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## PRIVATE EQUITY AND CORPORATE FINANCE

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

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# Tax evasion due to private equity investment? Reporting obligations in case of foreign investments

**The prompt and correct taxation of foreign investments has gained more importance again not least since the appearance of various CD-ROMs containing the data of German citizens and their banking details and movements in their foreign accounts. The exchange of information regarding fiscal matters has intensified all over the world. The fiscal authorities in Germany now increasingly review the foreign investments of German residents in this connection.**

German fiscal law can sometimes be very complex and confusing. Investors in private equity companies run the risk of becoming tax evaders under certain circumstances due to a regulation that was unknown and/or disregarded in the past. Hence it has become evident that the particularities of private equity as an investment form were not adequately reviewed at the time the fiscal legislation was passed. The law has contained the duty to report foreign investments since 2002. This duty can normally be fulfilled without major effort in case of direct investments, but private equity investors are confronted by problems as they might not be able to report the acquisition of a foreign investment to the fiscal authorities within the statutory period for a purely practical reason: their usually multilayered domestic and foreign holding structures. As tax advisers of many private equity structures we would like to draw your attention to the legal regulations and the practical problems arising in this context.

With regard to investments of individuals and companies in foreign partnerships or companies limited by shares that are taxable in Germany, the fiscal authorities provided in certain cases for a reporting obligation vis-à-vis the tax office, that is regulated in Section 138 (2) of the German Fiscal Code (*Abgabenordnung; AO*). These cases include among others:

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- the participation in foreign *partnerships* and its disposal, where the disposal of the investment and/or the increase or decrease of the invested amount has to be reported only since 1 January 2002 and
- the acquisition of investments in a *foreign corporation* (substantially companies limited by shares) if
  - this directly results in a participation of at least 10 per cent or indirectly in a participation of at least 25 per cent in the capital or assets of the corporation or
  - the sum of the acquisition costs of all investments exceeds € 150,000.

**Reporting procedure and legal consequences in case of violation**

The reporting obligation continuously applies to investments in foreign *partnerships* as *each change* in the investment must be reported.

In the case of an investment in a foreign *company llimited by shares*, the acquisition has to be reported only if the threshold of 10 per cent and 25 per cent respectively (see above) is reached or exceeded *for the first time*. Thus, the increase of an investment in a foreign corporation that has already been reported is no longer notifiable. Irrespective of the described limits on the percentage of shares acquired, the investment has to be reported, even if the aggregate acquisition costs of *all* investments in foreign corporations exceed € 150,000 in total. The reporting of the acquisition of investments in listed companies, however, can be waived if the investment amounts in each case to less than 1 per cent of the share capital and/or the assets of the corporation.

Following the revision of the statutory regulation, the reporting has to be made within one month after the notifiable even. It has also to be made to the relevant tax office in accordance with officially required printed forms. Such notices are then passed on from the tax offices to the Federal Central Tax Office (*Bundeszentralamt für Steuern*) for assessment. This might result in further inquiries and

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investigations pursuant to the provisions of the German Foreign Transaction Tax Act (*Außensteuergesetz; AStG*).

Failed or delayed reporting of foreign investments is an administrative offence and may be punished by a fine of up to € 5,000. Even the determination of coercive measures (e.g. administrative fines of up € 25,000 at most) is permissible. Pursuant to decrees of the fiscal authorities, the offices for administration fines and penalty payments have *compelled* to be involved in case of violations of the reporting obligation, i.e. the fiscal authorities have no discretion on principle.

**Problems in the practical execution arising for private equity companies**

The duty to report investments in foreign companies was already legally constituted at the end of 2001 but was hardly noted in practice and was generally not punished by fines by the fiscal authorities. As a result of statements made by the fiscal authorities that they intend to increasingly review the compliance with such reporting obligations, various parties are currently drawing investors' attention to such obligations. Further attention is attracted by the circular issued by the Federal Ministry of Finance on 15 April 2010. In this circular the fiscal authorities not only instruct the tax offices "to emphatically control the fulfilment of the reporting obligations" but also explain certain criteria that will trigger a reporting obligation. All such publications, whether issued by the fiscal authorities or by third parties do not, however, provide for a global solution of the specific problems and questions arising for private equity companies. It has also not been clarified as to who is subject to reporting obligations and entitled to make the reporting within these holding structures and to what extent. Given the ambiguous wording of the law, which allows multiple interpretations, it is all the more surprising that neither the legislator nor the fiscal authorities have provided for a clarification and that even the relevant expert commentaries only deal with this subject to a limited extent.

Various questions and problems that are of importance to private equity companies and their investors arise with regard to the reporting obligations set forth above and for which the wording of the law does not give answers or solutions. These are among others:

■ **Reporting of indirect investments in foreign partnerships?**
In case of a literal interpretation it cannot be inferred from the law's text that the *indirect* acquisition of foreign partnerships via an intermediate domestic or foreign partnership (fund-of-fund structure) has to be reported. The reference to the reporting obligation regarding purely indirect investments is literally contained only in that part of the legal provision that refers to investments in *companies limited by shares*. This, however, can be interpreted just as well as that the missing addition "direct or indirect" indicates that the reporting obligation applies to *all* types of investments in foreign partnerships.

As the legislator intended the *comprehensive* reporting of all kinds of foreign investments when introducing the reporting obligations for foreign investments, it can be assumed that also purely indirect investments in foreign partnerships have to be reported by German private equity investors. This is also supported by the fact that in the case of investments in foreign partnerships, *each* change in the investment has to be reported irrespective of the size of the investment. Only with regard to foreign companies limited by shares is a minimum investment decisive for the reporting to the tax office. The interposition of a domestic or foreign partnership thus would render the extended reporting obligation for an investment in foreign partnerships compared to an investment in foreign companies limited by shares absurd.

■ **Persons subject to a reporting obligation**
The reporting obligation applies to "taxpayers having their residence, habitual residence, management or place of business within the scope of this law". Thus, basically, only individuals and corporations have to report their investments in foreign companies as only these entities are taxpayers subject to income and/or corporation income tax. Partnerships are in fact independent legal entities that are not subject to income and/or corporation income tax – i.e. they are therefore not "taxpayers" with respect to the meaning of this provision.

The text of the law, however, possibly also allows another interpretation in this regard that has been advanced in the literature. The reference to such a legal provision, which is contained in the legislation regarding the reporting obligations in connection with foreign investments and which regulates the jurisdiction of the tax offices over the taxation of partnerships, suggests that domestic partnerships acquiring foreign investments may be subject to the reporting obligation. It is thus not conclusively clear whether domestic partnerships have to report their foreign investments, too, or – due to the fiscal transparency of partnerships – only their partners. This question is extremely important with regard to the scope of the reporting obligations as not only the investors in private equity funds but also the private equity funds themselves would thereby be subject to an additional reporting obligation.

As the legal provision applies to indirect as well as direct investments in foreign partnerships and as the legal provision assigns the reporting obligation exclusively to the taxpayer (this is always the respective limited partner due to the fiscal transparency of partnerships), it can basically be assumed for the time being that not the private equity company itself but only its limited partners are subject to the reporting obligation.

These problems are only seemingly mitigated in practice by the fact that – to the extent resident taxpayers invest in a foreign private equity fund and the income is to be assessed severally and uniformly for all resident taxpayers – the fiscal authorities accept the fulfilment of the reporting obligations by the foreign private equity fund, a trustee or another party representing the interests of the resident taxpayers. From our point of view, this method in fact enables domestic private equity companies and/or their managements and/or their tax advisers to effect the reporting for resident shareholders. But this only fulfils the reporting obligation of the shareholder of the private equity company. If domestic private equity funds are subject to a separate reporting obligation, this obligation has to be fulfilled, too. It cannot be inferred neither from legislation nor from the literature whether a notice made for the shareholder would also fulfil the separate reporting obligation of the private equity fund. Consequently, it would be more than desirable for this question to be conclusively answered by the legislator and/or the fiscal authorities.

- **Calculation of the € 150,000 limit for investments in companies limited by shares**

The law also provides for a reporting obligation in case the acquisition costs of all foreign investments in companies limited by shares exceed € 150,000 in the aggregate. In this regard, investments already held by private equity investors in companies limited by shares are also included. To be sure, only the first instance of exceeding the € 150,000 limit has to be reported. This, however, cannot be inferred from the wording of the law but only from the reasons given for the law. This opinion is concurrently advanced in pertinent commentaries to the German Fiscal Code.

The € 150,000 limit, however, harbours further uncertainties. Some of the literature, for example, also derives a reporting obligation from the wording "all investments" if the acquisition costs of *any and all* investments in several companies limited by shares exceed the € 150,000 limit. The instructions accompanying the official form to be used for the reporting contain the note that notification has to be made if "the sum of all of your investments amounts to more than € 150,000". Though the fiscal authorities have in the meantime exempted foreign companies limited by shares from the reporting obligation by decree if such companies are listed on a stock exchange and the investment amounts to less than 1 per cent of the share capital and/or the assets of the corporation. This interpretation, however, would still considerably increase the number of notifiable transactions, which is certainly not desired in practice if only because of the administrative expenses involved. Given this limit of only € 150,000, which is quite low, the question arises moreover whether the fiscal authorities should be granted such extensive rights to obtain information or whether this is out of proportion. From our point of view, the law should be interpreted such that the statutory reporting obligations apply only if the acquisition costs of all investments in *one and the same* foreign company limited by shares exceed € 150,000.

The wording of the law furthermore applies to an aggregation of indirect and direct investments only in the case of the calculation of the percentage amount of the investment. This only allows the conclusion that only *direct* investments in foreign companies limited by shares are to be taken into account when calculating this € 150,000 limit. This would correspond to the situation in practice, as

acquisition costs are normally not disclosed to private equity investors in case of investments which are only held *indirectly*. If the private equity structure is even a fund-of-fund structure, this would result in disproportionate administrative expenses, if and to the extent that the required information could actually be obtained, as the whole investment chain up to the final target company would have to be monitored within the scope of each transaction.

In literature, however, the opinion is also advanced that the calculation of the € 150,000 limit also gears to indirect investments. According to the current state of knowledge, the fiscal authorities seem to follow this opinion.

■ **One month reporting period**

The period for the reporting of foreign investments is only one month from the occurrence of the event. As this is a statutory period it *cannot be extended*. The fiscal authorities and the literature agree in this regard. In that case, from our point of view, the legislator was not aware of the particularities of private equity structures. This rigid standard period of one month is only tailored to the reporting of direct investments or to very simple and "short" holding structures at best. In the case of private equity companies, however, this period can usually not be met in practice as often several weeks or even months pass, in particular in cases of multilayered foreign holding structures before the parent company receives investment reports regarding the acquisition of investments and/or changes in the investment share.

Here something is expected from the taxpayer that is de facto impossible. And this may result in violations of the tax law committed by a private equity investor without any fault on his part and despite best efforts made by the fund company.

**Summary**

There are still many unanswered questions in connection with the obligations to report foreign investments as to their scope and/or execution. Such obligations furthermore confront private equity companies and their investors with partially

unsolvable problems, as the acquisition costs in case of indirect investments in foreign companies limited by shares are likely not known to the investor, in particular in case of multilayered foreign holding structures and as the notification period of one month cannot be met by fund companies at all times even in case of sophisticated controlling. In favour of the fiscal authorities it must be pointed out, however, that questions regarding reporting obligations are always interpreted at the expense of the fiscal authorities and not the fund companies and their investors. Finally, there are a lot of unanswered questions with regard to the application, interpretation and proportionality of the provisions concerning the obligations to report foreign investments that require complete clarification.

Our law firm is currently in close contact with the highest federal fiscal authorities as well as the state fiscal authorities in order to clarify questions of detail arising for private equity investments and to find solutions regarding the obligations to report foreign investments that are acceptable not only to the investors but also to the fiscal authorities. Our remarks have triggered a lively discussion among the various departments of the fiscal authorities which unfortunately was not yet concluded at the time of completing this article. In the meantime the fiscal authorities have indicated, however, that the highlighted problems should be promptly solved. We hope that these solutions result in reporting obligations that can be fulfilled by private equity investors at justifiable efforts and within a reasonable period of time.

In conclusion we can only note that not only the Bavarian fiscal authorities but also the Federal Ministry of Finance have meanwhile realized that this law makes demands on private equity investors that are impossible to be met. It has been confirmed that the current practice is not consistent with the principles of a constitutional state. Insofar we look forward to the announced measures and will be happy to keep you informed.

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