators of venture-capital funds. Another obstacle in Germany – unlike many other European countries – is that fund managers' income from administrative services is subject to value-added tax.[91] This makes it relatively unattractive to build up and administer a venture-capital fund in Germany.

Framework conditions for anchor investors threatening to deteriorate

Yet, more than tax arrangements are needed to revive the market for venture capital in Germany. A class of institutional investors that is important in other countries is missing: the pension fund. In countries with capital funded pension schemes, such funds often have the function of an anchor investor who delivers an important signal to foreign investors. Because the pension system in Germany is largely financed according to the pay-as-you-go principle, these anchor investors are missing. This makes it all the more important that other institutional investors are active in this field.[92] In this context, the Commission of Experts is critical of a new draft investment ordinance that has been prepared by officials of the Federal Finance Ministry,[93] because it restricts the opportunities of insurance companies and pension funds to invest in venture-capital funds, thus reducing their possibilities to act as anchor investors. The absence of private anchor investors has not been offset by public institutional investors over the last few years, either. For example, the KfW Bank Group withdrew from venture-capital funding several years ago. The Commission of Experts therefore welcomes the Federal Government's announcement that it intends to launch a fund with a volume of EUR 500 million via the European Investment Fund (EIF) to finance the growth of German start-ups.

Creation of liquid secondary markets necessary

In the long run, liquid secondary markets are also needed to increase incentives for investors. The availability of flexible exit options increases the incentive for investments in venture-capital funds.[94] It is therefore regrettable that the stock-market segment for young companies planned by the Federal Government and Deutsche Börse is not implemented because the number of exits is too small. Since the market potential for a national stock-market segment is too small, consideration should be given to whether the creation of a pan-European stock-market segment for growth-oriented companies can achieve a sustainable improvement in the financing possibilities for start-ups.

Recommendations

The projects and initiatives mentioned above are steps in the right direction in order to improve incentives for the provision of venture capital in Germany. They should be implemented without delay.

- The Commission of Experts welcomes the Federal Government's announced intention to revise the restrictive tax regulations on the treatment of carried-over losses (section 8 of the corporate tax law KStG). Depending on the outcome of the proceedings relating to the MoRaKG before the European Court of Justice in Brussels, new solutions must be sought quickly.
- The Federal Government should refrain from introducing a general taxation on capital gains realised upon the sales of free floating shares. This would also affect investment by venture-capital investors and business angels in young innovative enterprises and make these investments less attractive.
- Similarly, the Federal Government should not accede to the demands from the Bundesrat initiative for higher taxes on the remuneration of fund initiators, since this would reduce the incentives for investment in young innovative companies.
- Conditions for anchor investors must be designed in an investment-friendly way. New restrictions on investment opportunities for insurance companies and pension funds must be avoided. The Federal Government's plan to launch a fund via the European Investment Fund (EIF) to finance the growth of German start-ups should be implemented without delay.
- Consideration should be given to whether the creation of a pan-European stock-market segment for growth-oriented companies can achieve a sustainable improvement in the financing possibilities for start-ups.