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PRIVATE EQUITY AND
CORPORATE FINANCE

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

FOR YOUR BUSINESS

21 Years
FYB FINANCIAL
YEARBOOK



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Is Private Equity Devil's Work?

Hope is the last to die at the end. In the introductory statements to our last articles in respect of tax compliance for private equity and venture capital food e.g. in the FYB FINANCIAL YEARBOOK 2020: „Πάντα ῥεῖ – Everything flows!”, “Little is Flowing in the Right Direction!” (FYB FINANCIAL YEARBOOK 2022) or “Breaking out of a Time Loop” (FYB FINANCIAL YEARBOOK 2023) we were still basically hopeful and optimistic about a (return to a) systematic or dogmatically correct taxation of private equity.

However, now that we have taken a closer look at many of the various developments of the past years, and not least because of the article “Operation Luxembourg” recently published in a well-known monthly German business magazine, a certain resignation and frustration has set in. Even our cautiously expressed wish of last year to simply accept the case law of Germany’s highest fiscal court, the Federal Fiscal Court (*BFH – Bundesfinanzhof*), on the repayment of capital contributions to corporations domiciled in third countries has unfortunately not been acted upon, as feared, but more on that later and first things first.

Our tax and law firm has been dealing with a wide range of tax compliance issues concerning private equity funds and their (German) partners for more than 27 years now. In the course of preparing this article, we took a look at the “perennial issues” in the area of taxation, such as in particular the qualification of income for private equity and venture capital funds, the fiscal treatment of carried interest at the level of the carry holders and at the level of the private equity fund, the issue of VAT on management fees and, of course, the (mandatory) tax neutrality of capital repayments by EU corporations and third-country corporations and their respective varying developments in recent years, and then we took this opportunity to remind ourselves of how it all began for us in our tax and law firm.



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I. How did it all begin

Our first contact with private equity was in the summer of 1996: a group of German investors had subscribed to a U.S. private equity fund of funds in the legal form of a Delaware limited partnership a few months earlier, and our tax and law firm had been instructed to comply with the necessary tax declaration obligations in Germany related to the commitment by these German investors. There were neither legal regulations nor was there authoritative guidance from the fiscal authorities or tax literature on the subject of private equity at that time. In those days, only a few publications were known and available at the Chair of Banking Economics at university, which reported on a new kind of (equity) financing through venture capital in the form of private equity, primarily in the United States.

At that time, in the absence of other alternatives, this task was tackled simply by systematically and dogmatically approaching the various issues to be resolved, and by exchanging ideas with the structuring lawyer of the time, who, by the way, is still an institution in private equity tax practice today.

The income from this private equity structure was not taxable in the United States, and any withholding tax on dividend income was credited in Germany in line with the Double Taxation Treaty. The qualification of the income under German tax law was based on the general principles of the distinction between private asset management and commercial activities (which were later also included in the relevant BMF Circular of 16 December 2003, the so-called Fund Decree). The calculation of the income was based on German tax law and the German tax law system, since the U.S. K1 forms naturally reflect U.S. tax law. Deduction items related to income from capital assets (in the case of asset management structures) had been calculated on a flat-rate basis and, in agreement with the fiscal authorities, taken into account as a percentage deduction from current income. If several parties subject to the German tax assessment were invested, a separate and uniform tax assessment declaration was prepared and

filed for this group of persons for such income earned abroad but taxable in Germany. For any distributions from (intermediary) corporations, a corresponding shadow calculation was prepared analogous to the procedure for domestic corporations and, in accordance with the German sequence of appropriation, a distribution up to the amount of the previous year's profit was treated as a taxable dividend and distributions in excess of this amount as a tax-exempt repayment of capital contributions. So far so good, and ultimately not so bad.

II. Where are we today?

1) Asset management or commercial activity?

The distinction between private asset management and a commercial operation in the qualification of the income of domestic and foreign private equity and venture capital fund structures is to be made for each personalistic fund structure and has also been one of the perennial issues in this area from the beginning.

In the FYB FINANCIAL YEARBOOK 2022 we informed about the tendency according to which individual tax auditors had tried to push (German) structures into the "commercial corner", even if they are clearly and indisputably to be qualified as asset management according to the criteria of the Fund Decree. A specific case in our tax and law firm, in which a tax auditor literally "wanted to subject the foreign taxpayers participating in the (asset management) partnership to limited tax liability in Germany", has in the meantime fortunately been concluded without any change in the qualification of income from asset management as already reported in the FYB FINANCIAL YEARBOOK 2023.

Our cautious assessment last year that this issue had calmed down was obviously somewhat misleading and premature, as the article "Operation Luxembourg" quoted at the beginning hereof clearly shows.

By now, a number of cases have become known in the market in which tax auditors of the Munich Tax Office (often with the assistance of the tax inves-

tigation office and the public prosecutor's office) have attempted to move the place of management of foreign private equity funds to Germany. In the case of previously foreign structures, this usually has significant VAT consequences and, in the case of commercial structures, also leads directly to a limited tax liability of the non-resident taxpayers in Germany.

2) Carried interest in asset management funds

In the FYB FINANCIAL YEARBOOK 2020 (p. 26 ff.), we already described in detail the fiscal treatment of carried interest at the level of the carry holder as well as at the level of the asset management or commercial private equity fund and its partners.

In the case of asset management funds, the carried interest has been legally privileged for the carry holder since 2004, provided certain conditions are met, and taxation is based on the so-called partial income system (under which 40% of this income is tax-exempt). However, as the fiscal authorities do not recognise the disproportionate distribution of profits in the case of asset management funds, the fund investors – if they are natural persons – pay tax on their capital-weighted share of the capital gains, dividends and interest. Due to the statutory disallowance of deductions of income-related expenses in the case of income from capital assets, the carried interest paid to the carry holder(s) (which the fiscal authorities consider to be remuneration for services rendered by way of an abbreviated payment method) cannot be taken into account to reduce income and the same income is therefore taxed. Only in the case of direct disposals has the carried interest been accepted by the fiscal authorities as deductible costs of disposal.

However, the Munich Fiscal Court came to a different conclusion. In its ruling of 17 December 2020, the Court states that carried interest is a share of the profits of the carry holders (and not remuneration for services rendered) and that the investors only earn income reduced by these profit preferences. As expected, the fiscal authorities have not accepted this fiscal court ruling and have filed an appeal with the Federal Fiscal Court under the case number VIII R 3/21. With regard to this upcoming decision, a ruling already issued in 2018 (case number

VIII 11/16), in which the Federal Fiscal Court recognised the disproportionate distribution of profits at the level of the (commercial) private equity fund in the context of an obiter dictum may help the private equity industry.

Fortunately, the aforementioned appeal proceedings of the Munich Fiscal Court in connection with the disproportionate distribution of profits in asset management funds now also fall within the jurisdiction of the Eighth Senate of the Federal Fiscal Court. To the extent that this Senate of the Federal Fiscal Court adheres to its concept and legal interpretation in connection with commercial private equity funds, carried interest could also be recognised as a distribution of profits in the case of asset management funds and thus reduce the basis of assessment for the taxation of the investors.

3) Value added tax on management fees – VAT exemption only for venture capital funds?

It appears that the fiscal authorities are still not ready to accept a general VAT exemption for management fees in private equity and venture capital structures. Since 01 January 2008, the fiscal authorities had initially charged VAT on all management fees regardless of the structure, with the exception of purely profit-related fees. It was not until 2021, with the Act to Strengthen Germany as a Fund Location, that a VAT exemption for the management of venture capital funds was enshrined in law. The fiscal authorities have expressed their support for the objective of the Act to Strengthen Germany as a Fund Location, also through tax measures, and in particular to promote young growth companies through venture capital investments. As mentioned in last year's FYB FINANCIAL YEARBOOK 2023 (p. 38 ff.), the fiscal authorities had already defined the conditions for VAT exemption of venture capital funds in the BMF Circular of 24 June 2022.

This means that our fears already expressed in the FYB FINANCIAL YEARBOOK 2022, namely that only (certain) venture capital and EuVECA funds could 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 fund location as a whole – as intended by the Act to Strengthen Germany as a Fund

Location – and eliminate the current disadvantages for Germany as a fund location, the extension of the VAT exemption to the management of all private equity and venture capital funds would be imperative.

Finally, the legislator seems to have understood this aspect of location promotion after all. An existing draft of the Financing for the Future Act, which was passed by the German government on 16 August 2023, provides in particular for an extension of the VAT exemption for the fund management to all alternative investment funds. The current exemption, which applies only to the selected fund classes mentioned above, is thus to be extended to all venture capital and private equity funds. This draft law is long overdue and would finally eliminate a serious disadvantage of Germany as a fund location. It is to be hoped that this law will now be passed quickly and without further restrictions.

4) Repayment of capital contributions by corporations domiciled in third countries

In various articles in the FYB FINANCIAL YEARBOOK over the past few years, we have also drawn attention to the tendency of the German legislator and the fiscal authorities to undermine the fundamental tax principle of pure income taxation and to increasingly introduce or enforce approaches to introduce taxes on assets (cf. our articles in the FYB FINANCIAL YEARBOOKS 2019 – 2023).

This concerns (still or again) in particular

- the repayment of capital contributions by corporations domiciled in the EU,
- 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.

Following the publication of the relevant BMF Circular last year (BMF Circular of 21 April 2022), there was initially a glimmer of hope for the repayment of capital contributions by third-country corporations. After years of hesitation, the fiscal authorities finally seemed to recognise the established case law of the Federal Fiscal Court on the tax exemption of the repayment of capital contri-

butions by third-country corporations and also to accept the solution outlined by the Federal Fiscal Court for all outstanding cases in connection with the repayment of capital contributions by corporations domiciled in third countries. With regard to the individual conditions required by the fiscal authorities for the recognition of the tax exemption of the repayment of capital contributions by third-country corporations, we refer to our article in the FYB FINANCIAL YEARBOOK 2023 (pp. 38 ff.) to avoid repetition.

At that time, it seemed possible to break out of this time loop of years of tax liability for repayments of nominal capital and repayments of contributions not made to the nominal capital. However, the joy was short-lived and the hope that future cases would be processed in a (more) simplified manner and that the numerous cases that had accumulated in the meantime could now be resolved step by step and case by case in favour of the taxpayers was not or only partially fulfilled.

With respect to the repayment of nominal capital and contributions not made to the nominal capital by third-country corporations made after 31 December 2022, the legislator eliminated the formal differences that had arisen following the (temporary) acceptance of supreme court case law with respect to the determination procedure and the statutory one-year exclusion period for EU and third-country corporations in the Annual Tax Act 2022 and subjected the benefits of third-country corporations to the identical application requirements and exclusion periods analogous to those of EU corporations. Unfortunately, the wish expressed in last year's article in the FYB FINANCIAL YEARBOOK to cut down the cumbersome regulations and requirements for the repayment of capital contributions by EU corporations and to simplify the treatment analogous to the solution outlined by the Federal Fiscal Court for third-country corporations has not been fulfilled. Instead, as feared, the existing legal regulations on the repayment of capital contributions for EU corporations have simply been extended to third-country corporations.

As a result, corporations domiciled in third countries can no longer establish the tax neutrality of a repayment of capital contributions for repayments of nominal capital and repayments of contributions not made to the nominal

capital on the basis of the simplified procedure developed by the courts (and temporarily accepted by the Federal Ministry of Finance), but must fulfil the already applicable legal requirements analogous to the applications for determination of the repayment of capital contributions by EU corporations.

In various previous articles in the FYB FINANCIAL YEARBOOK 2019 (pp.21 ff) and 2022 (pp. 41 ff.), we already pointed out the challenges involved in again submitting these extensive and detailed pieces of evidence and documents to the Federal Central Tax Office (BZSt) and the difficulties in obtaining these documents in practice – often due to low ownership interest or also existing data protection.

Unfortunately, the desired closure of the numerous cases that have piled up in the meantime is also proving to be more difficult than expected in many cases. This is due to the documents and evidence required in detail by the fiscal authorities and listed in the relevant BMF Circular, which we already reported on in detail in the FYB FINANCIAL YEARBOOK 2023 (pp. 38 ff.). Practical (procurement) difficulties arise in particular with regard to the resolutions and evidence (account statements) required by the fiscal authorities on the distribution made and the foreign balance sheet of the entity making the payment. Often, the passing of such resolutions or the preparation of a balance sheet is not provided for or required in the foreign legal system and, consequently, these documents cannot be provided for past assessment periods. In individual cases, the fiscal authorities also make use of the option provided in the BMF Circular to request further information, documents or evidence.

However, the non-recognition of the tax exemption of repayments of nominal capital and repayments of contributions not made to the nominal capital is incomprehensible, especially in the case of private equity funds that have already been fully wound up. In the case of a fully wound-up private equity structure, it is quite easy to determine the amounts of contributions and repayments made. If the cumulative repayments are higher than the sum of the contributions made and this positive difference has already been taxed over the term of the structure, there is no need to subject the repayment of the nominal capital or the contributions not made to the nominal capital to an unsystematic tax on assets, e.g., because of a non-existent resolution.

5) Capitalisation (or non-capitalisation) of fund establishment costs within the meaning of Section 6e of the German Income Tax Act

In the FYB FINANCIAL YEARBOOK 2020 (pp. 28 ff.), we already examined in more detail the legal codification of the capitalisation (or non-capitalisation) of fund establishment costs by the Electric Mobility Act/Annual Tax Act of 2019. In order to avoid repetition, and with a view to the ideas and suggestions that follow, we will only point out here once again the (retroactive!) application of this new legal regulation in all current tax audits.

III. It could actually be so simple

Note for use: This section contains systematic and dogmatic solutions as well as potentially progressive ideas!

The following systematic and fiscally dogmatic solutions attempt to untie the tax knots identified above and, ideally, put an end to existing adversities and imbalances, some of which are intertwined and mutually influence each other. Of course, this requires courage and the will to make a change in this direction. Private equity is neither a German achievement nor a German invention; its origins lie in the Anglo-Saxon world. It might be useful to look beyond our own borders and see how the subject is dealt with abroad. After years of back and forth on this or that issue, one gets the impression that venture capital is good and private equity represents the evil locusts. Those who have been involved in private equity and venture capital for a long time remember only too well the unspeakable statement made by a former German party leader in 2005, which was completely unfounded at the time, but unfortunately still haunts some people's minds.

On the progressive idea and the systematic and dogmatic solutions proposed in detail:

1) Abolishing the distinction between private asset management and commercial activities of private equity funds

Much has already been written about the Fund Decree, which will celebrate its 20th anniversary in December 2023, and which we also discussed in detail in our first article in the FYB FINANCIAL YEARBOOK 2010. Over its lifetime, the Fund Decree has certainly aged and can therefore no longer fully cover the complexities associated with private equity structures.

For this reason, we are making a progressive proposal for a bold step at this point:

■ **Classification and treatment of any and all private equity funds as private asset management**

In line with international taxation practice, private equity funds with a personalistic structure would then be fully transparent, with the result that each investor would be taxed at his or her place of residence or at the registered office of the investing entity. For non-residents, this would also remove the sword of Damocles of a domestic limited tax liability, which otherwise always looms, as it would then no longer be possible to reclassify an asset management fund as a commercial operation. This increases the likelihood that more fund structures will be established in Germany and that more non-residents will invest in these (sheltered) German structures. Ultimately, this will pay off very well for Germany as a fund location and also avoid tax revenue-driven debates on the place of management.

2) Carried interest in asset management private equity funds

■ **Treatment of carried interest as pure profit share**

If carried interest is treated as a share of profits or income (and not as remuneration for services rendered) at the level of the carry holders, only the income reduced by the share of profit or income is logically allocated to the investors and subject to taxation. This would systematically avoid the imbalances described above in the current capital-weighted allocation of income to the investor in the case of asset management funds and the resulting double taxation of the same income at the level of the carry holder, and would also accurately reflect the allocation provided for in the partnership agreement.

3) Value added tax on management fees

■ Extension of the VAT exemption to the management of any and all private equity and venture capital funds

However, if the fiscal authorities want to strengthen not only young growth companies in particular, but also the fund location as a whole – as intended by the Act to Strengthen Germany as a Fund Location – and eliminate current disadvantages for Germany as a fund location, the extension of the VAT exemption to the management of all private equity and venture capital funds is imperative.

Full VAT exemption for the management fees of all private equity and venture capital funds could also prevent the migration of private equity funds to neighbouring or even more distant countries, since a general VAT exemption would eliminate the competitive disadvantages that currently exist visàvis foreign structures. Implementing the requirements of EU law in this way would also pay off for Germany as an attractive fund location, and the debate on the place of management would become less relevant in this context.

With the draft of the Financing for the Future Act of 16 August 2023, the legislator is finally addressing this demand and intends to extend VAT exemption for the fund management to all alternative investment funds. Provided that this draft law now also passes the parliamentary bodies without any changes, at least some sanity will finally have been restored on this point.

4) Repayments of capital contributions by EU and third-country corporations

■ Full tax exemption of repayments of capital contributions by EU and third-country corporations based on simplified conclusive evidence

The procedure and the evidentiary requirements for obtaining tax-exempt repayments of nominal capital and repayments of contributions not made to the nominal capital of EU corporations have already been cumbersome and costly in the past and remain so. For the repayment of capital contributions by corpo-

rations domiciled in third countries, the Federal Fiscal Court – after the fiscal authorities had previously refused to recognise the tax exemption in principle – had already established a useful system and procedure in several rulings at an early stage, which would have proved to be very practicable if the fiscal authorities had not raised the hurdles for providing evidence.

In line with the globally applicable principle that income is generally taxable and the so-called return of capital, i.e., also repayments of nominal capital and repayments of contributions not made to the nominal capital, are tax-exempt, the bridge built by the Federal Fiscal Court should be followed. Accordingly, the cumbersome procedure for applying for the tax-exempt repayment of capital contributions by EU corporations should be eliminated and treated analogous to the procedure proposed by the Federal Fiscal Court for the repayment of capital contributions by corporations domiciled in third countries.

The amount of distributable profit (and thus also the amount of repayment of capital contributions) should be determined for all foreign corporations in accordance with the respective foreign commercial and company law (according to which resolutions or the preparation of balance sheets are not mandatory), taking into account the general German principles on the assumed application, i.e., after the subordinated repayment of contributions. In this case the profits of the foreign corporations are first deemed to have been distributed, in analogy to the national rules for domestic corporations, and insofar result in taxable dividends. There is only a tax-neutral repayment of capital contributions to the extent that the payments exceed distributable profits.

This is the only way to overcome the current existing challenges for the taxpayers concerned and their tax advisors because some of the requested evidence cannot be provided. At the same time, however, this will also relieve the burden on the Federal Central Tax Office, which is already understaffed, and which is hardly in a position due to its numerous existing tasks and the additional responsibilities currently assigned to it, for example, to process applications for tax exemption for the repayment of nominal capital and contributions not made to the nominal capital by EU corporations within a reasonable and acceptable period of time.

5) Capitalisation (or non-capitalisation) of fund establishment costs within the meaning of Section 6e of the German Income Tax Act

■ No statutory retroactive legal effect on the capitalisation of fund establishment costs or other legal changes

This new legal regulation for the capitalisation of fund establishment costs has naturally caused a massive sense of disquiet, as the fiscal authorities are retroactively capitalising fund establishment costs in all current tax audits for all cases that are still open. There has always been justifiable criticism in the tax literature of the retroactive application of legislative changes. For this reason, it is wished and hoped that the courts will (again) reject this attempt at retroactive application by the fiscal authorities, too, and that the change in the law will be implemented only after it has been codified in law and thus at a more compatible point in time.

IV. Conclusion and outlook

This year marks the fifteenth consecutive year of our contributions to the FYB FINANCIAL YEARBOOK on current tax compliance issues. In this context, we note that the fiscal authorities are even more intensively involved with private equity and venture capital but are moving further away from the industry and the acceptance of its practices.

Unfortunately, the opportunity to extend the procedure outlined by the Federal Fiscal Court for the recognition of the tax-exempt repayment of capital contributions by third-country corporations to EU corporations was not taken. Instead, in the course of processing the large number of old cases that piled up, the requirements for recognition were even raised with regard to the repayment of capital contributions by third-country corporations.

We well remember that when we first started dealing with the tax compliance tasks of domestic and foreign private equity managers, they were very pleased with the experience and the open-mindedness of the Munich tax authorities

towards private equity to the extent that the responsibility for their private equity funds lay within the area of responsibility of the Munich fiscal authorities. However, in the spirit of the (reverse) motto of “Paul to Saul”, reservations about the local jurisdiction of the Munich fiscal authorities are now growing, not least as a result of “Operation Luxembourg”.

In this contribution we referenced articles of previous years to avoid repetition. If you no longer have the mentioned FYB FINANCIAL YEARBOOK articles, e.g., because older issues of the FYB FINANCIAL YEARBOOK are 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 2025.

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DR 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 well as comprehensive and complex separate and uniform tax declarations for domestic shareholders of foreign private equity funds including any CFC declarations.

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