WWW.FYB.DE

ENGLISH EDITION

FYB FINANCIAL YEARBOOK GERMANY/EU 2023

ALTERNATIVE TYPES OF FINANCING – THE REFERENCE SOURCE FOR ENTREPRENEURS AND INVESTORS

FOR YOUR BUSINESS

20 Years FYB FINANCIAL YEARBOOK

Dr. Christoph Ludwig
Tax Consultant and Partner
BLL Braun Leberfinger Ludwig Unger, Munich

Breaking out of a Time Loop – Current Innovations and (Non-)Developments in the Taxation of Private Equity and Venture Capital Funds

Regular readers of the annual issues of the FYB Financial Yearbook may still remember the introductory statements of our last articles in the FYB Financial Yearbook 2020: Πάντα ῥεῖ – Everything flows!" or "Little flows in the right direction!" (FYB Financial Yearbook 2022). The background at the time was the increased and intensified preoccupation of the fiscal authorities with the taxation of private equity funds or their limited partners subject to taxation in Germany and above all the frustration that the fiscal authorities simply negated several unambiguous and trend-setting rulings of Germany's highest fiscal court, the Federal Fiscal Court (*BFH – Bundesfinanzhof*), despite knowing better, over many years. Recently, a first break out of this time loop has seemed possible. Have fiscal authorities (finally) recognised the necessity and usefulness of private equity and venture capital and "fallen in love" with this asset class? In the movie "Groundhog Day", which we regularly quote, it was the love of Rita that finally freed Phil Connors from his groundhog day loop in Punxsutawney.

Our tax and law firm has been dealing with a wide range of tax compliance issues concerning private equity funds and their (German) limited partners for more than 26 years now. In the run-up to writing this article, records of the *8th Munich Venture Capital Conference* in 2004 fell into our hands more or less by chance. The topics discussed at this Conference, such as the qualification of income for and of private equity and venture capital funds, are still relevant today (or perhaps even more so than ever), while other topics, such as the taxation of the disproportionate carry claim of the carry holder, were subsequently codified in law, at least for asset management structures. The issue of value added tax (VAT) on management fees was also already discussed at that time. The then existing approach of structuring the management fees as a non-taxable

shareholder contribution and compensating the management fees by means of a priority profit share from net earnings as part of the appropriation of earnings (possibly in connection with the prior release of reserves in favour of net earnings) was withdrawn by the German Federal Ministry of Finance (*BMF – Bundesministerium der Finanzen*) with effect from 01 January 2008. Since then, the remuneration of the management regardless how that remuneration is structured (with the exception of purely profit-related remuneration) has been fully subject to VAT.

Instead of systematically exempting management fees for private equity and venture capital funds from VAT, as required by EU law, the legislator and the fiscal authorities agreed only to exempt so called "Wagniskapitalfonds" (for the definition see section II no. 1 of this article) from VAT. This restrictive interpretation and the non-implementation of existing EU legal requirements resembles the image of new wine in old bottles.

In the following, we will first turn our attention to the tax neutrality of capital repayments from corporations domiciled in the EU and in third countries again and outline the changes for corporations domiciled in third countries. In connection with the capital repayments from corporations domiciled in third countries, we had already prepared a "submission" to the Federal Ministry of Finance and to the Federal Minister of Finance, Mr Christian Lindner, in the spring of this year, but did not finalise and send it due to the current geopolitical issues that have already existed at that time. The Federal Ministry of Finance anticipated the timely and meaningful forwarding of our letter to the fiscal authorities by publishing its Circular.

Subsequently, we examine the ascertainment intended by the fiscal authorities in connection with the VAT exemption for "Wagniskapitalfonds" and also comment on the standstill or the direction of the flow of developments of further selected perennial issues in the area of ongoing tax compliance for private equity and venture capital funds.

I. Repayment of capital contributions by corporations domiciled in third countries – (possible) break out of the time loop?

In recent years, we intensively sensitised you in various articles in the FYB Financial Yearbook again and again to the tendency of the German legislator and the fiscal authorities to undermine the fundamental tax principle of mere income taxation and to increasingly introduce or enforce approaches to introduce taxes on assets (cf. our articles in the FYB Financial Yearbooks 2019 – 2022). For a long time, this essentially affected

- the repayment of capital contributions by corporations domiciled in the EU
- the repayment of capital contributions by corporations domiciled in third countries as well as
- distributions from investment funds within the meaning of the German Investment Tax Act (*InvStG – Investmentsteuergesetz*)

There is still a risk of taxation of assets when capital contributions are repaid by an EU corporation if (a) the distributing EU corporation does not submit the application for the assessment of the repayment of capital contributions to the Federal Central Tax Office (*BZSt – Bundeszentralamt für Steuern*) within one year after the end of the calendar year in which the payment was made (deadline!) and/or (b) the evidence required by the Federal Central Tax Office is not (cannot) be provided to a sufficient extent. As a result, the distribution made by the EU corporation is to be treated and recognised in full as a taxable dividend (cf. in detail inter alia FYB Financial Yearbook 2019 pp. 21 et seqq. and 2022 p. 41 et seq.).

The risk of a taxation of assets of the second and third groups of cases, the repayment of capital contributions by corporations domiciled in third countries and distributions from investment funds within the meaning of the German Investment Tax Act, has regularly been resolved in practice by means of share redemptions.

While a current BMF Circular (BMF-Schreiben) has resulted in a new provision for the repayment of capital contributions from corporations domiciled in third countries, the share redemption remains the only tried and tested means for investment funds for repaying capital contributions in a tax-neutral way. Otherwise, the acquisition costs initially remain in full and are only written off completely at the end of the term, subject to tax, although the statutory restrictions on offsetting capital losses apply to private investors. The instrument of share redemptions has now become established with (almost) all investment funds in Luxembourg, but also increasingly in other jurisdictions, not least at the insistence of German investors.

a) BMF Circular on the repayment of capital contributions by corporations domiciled in third countries

On 21 April 2022, the Federal Ministry of Finance finally published the long-awaited Circular on the repayment of capital contributions by corporations domiciled in third countries. In this Circular, the Federal Ministry of Finance addresses the fiscal treatment of repayments of nominal capital and repayments of contributions not made to the nominal capital of corporations domiciled in third countries and clarifies that such payments can be tax-neutral in certain cases and provided, certain conditions are met. In doing so, the Federal Ministry of Finance is following the now well-established case law of the Federal Fiscal Court and thus, in particular, the two rulings of the Eighth Senate already issued in 2016 as well as the most recent ruling of the First Senate from spring 2019. In these rulings, the Federal Fiscal Court had confirmed (several times) that corporations domiciled in third countries are also in a position to repay nominal capital and contributions not made to the nominal capital to their shareholders in a tax-neutral manner.

This change in the fiscal authorities' legal interpretation applies to all cases still open in connection with the repayment of capital contributions from corporations domiciled in third countries. Consequently and by doing this, the fiscal authorities have abandoned their long-standing self-imposed internal directive of not recognising a tax-neutral repayment of capital contributions from corporations domiciled in third countries for the time being. In the current BMF Circular, the fiscal authorities now clarify under which circumstances a payment is to be qualified as a tax-neutral repayment of capital contributions and which documents and evidence are required for this.

Corporations domiciled in third countries

According to the Federal Ministry of Finance, corporations domiciled in third countries are bodies corporate or associations of persons that are not subject to unlimited tax liability in Germany, an EU member state or an EEA state (EWR-Staat), but in another state at the time of the payment. This definition therefore includes, in particular, corporations that are subject to unlimited tax liability in the USA or Great Britain, on the Cayman Islands or the Channel Islands of Guernsey or Jersey or in Hong Kong.

Repayments of nominal capital

Section 7(2) of the German Law on Tax Measures in Case of an Increase of the Nominal Capital from Capital Reserves (*KapErhStG – Kapitalerhöhungssteuergesetz*) must also be applied and observed when nominal capital is repaid. This refers to cases in which nominal capital has been created through the conversion of capital reserves or retained earnings. The Federal Ministry of Finance requires in particular the resolution on the reduction and repayment of nominal capital as proof of this. For third-country corporations in private equity or venture capital funds, this regulation takes rarely effect probably. If it does, or for third-country corporations outside the "fund world", the resolutions on the nominal capital increase and the corresponding account statements for the payment and repayment should also be provided.

Repayment of contributions not made to the nominal capital

The repayment of contributions not made to the nominal capital may also qualify as a tax-neutral repayment of capital contributions. In the view of the Federal Ministry of Finance and now also in accordance with settled case law of the Federal Fiscal Court, the amount of the distributable profits (and thus also the amount of the repayable capital contributions) by a corporation domiciled in a third country is to be determined in accordance with the relevant foreign trade and corporate law taking the general German principles of assumed application into account, i.e. after the subordinate repayment of contributions. The foreign commercial balance sheet preceding the year of payment is decisive. A reconciliation statement to German tax law is not necessary. Thus – analogous to the national rules for domestic corporations – profits of the corporation domiciled in a third country are first considered distributed and then result in taxable dividends. There is a tax-neutral repayment of capital contributions only to the extent that the payments exceed a distributable profit.

Required documents and evidence

The Federal Ministry of Finance requires the following information and documents in German from the equity holder for the assessment of a repayment of capital contributions:

- Evidence of the unlimited tax liability of the body corporate domiciled in a third country making the payment for the period applied for
- Amount of the participation of the domestic equity holder
- Resolutions and evidence (bank statements) of the distribution made
- Foreign balance sheet of the corporation making the payment

In addition, the Federal Ministry of Finance points out that further information, documents or evidence may be requested in individual cases.

Against this background and depending on the evidence actually (subsequently) required by the fiscal authorities, it is to be hoped that the numerous cases that have accumulated in the meantime can now be resolved step by step and case by case, hopefully in favour of the taxpayers. There is no doubt that this BMF Circular is definitely a step in the right direction. Despite all the joy, justified doubts and unanswered questions remain, which are briefly addressed in the following.

b) Questions and doubts remaining after the publication of the BMF Circular

Right at the beginning of its Circular, the Federal Ministry of Finance emphasises that the (German) Corporation Tax Act (*KStG – Körperschaftssteuergesetz*) does not provide for a separate assessment procedure for the repayment of capital contributions from corporations domiciled in third countries, and that therefore the related questions can only be clarified in the course of the actual assessment procedures regarding the shareholders involved. The Federal Ministry of Finance thus also recognises that – in contrast to EU corporations – the strict deadline does not apply to corporations domiciled in third countries.

It is therefore to be feared, and this is also how initial statements from competent circles of the fiscal authorities are to be understood, that the fiscal authorities will not accept and maintain these formal differences with regard to the assessment procedure and the statutory deadline for corporations domiciled in the EU and in third countries.

Therefore, it can and must be assumed that the legislator will be mandated to bring about equal treatment of corporations domiciled in the EU and in third countries with regard to the tax-exempt repayment of capital contributions and to regulate the necessary procedures and requirements in the same way in the near future. Although it would be very desirable, it is also very unlikely that the legislator and the fiscal authorities will clear out and simplify the cumbersome regulations and requirements for the repayment of capital contributions for EU corporations. Rather, it is to be feared that, for reasons of convenience, the existing statutory regulations on the repayment of capital contributions for EU corporations will simply be extended and applied to third-country corporations as well.

In this case, corporations domiciled in third countries would no longer be able to establish the tax neutrality of a repayment of capital contributions on the basis of the simplified procedure developed by case law (and currently accepted by the Federal Ministry of Finance), but would have to fulfil legal requirements analogous to the applications for the assessment of the repayment of capital contributions from EU corporations. In our articles in the FYB Financial Yearbook 2019 (*pp. 21 et seqq.*) and 2022 (*p. 41 et seq.*), we have already pointed out the challenges of submitting these extensive and detailed evidence and documents to the Federal Central Tax Office (*area of competence BZSt?*) and the difficulties that exist in practice – with often low ownership interests or also due to the existing data protection – in obtaining these documents.

At the end of the BMF Circular, the Federal Ministry of Finance once again clarifies that the provisions of Section 27(8) of the German Corporation Tax Act apply to EEA bodies corporate in principle. If an EEA body corporate has not filed an application pursuant to Section 27(8) of the German Corporation Tax Act, the principles of the BMF Circular are also applicable to the EEA bodies corporate or associations of persons. Since the BMF Circular certainly does not intend to make up for or remedy missed and delayed applications of an EU corporation, we assume that this (catch-all) regulation serves to enable the tax exemption of repaid capital or reserves of EU special funds (e.g. FPCI, etc.) that are generally not eligible to file an application.

II. Standstill or developments going in the wrong direction: Stuck in the time loop

While it currently seems possible to break out of a long-standing time loop when it comes to the repayment of capital contributions in the case of corporations domiciled in third countries, the fiscal authorities are either not moving at all or are moving in the wrong direction when it comes to other "perennial issues" in the area of tax compliance for private equity structures and are still persistently insisting on their unsystematic or incorrect legal interpretation.

1) Value added tax on management fees: Exemption from value added tax for "Wagniskapitalfonds"

The fiscal authorities are still struggling with the recognition of a general VAT exemption for management contributions in private equity and venture capital structures. With effect from 01 January 2008, the fiscal authorities had initially charged VAT on management contributions – with the exception of pure profit-related remuneration regardless of the structure. With the Act to Strengthen Germany as a Funds Location (*FoStoG – Gesetz zur Stärkung des Fondsstandorts Deutschland*), a VAT exemption for the management of "Wagniskapitalfonds" was codified in law as early as 2021. With the BMF Circular dated 24 June 2022, the fiscal authorities support the objective of the Act to Strengthen Germany as a Funds Location through tax measures and, in particular, to promote young growth companies through venture capital investments and specify the conditions for the VAT exemption for "Wagniskapitalfonds". Accordingly, "Wagniskapitalfonds", including in particular qualified venture capital funds within the meaning of the EuVECA Regulation, are eligible for support and exempt from VAT if

- they invest more than 50% of the (aggregated contributed or uncalled but committed) capital in certain defined growth companies (target companies);
- the funds are subject to the same competitive conditions as undertakings for collective investment in transferable securities (UCITS); and
- they are subject to special state supervision or are registered as qualified venture capital funds.

The target companies must fulfil the following conditions:

- at the time of the first venture capital investment, the target company is not older than twelve years since it was founded
- at the time of the first venture capital financing, the size of the target company corresponds to a qualified portfolio company within the meaning of the EuVECA Regulation
- the target company has its registered office in an EU member state or a third country and fulfils the conditions defined in the EuVECA Regulation
- the target company is continuously (economically) active with the intention of making a profit

This means that our fears expressed in the FYB Financial Yearbook 2022, namely that only (certain) venture capital and EuVECA funds might benefit from the VAT exemption, have come true. However, if the fiscal authorities want to strengthen not only young growth companies in particular, but also the funds location as a whole – as intended with the Act to Strengthen Germany as a Funds Location – and eliminate currently existing disadvantages for Germany as a funds location, the extension of the VAT exemption to the management of all private equity and venture capital funds is imperative.

2) Capitalisation (or non-capitalisation) of fund establishment costs within the meaning of Section 6e of the German Income Tax Act (*EStG – Einkommensteuergesetz*)

In the FYB Financial Yearbook 2020 (*pp. 28 et seqq.*), we already reported in more detail on the codification of the capitalisation of fund establishment costs in law through the Electric Mobility Act/Annual Tax Act 2019 (*Elektromobilitätsgesetz/JStG 2019*). This new legal regulation has subsequently replaced the so-called "Munich model" of partial and proportionate capitalisation of perceived acquisition (incidental) costs, which was practised for years – at least in Bavaria. Tax returns for earlier assessment periods, which were still prepared under this regime, will now be adjusted to the new legal situation (retroactively!) in all ongoing tax audits.

According to the internally coordinated view of the fiscal authorities, (comprehensive) capitalisation of fund establishment costs takes place in the investment phase to the extent described in the law. So-called "broken deal costs" and "administration expenses" do not have to be capitalised, but are immediately deductible. This should also apply to interest expenses in connection with financing costs, but this is not the view of some representatives of the fiscal authorities. If, for example, no investments are made at the beginning or during the investment period, but fund establishment costs as defined in the law are nevertheless incurred during this time, these are recorded in a collective item and reversed over time according to individual economic criteria.

This new legal regulation naturally leaves a massive feeling of disturbance in the sense that the fiscal authorities are capitalising fund establishment costs retroactively in all current tax audits for all cases that are still open. Without going into the criticism of the retroactive application of legal changes that has always been voiced in tax literature, we hope and wish that the courts will (once again) reject such retroactive effects and that the legal innovation will only be implemented and applied once it has been codified in law and thus at a more acceptable time.

3) Changes in the obligation to report foreign investments

For cross-border situations, the German Fiscal Code (*AO – Abgabenordnung*) has long required increased obligations to cooperate from the parties involved. In addition to the aforementioned general clause, the German Fiscal Code also contains (specific) regulations on reporting obligations in connection with foreign investments. In 2002, this general clause was supplemented by certain reporting obligations for foreign corporations. In particular, this reporting obligation has not been completely clarified even after more than 20 years (!), although the Federal Ministry of Finance has consolidated all BMF Circulars issued on this topic since the beginning of 2018 in its Circular dated 26 April 2022 and also attempts to clarify legal questions that have remained open to date in this Circular.

However, the procedure for reporting indirect investments in foreign corporations is still problematic and has not been finally clarified. The legislator has so far failed to clarify whether only indirect acquisitions or disposals are covered by the reporting obligation.

While it had to be assumed on the basis of previous BMF Circulars that all indirect investments are also subject to reporting obligations, this statement is no longer found in the current BMF Circular replacing all previous BMF Circulars, which means an explicit restriction of the formerly fiscal authorities' opinion. Thus, when structuring private equity investments, there are cases in which several companies are interposed between the investing German shareholder and the foreign target company and this situation is not classified as reportable, at least not according to the wording of the law.

Nevertheless, the fiscal authorities also require a corresponding report for such indirect investments in foreign corporations to be made/made via a partnership, which leads to an immense effort on the part of the fiscal authorities and, above all, on the part of the taxpayers subject to the reporting obligation, who are exposed to far-reaching information requirements that are difficult or impossible to fulfil in practice.

Violations of these legal reporting obligations are sanctioned. If a reporting obligation is intentionally and recklessly not fulfilled, not completely fulfilled or not fulfilled in time, this constitutes an administrative offence which is punishable by a fine and, in certain case constellations, can entail further consequences under criminal tax law which are not to be neglected. In the FYB Financial Yearbook 2011, we published our first article on the obligations to report foreign investments under the provocative title "Tax evasion due to private equity investment?" – even then a title that still aptly describes the explosive nature of the topic today.

For this reason, taxpayers concerned should rather file one return too many than one too few in case of doubt, in particular to avoid a possible fine or criminal tax proceedings.

4) Asset management or commercial activity?

At this point, we have already reviewed the distinction between private asset management and trade and business in the qualification of income from domestic and foreign private equity and venture capital fund structures several times. The tendency reported in the FYB Financial Yearbook 2022, according to which private tax auditors tried to push (German) structures that clearly and indisputably qualify as asset management according to the criteria of the so-called fund decree into the "commercial corner" has at least calmed down somewhat in our perception. The case outlined last year, in which a tax auditor "wanted to subject the foreign taxpayers involved in the (privat asset-managing) partnership to limited tax liability in Germany", has in the meantime been concluded without a change in the income qualification.

Nevertheless, further cases become known from the market in which tax auditors (more and more frequently with the assistance of the tax investigation office and the public prosecutor's office) attempt to move the place of management of foreign private equity funds to Germany. In the case of hitherto foreign structures, this usually entails considerable value added tax consequences and, in the case of commercial structures, also leads directly to limited tax liability of the non-resident taxpayers in Germany.

III. Conclusion and outlook

This year marks the fourteenth consecutive year that we have contributed to the FYB Financial Yearbook on current tax compliance issues. In this context, we note that the fiscal authorities have become more and more intensively involved with private equity and venture capital, but have not necessarily made friends with the industry.

The hope expressed several times in previous years that the tax-free repayment of capital contributions from corporations domiciled in third countries would be recognised has now at least been taken up by the fiscal authorities. Against the background of the statement from the fiscal authorities that the repayment of capital contributions from EU and third-country corporations is to be treated equally, it is to be feared that the procedure for the repayment of capital contributions from corporations domiciled in third countries prescribed by the supreme court will not last in the long run. On the contrary, it must be expected that there will be no relief for EU corporations, but that corporations domiciled in third countries will also be burdened with the cumbersome procedure that applies to EU corporations.

The articulated objective of strengthening Germany as a funds location also through tax measures has unfortunately not been exploited (so far). Otherwise, the unnecessary restriction of the VAT exemption for "Wagniskapitalfonds" cannot be explained. Under EU law, a broad and comprehensive VAT exemption of management fees is permissible for all private equity structures and is understandably also implemented by various jurisdictions in neighbouring countries. The retroactive capitalisation of fund establishment costs in all outstanding cases and the attempts to move foreign private equity funds to Germany do not strengthen confidence in Germany as a funds location.

From a cinematic point of view, it appears that we are testing the fiscal time loop of Groundhog Day for one subject area, but remain stuck in it in relation to numerous other subjects. We can only hope that the breakthrough will finally be achieved, at least in the first-mentioned case, and that we will not have to realise in the near future that the time loop has sucked us back in like a black hole.

In this article again, we have referenced articles of previous years frequently and in many places to avoid repetitions. If you do not (or no longer) have the mentioned FYB Financial Yearbook articles, e.g. because older issues of the FYB

Financial Yearbook are out of print and/or not (or no longer) available, please do not hesitate to contact us. We still have some older issues of the FYB Financial Yearbook available or can at least provide you with the desired article(s) electronically.

We would be happy to respond to the further developments and selected current commercial, fiscal and/or regulatory issues in detail again in the FYB Financial Yearbook 2024.

christoph.ludwig@bllmuc.de | thomas.unger@bllmuc.de

About the author's:

Christoph Ludwig joined the firm directly after completing his studies in business administration at the Ludwig Maximilian University in Munich, he joined the law firm BLL, where he has been a partner since 1998. Christoph Ludwig specialises in the day-to-day national and international private equity and venture capital funds and the funds and comprehensive advice to wealthy (private) individuals with an entrepreneurial background. The range of services in the private equity sector includes the preparation of annual financial statements and tax returns for domestic structures as weil as comprehensive and complex separate and uniform declarations of declarations for domestic shareholders of foreign private equity funds, including any equity funds, including any AStG declarations.

Thomas Unger specialises in tax compliance for national and international private equity and venture capital funds in the form of direct and fund-of-fund structures. In particular, this includes the preparation of annual financial statements and tax returns for domestic structures as well as comprehensive and complex and uniform assessment returns for domestic shareholders of foreign private equity shareholders of foreign private equity funds, including any tax declarations and as well as purchase valuations in accordance with the KAGB and certifications of the of the real estate quota according to InvStG.