THE CURRENT STATE OF ALTERNATIVE INVESTMENTS IN RENEWABLE ENERGIES OF INSTITUTIONAL INVESTORS IN GERMANY

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Abstract
This article reviews the current trend of investments in renewable energies. In particular, institutional investors like pension funds and insurances need to look for new opportunities of profitable and adequate investments with regard to fulfill their obligations. Objective of this paper is to highlight certain aspects of this kind of investment constellation. In order to evaluate these issues, several studies and publications of official associations, statistical offices and German Federal Ministries have to be evaluated. In this paper, furthermore, tax implications will be pointed out. Especially, a German phenomenon will be emphasized, after which institutional investors lose their tax-privileged status through investing in typical closed-end investment structures. This tax effect can be described as a commercial infection of the yields, which have also a direct impact on the performance of the investments. In order to solve this kind of tax disadvantage, the papers carves out the possibility of interposing a corporation in the investment structure.

Keywords
Alternative Investments, Closed-end Investment Funds, Commodities, Renewable Energies, Institutional Investors, Commercial Infection

JEL Classification
G23, K34

Introduction

Capital investments in shares and particularly bonds – besides real estates the traditional asset classes – become unattractive both for private investors and institutional investors, based on the expected prolonged low-interest-rate phase within the European Union in special. Therefore all investor groups are looking for alternatives. Especially tax privileged institutional investors like pension funds, health insurance funds and foundations regularly need adequate returns of their participations to fulfill their obligations related to statutes of the articles. These investor groups especially, are forced to a greater extent than the others to reflect in investing in alternative investments.

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For this reason a literature review is necessary to classify the asset classes, which will be covered by alternative investments. Precisely large investors like institutional take renewable energies for an appropriate asset class in 2016 (Scope 2015a), in which an above-average yield can be achieved. Tax efficient structuring means higher profits according to the profitability of an investment. Since recently, however, institutional investors are subject to a permanent risk of losing their tax privileged status by investing in typical closed-end investment structures.

1. Literature Review - Classification of Alternative Investments

1.1 Asset Classes

In fact, there is no generally single accepted definition of alternative investments (Dönges 2008; Sokołowska 2014). One approach is to differentiate between traditional investments and alternative investments. Within that context alternative investments belong to modern financial instruments. Following Busack and Kaiser (2006), alternative investments is an investment strategy in several assets, in traditional asset classes as well, but the strategy divers from the investments in traditional assets. The whole literature uses several interpretations of alternative investments. According to Chorafas, et al. (2003), it is hard to find a clear and precise definition of alternative investments. Furthermore, a very strong diversity within the group of alternative investments can be identified as well as in the assets it selves. To substantiate the meaning alternative investments they will be described in assets, which represent an “alternative” understanding. So alternative investments can be classified as follows (Table no. 1).

Table no. 1 View of Asset Classes of Alternative Investments

Asset Classes of Alternative Investments				
Hedge-Funds	**Private Equity**	**Infrastructure**	**Commodities**	**Other**
Tactical	Venture Capital	Economic	Hard Commodities	Aircraft
Event Driven	Buyout Capital	Social	Soft Commodities	Art
Relative Value				Wine

Source: derived from BVAI 2016a

The chart shows a simplified representation of asset classes making no claim to be exhaustive from the author’s point of view. This selection of asset classes cannot be consistent in the general comprehension: Some parts of the literature do not consider the asset classes of infrastructure and other (Dönges 2008 with further references) or include real estate as part of alternative investments (BVAI 2016). Dorsey (2007) and Dönges (2008) are also considering currencies as a part of alternative investments. This short overview highlights the different way of looking on alternative investment, basically with regard to the high diversity and the individual features of alternative investments.

Because in the general comprehension commodities, regularly, are an asset class of alternative investments, this article shall focus on investments in commodities. Commodities can be divided into the following categories (Table no 2):

Table no. 2 View of Commodities

Commodities					
Hard Commodities				**Soft Commodities**	
Energy	**Precious metal**	**Industrial metal**	**(Weather)**	**Agriculture**	**Livestock farming**
Crude oil	Gold	Aluminum	Weather derivate	Corn	Cattle breeding
Natural gas	Silver	Nickel		Wheat	Cattle farming
Coal	Platinum	Chrome		Timber	Pork
Renewables	Palladium	Titanium		Soya	

Source: derived from Faust 2006, p. 44; BVAI 2016b.

1.2. Investment Instruments for Commodities

The participation in the performance of commodities can be placed in several instruments (Table no. 3). The direct investment is uncommonly and rarely. In general, solely investments in gold are also traded physically.(Busack and Kaiser 2006). The dominant form is the indirect investment in commodities. Indirect instruments, which are at the investor's disposal, are forward contracts and options, certificate, exchange traded funds (ETFs), exchange traded commodities (ETCs), commodities linked notes (CLNs), as well as open and closed-end investment funds. The investment conditions ETFs and ETCs can provide for a physical custody to represent a substantial capital investment.

Table No. 3 Simplified Tax Classification of Standard Products

Investment Instrument	Tax Classification
Forward contract (Future)	Unconditional Forward Contract
Option	Contingent Forward Contract
Certificate	Debt Security
ETC	Debt Security
ETF	Investment Fund (UCITS)
Closed-end Investment Fund	Alternative Investment Funds (AIF)

Source: Schmidt (2015).

2. Research Methodology

Based on evaluations of several studies and publications of alternative investment associations (Federal Association of Real Assets and Investment Funds "BSI" 2014, Federal Association of Alternative Investors "BVAI" 2016a, BVAI 2016b), German Federal Ministries (Federal Ministry of Economics "BMWi" 2014, Federal Government "BREG" 2016), further statistical offices (Scope 2015a, Scope 2015b) and special literature investment, some trends can be identified. Furthermore, these sources provide information concerning alternative investments' motives and yield factors. Important tax aspects have to be added with regard to real net yield after taxes. The authors of this paper want to consider special tax impacts on institutional investors by investing in typical corporate structures, which can reduce pre-tax returns up to 30%.

Essentially, this paper is initiated from the question of a tax efficient structuring of alternative investments. This issue is a current challenge of institutional investors and, in particular, a German phenomenon due to the still existing trade taxation ("Gewerbesteuer").

3. Taxation of Alternative Investments in Germany

3.1 Forward Contracts and Debt Securities

The taxation of forward contracts is different: It depends on the special arrangement of these products. For capital investors gains of unconditional and contingent forward contracts constitute one group in the catalogue of capital incomes (Art. 20 (2) No. 3. EStG – Einkommensteuergesetz). In particular, the fiscal allowance of losses by forfeiting of these products will be controversial disputed (compare Heinicke and Krüger 2016, p. 1671).

Yields of debt securities, in general, represents interests or interest-like capital claims (Art. 20 (1) No. 7 EStG). These kinds of returns are uncomplicated for international institutional investors, in special, because no withholding taxes are retained and so no problems with regard to refund can arise.

3.2. Privileged Investment Funds

Based on AIFM-Directive of the European Union (Directive 2011/61/EU), new legislation in Germany through the AIFM-UmsG (Act of 4 July 2013, BGBl. I 2013, p. 1981) and the AIFM-StAnpG (Act of 18 December 2013, BGBl. I 2013, p. 4318) has extended the taxation of investment funds as well as the supervisory regulation. Since then, it will be differentiated between privileged investment funds and investment corporations.

In this comprehension, privileged investment funds are UCITS (Undertakings for the Collective Investment in Transferable Securities) according to Art. 1 (2) Directive 2009/65/EC. For the purposes of this Directive, UCITS means an undertaking (i) with the sole object of collective investment in transferable securities or in other liquid financial assets referred to in Article 50(1) of capital raised from the public and which operate on the principle of risk-spreading; and (ii) with units which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets. Action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to such repurchase or redemption.

The qualification of a privileged UCITS leads to a modified kind of net income method with special tax deferral effects of certain capital gains (in detail: Elser et al. 2015, 420, Art. 3, 4). Especially ETFs will be applied for these legal consequences. Distributions of out these UCITS qualify for tax purposes as dividends (Art. 2 (1) 1 InvStG – Investmentsteuergesetz).

3.3 Alternative Investment Funds (AIF)

Generally, Alternative Investment Funds (AIF) are classified as all funds, which are not subsumed under the above mentioned UCITS-directive (COM 2009, p. 2). Alternative Investment Funds (AIF) may also qualify as privileged investment funds, if they fulfill all requirements regarding to Art. 1 (1b) InvStG. It is not common that AIF meet the demands of a privileged investment funds (Kind and Haag 2010, p. 1526). Typically, in the range of

AIF, they are established closed-end investment funds with no right to return the shares (Wassermeyer et al. 2015, p. 482). Thus will be taxed privileged solely open investment funds, which fulfill several investment restrictions and are controlled.

In the legal consequences, commodity funds for institutional investors qualify regularly as AIF (COM 2009, p. 2). Before implementing the new German Investment Fund Rules, it was disputed whether commodity funds could fall within the scope of the German Investment Fund Rules. Background of this dispute is manly caused by the BaFin circular of 22 December 2008 (14/2008), where an investment fund is compliant with the principle of risk diversification through investing in more than three assets (quantitative test) subject to different investment risks (qualitative test). Confirming this case, a look-through-approach may be applied possibly by taking into account assets underlying the fund's assets. Furthermore, following BaFin (14/2008), a specific weighting of the assets may also lead to the principle of risk diversification not being complied with. Through the extension of the framework of the German Fund Rules, the discussion become obsolete, with the effect that commodity funds are qualified as so called Investment Corporations ("Investitionsgesellschaft") (Art. 1 (1c) InvStG). That means that the new legislation has strengthened the regulation for alternative investment structures, which typically invest in renewable energies and timber (Elser and Stadler 2014).

German inbound investments, in such structures particularly, are implemented by a GmbH & Co. KG (limited partnership with a limited liability company as general partner). This kind of corporate structure generally leads to a commercial infection (Art. 15 (3) 2 EStG). It refers to a special effect of deemed commercial infection ("gewerbliche Prägung") in German tax law, when general partner of a limited partnership solely is represented by a corporation. In that context, regardless of the concrete activity, even if just asset-managing, the limited partnership is classified as a business entity taxed by trade taxes. In contrast operating of (i) solar or (ii) wind parks , (iii) hydroelectric power stations or (iv) biomass plants – these are the main source of German renewable energies (Fraunhofer ISE 2015) – represent originally a business respectively commercial activity.

In that context, tax privileged institutional investors like pension, death benefit and support funds participate in such structures to improve their results in practice. Hereby, a risk can arise by a commercial infection through that participation and the loss of the tax privileged status (Wassermeyer et al. 2015). A participation in such a typical fund structure can lead to the loss of tax privileges in all investment segments of the investors, what means unlimited, as well as restricted to the area of the specific investments. The loss of tax privileged depends on the following aspects:

Based on the Federal Fiscal Court (I R 52/13), the Federal Ministry of Finance has published an interesting administrative order (IV C 2 – S 2706/14/10001), after which the participation in a commercial partnership of an institutional investor constitutes an own business (a so called "Betrieb gewerblicher Art"). That means that the tax privileged investor solely loses its privileged status in the amount of the gain of the commercial partnership. That, of course, describes a better situation than the complete loss of the tax privilege. This kind of partial commercial infection the Federal Fiscal Court(I R 60/10) denied at a limited partnership of a tax privileged foundation, where the partnership was asset managing and just deemed commercial. As consequence, it will be relevant for a partial or complete commercial infection whether partnership is operating commercial, in fact, or asset-managing and just deemed commercial. To find a way out of a partial or complete commercial infection of a tax privileged institutional investor it is recommended to interpose a corporation (Elser et al. 2015, 456, p. 17). Through this it is possible to avoid a commercial infection and leads to a requalification of commercial gains into dividends for the capital investor.

Conclusions

There is no general valid definition of alternative investments. One possibility could be to differentiate between traditional investments and alternative investments. Another approach could focus on the special investment strategies in the field of alternative investments. Finally, it is difficult to find a clear and precise definition of alternative investments. That depends on the diversity within the group of alternative investments as well as in the customized strategies of the asset classes it selves. Alternative investments can be classified as Hedge-Funds, Private Equity, Infrastructure, Commodities, Real Estates, Currencies and others, like wine.

The political statements in Germany and the macroeconomic perspective present a big trend in expansion of new renewable energy plant. Especially institutional investors are looking for adequate returns of their investments to fulfill obligations in context with their statutes. With regard to the expected prolonged low-interest-rate phase within the European Union, further investments in alternative asset classes are planned in 2016. These alternative investments, particularly for institutional investors, are structured as closed-end funds, typically under the legal form of limited partnerships (Wassermeyer et al. 2015).

It will be differentiated between privileged investment funds and investment corporations. New regulations make it more difficult for investment funds to reach the privileged investment fund rules. The qualification of a privileged UCITS leads to a modified kind of net income method with special tax deferral effects of certain capital gains. Alternative Investment Funds (AIF) may also qualify as privileged investment funds, if they fulfill all necessary requirements. However, this failed because AIF typically are closed-end investment funds, which supply no right to return the shares regularly.

The participation of a tax privileged institutional investor in a commercial partnership represent an own business within the scope of the investor's activities, which means that the tax privileged investor solely loses its privileged status in the amount of the gain of that commercial partnership. Completely different, in the case of an investment in a limited partnership, where the partnership is asset managing, but deemed commercial, too. This leads for the complete tax status of a privileged institutional investor like a pension fund to a complete commercial infection of all returns, the investor has generated. To find a way out of a partial or complete commercial infection of a tax privileged institutional investor, it is recommended to interpose a corporation.

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