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

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Formal Tax Compliance in Case of German and Foreign Private Equity Funds

The economic successes and attractive return potential of private equity investments compared to the extremely low level of interest rates on the capital markets, which has been close to zero for many years, has increasingly motivated numerous long-standing private equity investors as well as newcomers to expand their investment focus and engage in German and foreign private equity funds.

Interestingly, however, there is still no explicit legal regulation in Germany regarding the taxation of German private equity funds or the taxation of domestic taxpayers when investing in foreign private equity funds. The German Act to Modernise the General Conditions for Capital Investments (*"MoRaKG" – Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungen*) and the German Venture Capital Act (*"WKBG" – Wagniskapitalbeteiligungsgesetz*) were tentative attempts to create a legal framework, whereby only some parts of the MoRaKG were implemented and essential elements of the WKBG were declared inadmissible by the EU Commission in Brussels under EU subsidy aspects and were therefore not allowed to be implemented.

The coalition agreement for the 2013-2017 legislative period once again listed the Federal Government's support for risk capital to strengthen Germany as a financial centre. However, since this project was again not taken up in the subsequent period, the German Private Equity and Venture Capital Association (*"BVK" – Bundesverband der Kapitalgesellschaften*) took the initiative to draw up a legislative proposal and submitted a possible act on venture capital with important and fundamental regulation for the risk capital industry in the spring of 2015. It would have been desirable for the Federal Government to approach this issue right at the beginning of the legislative period, as experience shows that such kinds of

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innovation and complex changes at the end of a legislative period are generally no longer feasible due to the impending elections.

Thus, German private equity funds and investments of domestic taxpayers in foreign private equity funds are still taxed on the basis of general regulations and the circular of the German Federal Ministry of Finance on the "Treatment of venture capital and private equity funds under income tax law" of 16 December 2003. The first major decision of the Federal Fiscal Court (*"BFH" – Bundesfinanzhof*) of 24 August 2011, which was not officially published until 2014, and with which the BFH for the first time took a position in an *orbiter dictum* on the qualification of private equity funds, has also not led to any significant changes in the practice and tax treatment of private equity funds in force up to then.

Against this background, selected essential aspects of formal tax compliance from daily tax practice in connection with German and foreign private equity funds are outlined below and the current procedures and views of the fiscal authorities described.

Formal tax compliance

Formal tax compliance does not only comprise the obligation to prepare a separate and uniform tax return with regard to investments in German and foreign private equity funds structured as partnerships but, among other things, also various notification requirements in connection with tax issues. The following article is limited to the obligations to file tax returns of or for German taxpayers investing in foreign private equity funds as well as to the currently stricter reporting obligations with regard to foreign investments and the regulations on the tax-free repayment of capital contributions in connection with EU and non-EU corporations. The topic of the FATCA – Foreign Account Tax Compliance Act, which was already described in detail in previous articles in the FYB Financial Yearbook, has meanwhile taken a more general turn and can be dealt with in

a very good and satisfactory manner. The further development of FATCA into an international information exchange model, which was already envisaged in 2012, has now also been implemented by the OECD. The first reporting in accordance with this Common Reporting Standard ("CRS") was to be taking place in September 2017 at the latest for the reporting period 2016.

Separate and uniform tax return of income from foreign partnerships with several German taxpayers being invested

Due to the increasing number of investments of current and new German investors also in foreign private equity funds, the requirement for these foreign private equity funds to prepare a separate and uniform tax return and to file it with the respective fiscal authorities rises when such funds have two or more German investors. In the FYB Financial Yearbook 2013 we still wrote that the fiscal authorities contacted German investors known to them – naming the other German investors known to them – requesting the filing of a joint tax return. Meanwhile, the fiscal authorities have abandoned this practice, as far as known, certainly also for reasons of data privacy, and now contact the German investors known to them requesting permission to pass on the personal data to the other investors involved in the determination to coordinate the joint tax return. Below, we shall shortly discuss the difficulties encountered in the required coordination of the preparation of tax returns for several years in the past, if applicable, and the possible diverging interests.

Pursuant to statutory provisions, a German investor in a foreign private equity fund is generally personally responsible for ensuring that income can be determined in accordance with German tax law. If this investor is not the only fully taxable German investor of in foreign private equity fund, the following provisions apply in addition.

The taxable income as well as the related tax bases are to be determined "separately". This has to be made "uniformly" for all investors if they are relevant for taxation in Germany. Since generally neither the management nor the assets of such funds are located in Germany, the income from foreign private equity funds is determined for all fully taxable German investors with the tax office in whose

district a joint representative (such as a trustee or the tax advisor, if any) or the most valuable part of the assets from which the income is derived is located.

The aforementioned declaration obligations do not only apply to the German investors involved in the determination but also to the management of the (foreign) private equity fund which is partially very surprised and frequently also sceptical– at least initially when encountering and having to deal with German tax compliance obligations in the form of the separate and uniform tax return for the first time.

Some general partners, however, simply do not respond to the German fiscal authorities' requests to file a tax return for their German investors involved in the determination. Consequently, the obligation to assist in the preparation and filing of the joint tax return (also and/or particularly) remains with the German investors. In case the general partner does file the tax return, the other German investors are generally released from such obligation. But if the tax return is incorrect or incomplete, they continue to be obliged to file such a return.

It goes without saying that it cannot be ensured in all cases of investments in foreign private equity funds that full information about all German investors involved in the determination is available. Reasons for this can be (a) that the foreign fund manager does not respond to the request of the German fiscal authorities and that the fund manager neither commissions the preparation of the tax return nor coordinates the German investors, or (b) that the fiscal authorities themselves have not (yet) initiated the above described coordination of the preparation of the tax return for the German investors concerned. The individual German investor generally does not know the other German participants in the tax return.

Should individual concerned German investors in a foreign private equity fund, nevertheless, know each other (by chance) or should, for example, several shareholders/companies of a family office or an institutional investor like an insurance company invest in the same foreign private equity fund, these investors jointly file a so-called partial tax return because they are unaware of the other German investors.

As soon as other German participants in the determination declaration become known at a later point in time, for example, due to a subsequent action of the foreign fund manager or on the initiative of the German fiscal authorities, and as soon as these other concerned German investors join each other for filing a joint tax return or join an existing partial tax return, a considerable need for co-ordination usually arises. Examples for this are the qualification conflicts already explained in the FYB Financial Yearbook 2013 (see p. 34 et seq.) as well as the understanding and agreement of the German participants in the determination declaration upon a joint tax advisor, particularly in such cases in which an own tax return has already been commissioned.

The later first-time filing of a tax return for German investors involved in the determination and/or the later extension of an already filed partial tax return by other German investors who only became known at a later point in time, however, bears considerable potential for conflict. Several cases have meanwhile become known in which the fiscal authorities assessed the late filing of a tax return for concerned German investors in a foreign private equity fund and the late consolidation of the declared fiscal results of individual investors in a joint tax return as so-called voluntary disclosure (*"Selbstanzeige"*) according to the provisions of the German Fiscal Code (*"AO" – Abgabenordnung*) and also instituted criminal proceedings involving fiscal offences against German investors as a result thereof.

Numerous managers of foreign private equity funds are meanwhile sensitised to German tax declaration obligations and increasingly start to engage German tax advisors to prepare the separate and uniform tax return for German investors involved in the determination already at the beginning of the term of the foreign private equity fund. This approach offers the following advantages for all German investors involved in the determination and the foreign fund management:

- Uniform qualification of the income of the foreign private equity fund and avoidance of potential qualification conflicts;
- Identical tax results for all German investors; and
- Avoidance of identical or at least similar questions asked by the different tax advisors of the individual German investors to the finance/management team of the foreign private equity fund.

Stricter notification requirements in case of foreign investments pursuant to Section 138(2) of the German Fiscal Code

For many years now, German taxable entities being fully liable to income and/or corporate income tax have to notify the competent tax office of certain foreign shareholdings and investments by using officially prescribed forms. We already extensively described the details of the reporting obligations in case of foreign investments based on a corresponding circular of the German Federal Ministry of Finance in an article in the FYB Financial Yearbook 2011 with the provocative title "Tax evasion due to private equity investment? – Reporting obligations in case of foreign investments".

An intense discussion about the legality and legitimacy of letterbox companies developed as a consequence of the publication of the so-called Panama Papers in April 2016. The Federal Government and the German Bundesrat initiated a corresponding Act on Combating Tax Evasion (*"StUmgBG" – Steuerumgehungsbekämpfungsgesetz*), which shall make it easier for the German fiscal authorities to determine the corresponding facts. The Act on Combating Tax Evasion entered into force on 25 June 2017 and extensions and modifications of the reporting obligations of German taxpayers regarding their foreign investments basically apply for the first time to transactions taking place after 31 December 2017.

The following circumstances have thus to be reported. For reason of clarification, existing provisions are marked with "as before" and new provisions must be identified with "new":

- Set-up and acquisition of business operations and permanent establishments abroad (as before);
- Establishment, abandonment of, or change in, investments in foreign partnerships (as before); and
- Acquisition and (new) sale of investments in foreign corporations and other foreign bodies corporate with registered office and management abroad, if

a) there is an investment of no less than 10% in the capital or assets; or
b) the sum of the acquisition cost for all investments exceeds EUR 150,000.

It is worth emphasizing that the former differentiation between directly and indirectly held shareholdings in foreign corporations has been abandoned and that the reporting threshold was (new) decreased to 10% uniformly for direct and/or indirect shareholdings and that therefore, for example, investors in private equity funds are liable to report any facts earlier than in the past due to the lower threshold.

It is also new that with all reports of the aforementioned facts as well as the completely new reporting obligations regarding investments in a non-EU company as described below also the kind of the business operations, the permanent establishment, the partnership, the body corporate, the body of persons, the estate or the non-EU company have to be disclosed in future. The following extension of the reporting obligations regarding the investment in a non-EU company clearly underlines the legislator's goal of higher transparency and combating tax evasions by means of the Act on Combating Tax Evasion in a particular manner. It is also new that the following fact has to be reported:

- The fact that the German taxpayer alone or together with related persons within the meaning of Section 1(2) of the German Foreign Tax Act (*"AStG"* – *Außensteuergesetz*) can/should directly or indirectly exercise a controlling or decisive influence on the corporate, financial or business affairs of a non-EU company for the first time.

A non-EU company in this regard is a partnership, body corporate, body of persons or estate with registered office or management in countries or territories that are not member states of the European Union or the European Free Trade Association. After the revision of the law, actual influence is sufficient; a formal ownership position is not required. Consequently, these reporting obligations also apply to trust structures and probably also to foundations.

In addition, investors who exercise a controlling or decisive influence on the corporate, business or financial affairs of a non-EU company are obliged to keep the respective documents for a period of six years. This could result in tax audits being carried out at taxpayers controlling "non-EU companies" to examine these documents without further explanation.

Fortunately, the deadline for filing the report on foreign investments was extended. The period of one month following the event to be reported was harmonised with the general deadline for filing tax returns by 31 May of the following year in November 2011 – as already described in FYB Financial Yearbook 2013 – the report on foreign investments has now to be filed according to current legislation together with the income or corporate income tax return for the taxable period in which the event occurred but not later than by expiry of 14 months after the end of the taxable period, using the officially prescribed data forms via the officially defined interfaces. In deviation from the regulation described above according to which the explained new provisions and stricter provisions only apply to facts occurring after 31 December 2017, German taxpayers who could directly or indirectly exercise a controlling or decisive influence on the corporate, financial or business affairs of a non-EU company before 01 January 2018 for the first time have once to report any facts continuing to exist after 31 December 2017 together with the income or corporate income tax return for 2018.

If the obligation to report is not met and if such obligation is breached, the commencement of the period for assessment is suspended and thus also the commencement of the period of limitation for the assessment. Furthermore, the failure to comply with the reporting deadlines will be punished by a fine of up to EUR 25,000 in the individual case.

After several cases became known again and again in recent years in which the fiscal authorities addressed these reporting obligations in connection with foreign investments – also within the scope of investigations – and partially even exercised their right to impose fines, it could be expected that the intensity of the examinations in this area and with regard to these facts increases even more with the aim of achieving the legislator's goal of greater transparency regarding such foreign investments. For the lack of a legal definition of the terms "controlling" or "decisive" influence and due to the legislator's failure to substantiate the criteria, disputes with the fiscal authorities – particularly in connection with non-EU companies – are inevitable not least against the background of the above-described suspension of the commencement of the periods for assessment/commencement of the period of limitation for the assessments and the strongly increased fines.

For the sake of completeness, we also would like to point out the new provisions introduced within the scope of the German Act on Combating Tax Evasion, such as the reporting obligations of banks, credit institutions and financial service providers when they establish contacts between German taxpayers being their customers with a non-EU company and when they are aware of the controlling or decisive influence of their customer.

- **Tax neutrality of capital repayments / (New) regulations regarding deposit accounts with EU and non-EU companies for tax purposes**

German and foreign private equity funds usually invest in German and foreign corporations. In case of payments by such corporations to the German or foreign private equity fund, (taxable) profit distributions and capital repayments have strictly to be distinguished. The repayment of equity (registered capital or capital reserves) by a corporation shall generally not be taxable. This is generally no problem with regard to German corporations as they file a declaration on the assessment of the balance of the deposit account for tax purposes within the scope of their annual tax return.

With regard to *EU corporations*, the repayment of capital contributions is regulated in Section 27(8) of the German Corporation Tax Act (*"KStG"* – *Körperschaftsteuergesetz*) and has to be made by applying the corresponding provisions applicable to German corporations. An EU corporation has to file the application for the assessment of the repayment of capital contributions with 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!). Distributions not certified to be repayments of capital contributions are deemed to be taxable dividends.

At the beginning of December 2014, the Federal Central Tax Office abandoned its previous and long-term administrative practice with regard to EU corporations in connection with the application for the assessment of the repayment of capital contributions and changed it in such a way that not only the repayment of capital contributions but also the repayment of registered capital has to be reported within the (preclusive) period of one year.

In the FYB Financial Yearbook 2016, we already expressed our conviction and concerns that the changed interpretation of the law would lead to massive squeezes at the affected private equity funds having invested in EU corporations 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. It is doubtful whether all of the then affected private equity funds and their tax advisors, respectively, have chosen the sole resort by filing a precautionary "comprehensive and broad" application in due time because of the short-term nature of the change in the legal interpretation and the approaching end of the year (deadline for applications for the assessment period 2013). This approach would have allowed the affected private equity funds to partially withdraw the filed application, if necessary, after receipt of the required documents and information. A comprehensive and broad application may be shortened, but an application that is too brief and narrow cannot be extended.

As a result of the severe legal consequences, i.e., the taxation of a payment fully as dividend instead of as a repayment of capital contributions that is fully or partially not taxable, disputes with the fiscal authorities were inevitable. Fortunately, the separate determination of repayments of registered capital by foreign corporations was explicitly regulated in a corresponding circular of the German Federal Ministry of Finance that also clarified that repayments of registered capital paid in before 01 January 2014 and with regard to which an application for the determination of the repayment of capital contributions was dismissed, withdrawn or not filed are not treated as (taxable) profit distributions in deviation from the general standard if the shareholder's repective tax office has not qualified the payment as taxable repayment of registered capital.

However, the level of detail of the supporting documents relating to the applied repayment of capital as requested by the Federal Central Tax Office could also be a further problem for German investors in foreign private equity funds with regard to any applications for repayment of capital contributions already filed. Particularly in case of relatively small shareholdings or in case of only indirect shareholdings through a fund-of-funds, the collection of all supporting documents, in particular account statements of the paying corporation, could regularly be very difficult.

The treatment of payments by corporations based in a non-EU country, such as the USA, Hong Kong, the Cayman Islands or the Channel Islands Guernsey or Jersey is controversial and unclear – at least in the fiscal authorities' view. Capital repayments by non-EU corporations are not regulated by law and within the fiscal authorities the viewpoint, which is contrary to the system and nonsensical, recently consolidated according to which a tax-exempt repayment of capital contributions by non-EU corporations is not possible in general and that, instead, any and all payments by such corporations, i.e., also capital repayments have to be qualified and treated as taxable profit distributions.

On 13 July 2016, the Federal Fiscal Court fortunately issued two decisions on the repayment of capital contributions in relation to non-EU corporations. It repeatedly dealt with the repayment of capital contributions by corporations located in non-EU countries within the scope of these two decisions and recommended again, in deviation from the opinion of the fiscal authorities, that a non-taxable repayment of capital contributions shall generally also be possible in the relationship between a corporation located in a non-EU country and its German shareholders. These two decisions have not yet been published in the Federal Tax Gazette as the fiscal authorities still do not intend to renounce their previous interpretation of the law despite the clear and unambiguous decisions of the Federal Fiscal Court.

Future prospects

Due to many economic and country-specific aspects, only small interest-rate increases – if at all – are currently expected so that the current and/or moderately higher low-interest environment will continue for a longer period. Consequently, the investments in German and foreign private equity funds will continue to remain high for lack of suitable investment alternatives.

The still existing gaps regarding the preparation of joint tax returns by concerned German investors in foreign private equity funds will close over time due to the increasing awareness of foreign fund managers but particularly due to the stricter reporting obligations regarding foreign investments.

The intention of the German legislator to create comprehensive transparency regarding foreign companies of German taxpayers is fully understandable against the background of the Panama Papers and the further discretionary investments identified abroad in recent years. However, the formulation of the German Act on Combating Tax Evasion is worrying as it emphasizes that the legislator obviously implies criminal energy of any structures in principle when a non-EU company is involved. This general suspicion is strange and frightening at the same time, especially since the globalised world also requires global structures.

With regard to the repayment of capital contributions by non-EU corporations, one can only hope and wish that the fiscal authorities finally abandon their refusing attitude and recognise again the possibility of a tax-exempt repayment of capital contributions also by non-EU corporations in agreement with the Federal Fiscal Court.

We would be happy to respond to the further developments and selected current commercial, fiscal and regulatory issues in detail again in the FYB Financial Yearbook 2019.

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