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PRIVATE EQUITY AND
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FYB FINANCIAL
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Inheritance-Tax Aspects of the Valuation of Private Equity Funds

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 29 years now. In recent years, we have regularly reviewed income tax issues in the FYB FINANCIAL YEARBOOK. These included, for example, the classification of income received from private equity and venture capital funds and the tax treatment of carried interest, both at the level of the carry holders and at the level of private equity funds. We also addressed the issue of value-added tax on management fees. Another key topic was the (mandatory) tax neutrality of repayments of capital contributions by EU and third-country corporations. We have examined these areas and their varying developments in recent years, and where necessary, also took a critical look at them.

In this year's article, we take a detour into inheritance tax law and (once again) address inheritance tax aspects of the valuation of private equity funds.

The question of how interests in private equity funds should be valued in the event of inheritance or gifts is becoming more and more important. In recent years, there has been an increase in the number of such cases in tax practice. This is due to the natural life cycle: private equity became established in Germany at the end of the 1990s and increasingly from the early 2000s onwards. Many of the investors at that time are now considering transferring their interests to their children or other successors, or have already done so. Transfers through the accrual of inheritance have also increased significantly.

Several years ago, in an article in the FYB FINANCIAL YEARBOOK 2017, we already pointed out the first fiscal peculiarities in the valuation of private equity investments in the context of inheritance tax. Since then, the topic has become



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more relevant than ever. Despite the proven growing importance of this form of investment in Germany and abroad, there are still no specific tax regulations for its valuation in the event of inheritance and gifts. As a result, general valuation principles have to be applied to a specific and complex structure.

This article aims to classify the functioning of a private equity fund from a tax perspective, to present typical valuation issues in the context of inheritance tax, and to highlight practical solutions for investors.

I. Private Equity Funds

1) Private equity fund structure

In practice, the structure of a private equity fund often follows a uniform pattern. There are basically three key stakeholder groups: investors, sponsors, and fund manager.

The investors provide the required capital. The sponsors initiate and structure the fund, while the management company is responsible for the operational management of the individual investments.

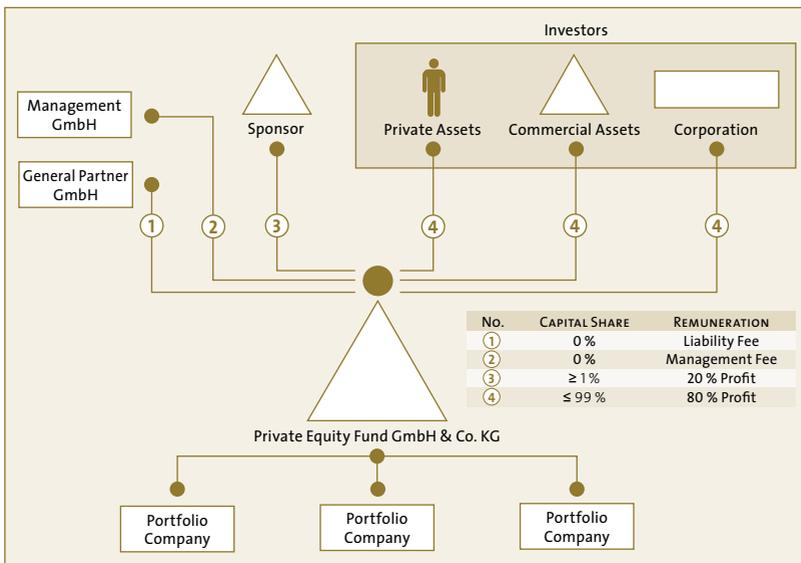
Typically, the sponsors only hold a small interest in the capital of the funds they set up. Nevertheless, they are entitled to a disproportionate share of the economic success – the so-called “carried interest”. Such a share is measured by the profit generated and is usually only paid out once the investors have been repaid their invested capital and received a certain minimum return (“hurdle rate”). The reason for this performance-based allocation of profits lies in the central role played by the sponsors in identifying, structuring, and strategically managing portfolio investments. Therefore, the carried interest ensures that the interests of sponsors and investors are aligned. It represents the key mechanism for matching risk and reward between sponsors and investors.

The management company, on the other hand, provides contractually agreed services to the fund. These services include, in particular, selection, acquisition, supervision, and sale of portfolio companies, reporting to investors, and fund management. The remuneration of the management company is usually a fixed, annually recurring amount, which is often proportional to the capital commitments made by the investors. The management company, therefore, assumes a clear role of a service provider vis-à-vis the fund and receives ongoing remuneration for this, which is paid regardless of how successful the investments are.

In Germany, private equity funds are usually structured in the legal form of a partnership, typically a GmbH & Co. KG. Outside of Germany, too, a partnership-like structure is often chosen – for example, in the form of a limited partnership (U.S.), whose contractual structure corresponds in essential respects to that of a German GmbH & Co. KG.

Typical structure of a German private equity fund

Fig. 1



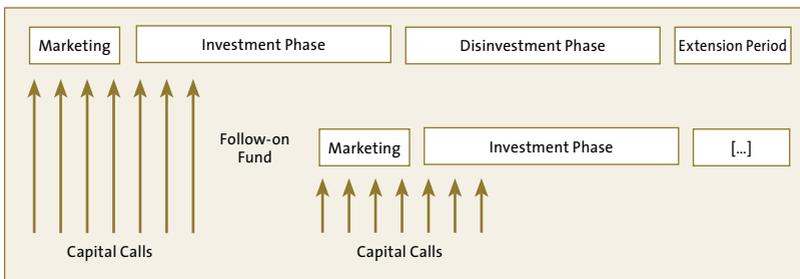
2) Life cycle of a private equity fund

Once the fund concept has been finalized and capital has been raised, the private equity fund is usually closed to new investors, and the investment phase begins. During this phase, the fund manager gradually draws down portions of the investors' capital commitments from them – known as “capital calls” – to finance envisaged investments in companies. Investors do not make their contributions in a single sum, but in several tranches, typically spread over a period of three to six years.

The end of the investment phase also marks the end of the opportunity to draw down further capital from investors. This phase is followed by the disinvestment phase, during which the fund manager usually has a period of five to seven years to realize the hidden reserves or any value adjustments built up during the investment phase. Once a portfolio company has reached the desired level of maturity or at the end of the fund's term, the portfolio company is sold. The fund can pursue various exit strategies, such as a sale to a strategic investor, a secondary buyout by another private equity fund, or an initial public offering with subsequent placement of the shares.

Life cycles of a private equity fund

Fig. 2



The fund manager often begins marketing and raising capital for a successor fund even before the investment phase has expired. During this phase, there is a risk that the manager may be tempted to influence the performance figures of the ongoing fund to convince existing and potential investors to invest in the new fund. Thereof, it is essential for investors to critically analyze the performance of

the ongoing fund. The net asset value (NAV) reported by the manager is usually the decisive factor in this respect. However, depending on whether conservative or aggressive valuation methods are applied, this value can be significantly influenced by the fund manager.

II. Valuation of Private Equity under Inheritance Tax Aspects

The valuation of interests in private equity funds under inheritance tax aspects is based on the general valuation principles applied to asset management and commercial partnerships. As there are currently no specific legal regulations for the valuation of such investments, the general provisions apply.

Not only the value of the transferred assets but also any liabilities of the estate are determined based on the fair market value – i.e., the price that would be obtained in the ordinary course of business upon sale. This value forms the basis for the tax assessment in the context of inheritance tax.

1) Asset management partnership

An asset management partnership generates income from the use of assets in the sense of drawing benefits, without the focus being on active restructuring or utilization of the assets. A further prerequisite is that the partnership is neither commercially infected nor considered to be predominantly commercial due to its structure.

When transferring an interest in such an asset management partnership, it is not the interest itself that is considered, but rather the proportional acquisition of the assets held in the partnership. Debts and other obligations of the partnership that are also transferred to the acquirer in the course of the transfer reduce the acquired assets in the same way as any consideration.

The object of valuation is, therefore, the individual assets of the fund, in particular the investments made in the respective portfolio companies. These form the basis for the tax valuation of the transferred assets.

2) Commercial partnership

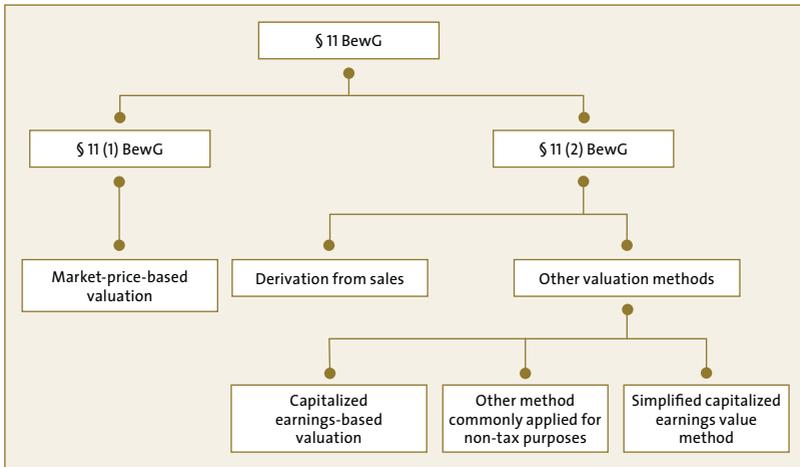
In the case of commercially operating or predominantly commercial partnerships, too, the valuation of interests under inheritance tax aspects is generally based on a proportional allocation of the partnership's assets to the partners. In this respect, the decisive factor is the total value of the partnership's assets, which will be divided according to the participation quotas.

In this case, too, the object of valuation is, in particular, the relevant portfolio company.

3) Valuation of portfolio companies

Tax Valuation Methods

Fig. 3



Portfolio companies are generally unlisted corporations. There are basically three valuation approaches for determining their fair market values:

- **Market price-based valuation:** This approach is based on the price resulting from recent sales between unrelated third parties.

- **Capitalized earnings-based valuation:** The value is determined based on the company's future earnings prospects. A special tax feature exists in the form of the so-called simplified capitalized earnings value method.
- **Other common valuation methods:** Methods that are common in general business dealings and that are applied in particular by purchasers to determine the purchase price are also recognized.

■ Market price-based valuation

The fair market value of unlisted shares in a corporation is primarily derived from actual sales prices realized between unrelated third parties, provided that these sales transactions took place less than one year ago. For a reliable valuation, several comparable sales transactions should be considered if possible. In individual cases, however, a single sale transaction may be sufficient if the legal and factual circumstances indicate that the price achieved corresponds to the value of the remaining shares. Serious purchase price offers may also be considered, even if the shares are not actually sold before the valuation date.

If there are no comparable transactions or reliable purchase price offers, the fair market value can be determined by means of expert appraisal. The actual purchase price does not necessarily have to correspond to the fair market value. Special circumstances – such as differences in the rights or obligations of certain shares, for example, with regard to profit participation rights or deferred charges based on carried interest – may require adjustments.

In the case of private equity funds, portfolio companies are typically acquired during the investment phase and only sold many years later. At fund level, therefore, no transactions generally take place in the meantime from which the value of the individual investments can be directly derived.

If the asset to be valued or a comparable asset has not been sold, the value must be estimated. This estimate assumes that it is an intended sales transaction in which a fair market price is negotiated in the ordinary course of business with serious potential purchasers. All circumstances affecting the value must be

considered, but exceptional or personal circumstances must be disregarded. The decisive factor is the assessment that a knowledgeable, unbiased person would make, considering general experience and the usual market perception.

■ Capitalized earnings-based valuation and simplified capitalized earnings value method

The capitalized earnings value method is generally suitable for determining the fair market value of any and all assets that can generate future income. The value is derived from the expected future income and determined by capitalization, provided that no suitable comparable sales transactions are available.

In practice, however, this method poses considerable challenges in the case of private equity investments. It is often difficult to reliably forecast future corporate profits, determine an appropriate capitalization rate, and assess uncertainties. Especially in the early stages of a company's development (venture capital), there is usually a lack of current income, as these investments are still completely dependent on the capital provided by the fund. For investors of private equity funds, the application of the capitalized earnings value method is, therefore, usually impractical due to the limited information available.

In principle, shares in portfolio companies can also be valued for tax purposes, applying the simplified capitalized earnings value method. Investors have the option of applying this method. The simplified capitalized earnings value method is based on the results of the last three financial years and is, thus, based on historical results.

The simplified capitalized earnings value method should not be applied if it leads to obviously unrealistic results. This is particularly the case for young companies for which the future earning power cannot yet be reliably derived from previous business results. Particularly in the case of portfolio companies of venture capital funds, there is, therefore, a risk that the fiscal authorities will not accept a valuation based on the simplified capitalized earnings value method and instead require a different valuation method. In essence, the simplified capitalized earnings value method is of limited relevance for early-stage companies.

■ Other common valuation methods

For assets that can generally be valued applying the capitalized earnings value method, it is also possible to rely on valuations made by qualified third parties, provided that these are based on recognized valuation principles and are also customary in the ordinary course of business. This is particularly relevant in the case of holdings in private equity funds.

An independent valuation applying the traditional capitalized earnings value method is often virtually impossible for investors in private equity funds, because it is difficult to obtain information about the portfolio companies. In practice, however, fair values are determined every quarter and submitted in investor reports. These valuations are usually based on the International Private Equity & Venture Capital Valuation Guidelines or, in the case of U.S. and Asian funds, on the relevant U.S. accounting standards.

The sum of the fair values of any and all portfolio companies equals the NAV of the fund. This value reflects the market value of the investments before fund-related factors are considered.

The following example illustrates the valuation process: The fair market values of the individual portfolio companies are determined quarterly on the basis of internal valuation guidelines. This is usually the responsibility of an internal valuation group, which provides guidance to the relevant portfolio managers. The values determined are reviewed by the manager responsible and checked by the fund manager and by external third parties on a random basis.

No statutory valuation approach exists for private equity funds that is specifically tailored to inheritance tax. Simply deriving the fund value from the valuations of the investments held is insufficient, as this approach does not consider the special structures and contractual framework conditions of closed-end private equity funds.

However, the NAV of a private equity fund is a very good starting point for subsequently determining or deriving the fair market value of a fund unit. It is calcu-

lated by the fund manager based on recognized valuation principles and reflects the fair values – i.e., the fair market values – of the individual portfolio companies and their sum.

Private equity funds, however, generally have several characteristics that should be taken into account in the valuation:

- Possible financial burden created by the sponsor’s carried interest
- Regularly payable fixed management fee
- Restrictions on the transferability of fund units
- Limited tradability in the secondary market
- Potential influence exerted by the fund manager on the NAV.

These factors can significantly reduce the tax base or fair market value of an investment. In inheritance tax valuation practice, they should therefore be considered in the form of a discount on the NAV.

4) Discounts on the NAV

■ Carried interest

Carried interest is a special form of profit sharing for sponsors of private equity funds. The term results from the fact that the sponsor holds an “interest” in the investment, the capital employed for which is financed entirely or predominantly by others – usually the investors (“to carry”).

In partnership agreements, the carried interest is usually structured as a disproportionate share of profits that deviates from the usual profit distribution. It becomes due as soon as investors have received their invested capital in full, plus an agreed minimum return (“hurdle rate”). This point in time is referred to as “full payout”. From that moment on, 80% of further distributions are made to the investors and 20% to the sponsors, in most cases.

At this point in time, the capital share differs significantly from the enterprise value share. The capital share – reflected in the partner’s capital account – only

shows the equity share as shown in the balance sheet. The fair value share, on the other hand, also takes into account the partnership's hidden reserves. Carried interest claims included in these hidden reserves reduce the value of the interest in the fund, as, once full payout has been reached, the profit distribution stipulated in the partnership agreement applies, which guarantees the sponsors a fixed share of further profits.

In comparison, a direct acquisition of the investments in the portfolio companies – without the intermediary of the fund – would not trigger this carried interest obligation. For a potential acquirer of an interest in the fund, the carried interest, therefore, represents a value-reducing factor that has to be considered in the investment decision. Such disproportionate distribution of profits must also be recognized for tax purposes and leads to a reduction in the NAV for inheritance tax purposes.

■ Management fee

In addition to investment risks, limited liquidity during the fund's term, and the significant reduction in returns due to the carried interest, the fund value of an investor is also reduced by the annual management fee. In practice, the amount of the management fee is usually based on a few established calculation models. When a fund unit is transferred, the obligation to pay such a fee is also transferred to the acquirer, whether an heir or a donee.

For valuation purposes, the future management fee is discounted to the present date to determine its current value.

■ Restrictions on the transferability of fund units

The partnership agreements of private equity funds generally stipulate that the transfer of an interest in the fund requires the written consent of the general partner. In many cases, the general partner has an unrestricted right to reject potential acquirers. This allows the managers behind the general partner to ensure the homogeneity, stability, and exclusivity of their fund. The general partner thereby retains full control over the composition of the investor base.

In practice, this consent clause significantly reduces the value, as a sale to an external purchaser always depends on the general partner's consent, and the latter usually has no primary interest in a change of partners. Often, only investors who are already known and considered reliable are admitted.

Compared to other forms of investment, such as listed investments, the liquidity of an interest in a private equity fund is severely restricted. The associated illiquidity risk is one of the key factors that investors consider when deciding on an investment. Whether a transfer is ultimately possible depends largely on the willingness of the general partner to give its consent to such a request.

If the general partner consents, it is in its own interest that the interest in the fund is acquired by a financially strong and long-term oriented successor investor. In this context, specialized intermediaries and advisors for fundraising and secondary transactions are increasingly involved. They are familiar with the structures and requirements of the various funds and have the necessary contacts to identify suitable purchasers who meet the general partner's quality criteria.

■ Limited tradability in the secondary market

The intended sale of an interest in a private equity fund in the secondary market – i.e., trading in interests that have already been subscribed – is subject to de facto restrictions. This is primarily because there are usually only a few suitable and interested purchasers for such investments.

The amount of discounts applied in the secondary market depends heavily on the fund's stage of development. Older funds that are about to be dissolved and the investments of which will soon be liquidated generally have lower discounts, as the return of capital is foreseeable. In contrast, discounts on newer funds are significantly higher, as the liquidity risk is greater. Additional impairments arise in the case of so-called "tail-end" funds, which are in the final years of their term. In these cases, the high-value investments have usually already been sold, and the remaining companies – often referred to as "zombie companies" – are characterized by low attractiveness and limited sales opportunities.

Even though the secondary market has recently been portrayed in the press as increasingly attractive, this mainly refers to transactions initiated by the fund manager (general partner) in which the fund is transferred to another fund (so-called “continuation funds”). In these cases, the discount is often around 10%. The discounts, however, are usually significantly higher for individual limited partners.

■ Possible influence exerted by the fund manager on the NAV

Private equity funds are generally not obliged to prepare their annual financial statements in accordance with U.S. GAAP or IFRS, but they often follow recognized industry standards. Compared to listed companies, fund managers have significantly greater discretionary powers in valuing and determining the NAV. The main reason for this is the lack of comprehensive statutory reporting obligations. Instead, valuation standards usually result from contractual agreements with the investors or from the manager’s interest in maintaining its reputation.

This margin of discretion opens up the possibility of specifically influencing NAVs to gain an advantage. The valuation of private and illiquid assets – such as the portfolio companies of a private equity fund – is both methodologically challenging and dependent on interpretation. Even when standardized procedures are applied, a considerable degree of subjectivity remains, particularly in the selection of the valuation model and the underlying assumptions. As a result, different, equally justifiable approaches can lead to significantly different results.

In certain situations, this discretionary power can be exploited opportunistically. The marketing and capital raising phase for a successor fund is particularly critical, as the published valuations play a key role in attracting new investors. Empirical studies show that the NAVs tend to be overvalued during this phase, especially by fund managers with limited market experience or a lesser reputation.

In summary, it can be said that the risk of excessive NAV valuation is particularly high during follow-up financing, and investors should exercise increased caution during this phase. In the context of inheritance tax valuation, a further discount should therefore be taken into account for this circumstance.

III. Conclusion and outlook

This year, we have authored an article in the FYB Financial Yearbook for the sixteenth time (after not writing one last year). Once again, we observe that the fiscal authorities continue to focus intensively on private equity and venture capital, and that inconsistencies in (income) tax law relating to private equity and venture capital structures are becoming more entrenched, at least in some cases. However, clear and reliable regulations are still lacking in some areas.

Inheritance tax and valuation laws do not provide a specific methodology for valuing private equity funds, which is why the valuation of asset management and commercial partnerships must be applied. The starting point for the valuation is the NAV determined and communicated by the fund manager, from which, in our opinion, various discounts should be applied. These discounts result, among other things, from fixed management fees and the carried interest received by the sponsors. In addition, the risk varies depending on the type of investment focus of the private equity fund. The discretionary powers of the fund manager in determining the NAV are also a factor that should not be neglected and, according to empirical studies, is particularly exploited during the capital raising phase, i.e., during the fundraising for a follow-on fund. Further discounts may result from special provisions in the partnership agreement, such as the restricted transferability of interests.

In this article, we also referred to topics from previous years' articles in the introduction. If you do not (or no longer) have the earlier FYB FINANCIAL YEARBOOK articles, for example, because older issues of the FYB FINANCIAL YEARBOOK are out of print and/or not (or no longer) available, please do not hesitate to contact us. We still have some older issues of the FYB FINANCIAL YEARBOOK available, or we can at least provide you with the desired article(s) electronically.

We would be happy to respond to further developments and selected current commercial, fiscal, and/or regulatory issues in the context of private equity structures in detail again in the FYB FINANCIAL YEARBOOK 2027.

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