WWW.FYB.DE

ENGLISH EDITION

FYB FINANCIAL YEARBOOK GERMANY/EU 2016

PRIVATE EQUITY AND CORPORATE FINANCE

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

FOR YOUR BUSINESS

13 Years FYB FINANCIAL YEARBOOK

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

Compliance under Commercial and Tax Law as well as Other Regulatory Aspects Relating to Private Equity Funds

Day-to-day compliance duties as well as the innovations and amendments introduced by the German Capital Investment Code („KAGB“ *Kapitalanlagegesetzbuch*) keep domestic and – if applicable – also foreign private funds busy in the course of their daily work. For this reason we have selected aspects from various compliance areas, which we would like to explain in more detail below.

The first part of our article deals with some aspects relating to accounting at private equity funds. In the second part, we shall describe important issues of material and formal tax compliance. We would like to lay out, in detail, the following topics: separate and uniform declaration of assessment (for domestic and foreign private equity funds), reporting of investments in foreign entities according to Section 138 of the German Fiscal Code („AO“ *Abgabenordnung*) as well as the (new) regulation of the repayment of contributions at foreign companies limited by shares.

Finally, in a third part, this article will look at selected regulatory topics, such as the newly introduced reporting to the German Federal Financial Services Supervisory Authority („BaFin“) according to KAGB, the initial/acquisition valuation according to KAGB and/or the German Regulation of Capital Investments, Accounting and Valuation („KARBV“ – *Kapitalanlage-Rechnungslegungs- und -Bewertungsverordnung*) as well as recent findings on (alternative) depositaries for private equity funds.

In respect of some general information on tax compliance and further aspects of compliance for private equity funds we refer to our previous articles published in the *FYB Financial Year Book* since 2010.

Thomas Unger
Tax Consultant, Auditor and Partner
BLL Braun Leberfinger Ludwig, Munich
Managing Director of Private Equity Verwahrstelle GmbH, Munich

Compliance under commercial law: accounting

General principles

The responsibilities of a fund partnership (GmbH & Co. KG) under the German Commercial Code („HGB" – *Handelsgesetzbuch*) to prepare annual accounts are sufficiently known. The existing simplification options within the meaning of comprehensive investor information are usually not exercised in practice.

Even if there is no statutory obligation to have the prepared annual accounts audited, the annual accounts are usually audited due to corresponding provisions of the partnership agreement.

The balance sheet (not the profit and loss account („PLA")) as well as the notes on the annual accounts (excluding any PLA-related notes) must generally be published in the Electronic Federal Gazette of Germany directly after they have been presented to the partners, but not later than twelve months after the balance sheet date. If such information is not or not in due time published, the Federal Office of Justice commences proceedings for the imposition of administrative fines and gradually increases the imposed fines with each subsequent reminder.

Recently, more and more cases have become public in which the Federal Office of Justice also demanded private equity funds to publish their consolidated annual accounts and in which it follows up the publication and commences proceedings for the imposition of administrative fines in this context.

Particularities of accounting under the KAGB

The „mere" accounting under the German Commercial Code exclusively applies to alternative investment funds („AIF") that are no limited investment partnerships (*Investment-Kommanditgesellschaft*). But there are special provisions, particularly concerning publicly offered AIFs, to which not only the relevant provisions of the

KAGB but also, among others, the supplementary provisions of the KARBV apply. Such statutory requirements result, among others, in a different balance sheet structure, the disclosure of „unrealized profits and losses", the application of special valuation methods and the illustration of the statement on appropriation (of profits and losses). Furthermore, the preparation of a management report is mandatory. The modified and extended annual accounts have to be audited and published, as well. They must, moreover, also be submitted to BaFin and made available to the public, for example on the website.

The task of the fund managers („AIFM") and their advisors in this regard is to figure out the relevant provisions of the KAGB as well as the supplementary statutory provisions so that the AIF, on the one hand, submits the necessary data and information in the legally required form and, on the other hand, can benefit from any existing exemptions and relief.

After the first annual accounts have been prepared, it already becomes evident that no AIF is like the other in this regard and that different transitional and exceptional rules and/or simplification options apply in the specific individual case.

Compliance under tax law: obligations to declare

Separate and uniform declaration of assessment

In the past, we already discussed the issue of the separate and uniform declaration of assessment at (domestic and foreign) private equity funds and the related issues of income qualification and zebra members, i.e. the participation of corporate investors, including companies limited by shares, in asset managing partnerships (see the *FYB Financial Yearbooks 2010, 2013* and *2014*).

A separate and uniform declaration of assessment is usually uncomplicated for domestic fund partnerships (GmbH & Co. KG). There are particularities regarding asset management companies to the extent that individual shareholders (only with regard to individuals) hold a material investment (*wesentliche Beteiligung*) within the meaning of Section 17 of the German Income Tax Act („EStG" –

Einkommensteuergesetz), as they are not separately and uniformly assessed but only a notification for information is made in this regard. The sale of the material holding must be disclosed in the investor's individual income tax return. This also applies, of course, if the materiality of the holding does not indirectly result from one private equity fund but two (or more) fund partnerships, as any and all indirect and direct holdings have to be considered in the determination of the materiality.

Foreign entities affected by the assessment have only to be taken into account in the domestic separate and uniform declaration of assessment if they realize income subject to limited taxation. This, however, does not apply to material investments of non-resident taxpayers in domestic companies limited by shares, the sale of which is taxable in Germany, which have, nevertheless, not to be included in the separate and uniform declaration of assessment.

There are repeatedly cases in practice in which private equity funds do not notify their investors of the sale of a material investment by the fund partnership and the domestic or foreign investors, therefore, submit incomplete income tax returns.

The binding force that a separate and uniform declaration of assessment has for the competent tax office of the individual investor is also worth mentioning. The investor has thus no chance to assert own expenses (such as special business expenses) within the scope of his individual tax return and/or to give notice of inaccurate/incorrect (basic) notices of assessment at his level by raising an objection or filing an action.

A separate and uniform declaration of assessment also affects investments in *foreign* partnerships if two persons taxable in Germany, at least, participate in such partnerships.

The difficulties and problems arising from the fact that the general partner is usually located abroad and that there is no enforceable obligation vis-à-vis the German finance authorities to file a tax return are widely known. In the *FYB Financial Yearbook 2010* we explained that the German fiscal authorities are contacting individual German investors more and more frequently demanding the filing of a separate and uniform declaration of assessment. Such requests have since become more frequent. The fiscal authorities' course of action, however, does not take into account that German investors of a foreign partnership are usually not provided with sufficient information and that the investors generally have only limited possibilities to obtain such information themselves.

Further particularities and intricacies also result from multi-level structures. To the extent that individual German investors, for example, directly participate in a foreign private equity fund, but other German investors – frequently organized through banks –, for example, constitute a pool in the same target fund through foreign feeder fund structures, German duties to declare taxes, if any, have to be considered at all levels. If required, an individual separate and uniform declaration of assessment has to be made at every level.

Reporting obligation in case of foreign investments pursuant to Section 138(2) AO

We already described in detail the reporting obligation in case of foreign investments in the *FYB Financial Yearbook 2011*. According thereto, the following events must be reported:

- Set-up and acquisition of undertakings and permanent establishments abroad;
- Establishment, abandonment or change of investments in foreign partnerships; and
- Acquisition of investments in foreign companies limited by shares and other foreign corporations to the extent
  - there is a direct investment of no less than 10% in the capital or assets;
  - there is an indirect investment of no less than 25% in the capital or assets;
  - the total acquisition cost for all investments exceeds EUR 150,000.

As already reported in the *FYB Financial Yearbook 2013*, the deadline for the reporting of foreign investments of initially one month was adjusted to the general deadline for tax returns in November 2011. As a result, the outlined reporting obligation regarding foreign investments must be fulfilled by 31 May of the subsequent year. Unfortunately, our concerns expressed at the Bavarian Ministry of Finance in 2012 regarding this deadline and our proposal to link the deadline for reporting foreign investments to the extended deadline for the separate and uniform declarations of assessment of the respective fund or German investor have not been considered (yet). Therefore, the deadline is so far still considered to be not prolongable and presents substantial problems to private equity funds, a trustee or another representative if any of the aforementioned make the notification of foreign investments as well as the investor generally being subject to the reporting obligation to obtain and present the relevant information by the deadline.

Any non-reporting and/or incomplete or late reporting is an administrative offence under statutory provisions and punishable by a fine of up to EUR 5,000 in each case of offence.

Cases became repeatedly public recently in which the finance authorities took up this issue also within the scope of investigations by the tax authorities and partially exercised their right to impose fines.

(New) Regulations regarding capital contribution account for tax purposes

The repayment of equity, i.e. registered capital or capital reserves of a corporation shall generally not be taxable. The title of the statutory provision in the German Corporation Tax Act („KStG" – *Körperschaftsteuergesetz*) relevant in this regard is „Contributions not made to the registered capital".

This is generally no problem with regard to *domestic* corporations, as they file a declaration on the assessment of the balance of the capital contribution account for tax purposes within the scope of their annual tax return.

With regard to EU companies limited by shares, Section 27 (8) KStG regulates the separate assessment of the repayment of contributions. Accordingly, the assessment has to be made in accordance with the provisions applicable to German companies limited by shares. The EU company limited by shares has to file the application for taxation of repayment of the contributions with the Federal Central Tax Office („BZSt“ – *Bundeszentralamt für Steuern*) within one year after the end of the calendar year in which the distribution was made (deadline!). Distributions not certified to be repayments of contributions are deemed to be taxable dividends.

In early December 2014 rumors intensified, according to which the BZSt will abandon and change its previous administrative practice in connection with the application for taxation of repayments of contributions applicable to EU companies limited by shares at the initiative (or rather pressure?) of the Federal Ministry of Finance („BMF“ – *Bundesministerium der Finanzen*).

Contrary to the directions published on the BZSt's own website until then, not only the repayment of contributions but also the repayment of registered capital shall be reported and assessed with the period of one year (deadline).

We are convinced that the changed interpretation of the law has led to massive squeezes at private equity funds having invested in EU companies limited by shares and their tax advisors, as the complete and partially extensive and/or detailed information could certainly not be obtained and presented in due time within the short period until the end of the year. The only loophole in many cases was surely to file a „comprehensive and broad“ application by way of precaution to partially withdraw the application afterwards after all required documents and information had been obtained. The comprehensive and broad application may be reduced, but an application that is too brief and narrow cannot be extended.

The described changes in the administrative practice in connection with the application for taxation of repayment of contributions at EU companies limited by shares lacks, in our opinion, a legal basis, as the regulations applicable by analogy to domestic companies limited by shares are unreasonably extended. As a result of the severe legal consequences, i.e. the taxation of a payment as dividends instead of a repayment of contributions that is not taxable, disputes with the fiscal authorities will be inevitable. In case of doubt, the fiscal courts will have to decide this issue imposing long-lasting proceedings on the affected private equity funds with the respective uncertainties.

Selected regulatory aspects relating to private equity funds

BaFin – reporting pursuant to Section 35 KAGB

With the introduction of the KAGB, the legislator defined extensive reporting obligations for any and all capital management companies („KVG" – *Kapitalverwaltungsgesellschaft*).

According to the provisions of Section 35 KAGB, the KVG regularly has to report to BaFin any information about the most important markets and traded instruments as well as the material risks and concentrations of each managed AIF not only relating to itself but also to all AIFs managed by it. The reporting obligation, furthermore, relates to important features such as the amount of assets of an AIF that can only be liquidated with difficulties, information about the liquidity management and risk profile and risk management systems.

The reporting is mandatory from August 2015 following several test runs by BaFin through its MVP portal within the scope of which it tested the program itself as well as the compatibility with ESMA that eventually analyses and aggregates the data. Practice has shown in this regard that the KVG cannot complete the required XML format in accordance with BaFin's requirements without considerable technical support. In the meantime, several providers have launched reliable and manageable solutions that permit meeting the reporting obligations correctly and timely.

From August 2015 the reporting is to be made with retroactive effect from the quarter following the registration/issuance of permit. The following reporting is to be made annually in each case at the end of January of the following year.

Initial/acquisition valuation pursuant to KAGB/KARBV

With regard to closed-end publicly offered AIFs, the KAGB has introduced another regulation previously applicable to investment funds. Within the scope of the acquisition of a direct or target fund investment, the AIF has to commission a valuation report regarding the acquisition valuation pursuant to KARBV. In the past, corresponding obligations existed within the scope of the Investment Accounting and Valuation Ordinance („InvRBV" – *Investment-Rechnungslegungs- und Bewertungsverordnung*) that applied to investment assets and is now, in a comparable form, binding on publicly offered private equity funds. It seems that materially closed-end real estate funds have been the relevant target asset class when this regulation was drafted. Literature and workshops thus substantially focus on this scope of application. The requirements, however, are to be applied to publicly offered private equity funds although the individual provisions do not take the trade-specific particularities of private equity funds into account. Consequently, individualized valuation methods have to be taken as a basis for work and arguments in this area.

Statutory framework

According to Section 261(6), sentence 1 KAGB, investments in companies or interests in domestic or foreign closed-end publicly offered and special AIFs have to be valued by an external expert engaged by the KVG prior to their acquisition.

The valuation shall be based on the last annual accounts of the closed-end AIF certified by an auditor or, if the last annual accounts have been prepared more than three months before the valuation date, on the assets and liabilities of the closed-end AIF as proved by the auditor by means of an audited updated statement of net assets.

Interests in closed-end special AIFs are regularly assets that are neither admitted for trade at a stock exchange nor at another freely organized market or included in the regulated market or over-the-counter trading of a stock exchange or for which there is no trading price available. With regard to these assets the fair market value shall be taken as the basis pursuant to Section 28(1) KARBV in conjunction with Section 168(3) KAGB which is adequate after due assessment according to appropriate valuation methods in consideration of the current market conditions.

The typical methods of enterprise valuation according to IDW S1 (capitalized earnings value method, DCF method) are thus usually not appropriate in the private equity sector. Insofar the valuation must be geared to the particularities of this form of investment. This procedure is described by the example of an investment in a (primary) target fund (special AIF) below.

Valuation of the interest in a special AIF

The investment in a so-called primary fund is usually made in a still unknown portfolio (so-called blind pool). From experience, only a few investments are known and/ or have already been acquired at final closing.

The valuation of a primary investment is associated with particularities due to the general characteristics of a blind pool. In this case, the valuation of the investment is indirectly made by a derivation from the fund‘s total value and is substantially based on reference values, such as the fund‘s capital commitments and the payments possibly made until the valuation date by previously accessing limited partners. As the target companies to be acquired have largely not been identified yet, the calculation of the fair market value of such target companies is not possible. The fair market value of the investment in the target funds thus is initially calculated on the basis of the payments of present limited partners less pro rata internal costs of the fund. Furthermore, the fair market values of the target companies already acquired by the valuation date are considered in the valuation of the investment.

The valuation of the investment in the target fund at the valuation date is initially based on the fund‘s audited annual accounts as of the last balance sheet date. They contain the fair market values of the target companies as of the balance sheet date determined in accordance with accepted and adequate valuation methods as well as capital contributions and distributions made. In addition, the target fund regularly prepares quarterly accounts and (unaudited) investment reporting being the basis for the further valuation of the target companies.

Furthermore, circumstances relevant for valuation must be taken into account in the calculation for the period between the last quarterly closing date and the actual valuation date. Particularly, if applicable, capital contributions (increasing the value) and distributions (decreasing the value) must be taken into account in the valuation.

If, in addition, events become known, which materially affect the valuation of the target companies (subsequent events), they have to be taken into account accordingly in the determination of the actual cash value.

As a result it can be said that the legally required documents and/or requirements, such as audited annual accounts that are not older than three months, can de facto often not be presented and/or fulfilled if the target fund accepts subscriptions during the fiscal year. Consequently, a consistent continuation of the valuation of the target fund has to be made on the basis of the last audited annual accounts considering the quarterly (unaudited) valuations by the fund's management, material transactions as well as material cash movements of the target fund to be acquired.

■ (Alternative) Depositary for private equity funds

With the new regulation of investor protection within the scope of the KAGB, the legislator has provided for the (alternative) depositary pursuant to Sections 80 KAGB as a further regulatory institution for new private equity funds. With regard to alternative asset classes, such as private equity funds, that do not acquire and hold the typical assets that can be held in custody, the legislator has created a so-called „alternative depositary" in the form of a trustee as defined by Section 80(3) KAGB. These „alternative depositaries" may be a constructive and reasonable alternative to the conventional depositary bank solution for the responsible bodies of the KVGs. We hereby would like to refer to our article on (alternative) depositaries for private equity funds published in *FYB Financial Yearbook 2015*.

Practice has shown that the support of private equity funds particularly requires an extensive understanding of the structures, the typical procedures and processes and specifically the trade-specific maturities for establishing a complementary and constructive business relationship. This understanding already starts with the basic structure (is the fund a direct fund, a fund of funds, a co-investment fund, a primary or secondary fund, etc.), the capital contribution modalities (full contribution versus call in installments) to the particular characteristics of the relevant asset class.

Particularly direct funds clearly show the individuality of each fund that is very different for example in case a fund focuses on renewable energies, biotech or infrastructure. As each structure, thus, has individual features, the „proven“ standardized processes of the custodian banks cannot be drawn on for private equity funds.

This becomes specifically clear, for example, with regard to the verification of ownership to be made by the depositary. In this regard the depositary has inevitably to deal in detail with the asset-specific particularities of, for example, solar parks, wind parks, hydroelectric power stations, airplanes, among others, to be able to issue a corresponding opinion. The individual specifications of each asset, such as rights of way, restoration liabilities, yield assessments (wind study, solar radiation, etc.), statutory purchase prices, etc. have to be considered and assessed in this connection.

A proven standardized software solution cannot be used in this regard. Rather, individually developed verification processes and check lists are necessary to collect and assess the relevant procedures and information of the respective asset.

To ensure a smooth operation of the verification processes also for the KVG and to avoid any misunderstandings in the interpretation of the rights and duties both of the CMC and the depositary, the individual asset-specific processes must be adequately specified and finally defined in the service level agreement attached to the relevant contract of deposit.

This, however, indispensably and mandatorily requires the specific expertise of the persons in charge at the depositary in the relevant asset classes as well as their structures and processes. Only if this expertise exists at the level of the depositary, may it substantially support the KVG’s processes.

Future Prospects

In addition to the aforementioned compliance issues under commercial and tax law and the regulatory aspects relating to private equity, numerous further regulatory requirements keep the private equity sector busy. As already described in detail in our previous articles published in the *FYB Financial Yearbook*, the first FACTA reports had to be made to the Federal Central Tax Office in August 2015. The bilateral treaty between Germany and the USA and the possibility of not filing a report (i.e. also no negative report) if no reportable facts existed for 2014, provided relief for that year. As from 2016, a so-called negative report will presumably also have to be made in such cases.

Parallel to this, the USA and the „EU 5" (Germany, France, Spain, Italy and Great Britain) made a joint statement in 2012 according to which FACTA was to be developed to become a model of international information exchange. Subsequently, the OECD was instructed to create a common reporting standard („CRS"), which now exists and has been published in the meantime. The aim is to globally extend the adopted FACTA regulations. According to current planning, the first report will have to be made on 30 September 2017 for 2016. The corresponding German implementing law does not, however, exist yet.

The introduction of the so-called participation exemption for capital gains (abolition of the general privilege according to Section 8b KStG) is also still being discussed. According to current information, it shall be implemented within the scope of the revision of the German Investment Tax Act presumably at the end of 2015, effective, however, only as of 01 January 2017. According to the most recent key issues paper "Venture Capital", exceptions are only planned for certain innovative companies. This means that the private equity sector will be threatened by another significant deterioration of the fiscal basic conditions in Germany after the taxation of dividends on widespread shareholdings under the corporate income tax was introduced as of 01 March 2013.

Current as well as looming changes in compliance under commercial, tax and regulatory law will, thus, continue to keep the private equity sector very busy. We would be happy to respond to any further developments and selected current issues in detail in the *FYB Financial Yearbook 2017*.

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