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PRIVATE EQUITY AND CORPORATE FINANCE

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

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11 Years FYB FINANCIAL YEARBOOK

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Determination of Income for "Zebra Companies" and Depositary as Defined by the German Capital Investment Code – Update of Tax Compliance by Private Equity Funds

Continuous formal and material tax compliance as well as the regulatory requirements and innovations introduced by the German Capital Investment Code ("KAGB") make up an ever larger part of the daily work of domestic and foreign private equity funds. For this reason we have this year again chosen two subjects – one dealing with tax issues and the other with regulatory issues regarding private equity funds – which we would like to go into in detail below.

The first part of our article deals with so-called „zebra limited partners/investors", i.e. with investments made by corporate investors in non-business partnerships. If a corporate investor invests in a non-business private equity fund, he may not utilize the cash basis accounting determined at the non-business private equity fund's level but needs so-called additional tade or business income.

We have already discussed the possible conflict of qualification as well as the varying interests of the individual groups of investors in the qualification of a private equity fund's income in the FYB Financial Yearbook in previous years. This article explains the need for the additional trade or business income, their treatment by the tax authorities as well as any need for action resulting therefrom.

The second part of the article deals with a subarea of the implementation of the Alternative Investment Fund Manager Directive ("AIFMD") in national law. In this connection we go into the requirements and particularities of the so-called depositaries at private equity funds contained in the framework of the German Capital Investment Code in more detail.

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Non-Business Private Equity Funds: Need for Additional Trade or Business Income and Treatment by Tax Authorities

The qualification of income at the level of private equity funds (PE funds) is of material importance to German investors (private investors on the one hand and corporate investors on the other hand). There are, however, different requirements for both groups of investors investing in non-business PE funds with regard to the income resulting from the investment that is to be determined and assessed in each case.

Income (interest, dividends and capital gains) is determined in accordance with the inflows and outflows principle at the level of non-business PE funds and has generally been subject to the uniform flat tax rate of twenty-five per cent plus solidarity surcharge and church tax, if applicable, in case of private investors as from 2009.

In case of corporate investors investing in a non-business structure (so-called "zebra investors"), this income is newly qualified as trade or business income at their level. Interest income is then fully taxable. Dividends and capital gains are subject to taxation in accordance with the partial-income system and with regard to investors being a corporation, as the case may be, generally in consideration of a ninety-five per cent tax exemption from corporate income and trade tax. If, however, the tax participation exemption, i.e. the (broken down) investment of at least ten per cent (as from March 2013 regarding corporate income tax) and fifteen per cent (for trade tax purposes), as the case may be, in the nominal capital of the domestic or foreign corporation for such so-called dividend for non-substantial shareholdings, is not complied with, the full corporate income and trade tax, as the case may be, becomes due.

As already mentioned above, the income from non-business structures generally has to be newly qualified as trade or business income at the level of corporate investors in the tax authorities' opinion. Such income, however, which is person-

ally determined by these corporate investors, can hardly or not at all be verified by the competent tax office at the corporate investor's place of residence. As the respective tax office at the corporate investor's place of residence has no access to the PE fund's books and thus is not familiar with the data of the company reporting the income, the tax office is not able to assess the correctness of the respective information.

As a result of the continuous inquiries made by the tax offices at the corporate investors' places of residence to the tax offices assessing the PE funds caused by the tax authorities' own provisions, the German states have agreed upon a new way of administrative assistance by the tax offices assessing the PE funds. According thereto, the income determined with respect to corporate investors realized in a non-business partnership shall already be determined at the level of the PE fund for information and communicated to the respective tax offices at the corporate investors' places of residence.

Such informational trade or business income has generally increasingly been determined within the scope of tax audits for more than about three years now. Recently, this informational trade or business income has been determined in individual cases already within the scope of the non-business PE fund's assessment. The trade or business income determined within the scope of the tax audits has initially been reported by the assumed investors concerned to the tax offices at their places of residence by way of separate reporting notices. More recently, the notice of the informational trade and business income determined is directly made within the scope of the notice of the separate and uniform tax declaration of the non-business fund in coordination with the states.

Because of the determination of the informational trade or business income now made and their notification or inclusion in the PE funds notice of assessment, this data factually is now virtually binding on the respective tax offices at the corporate investors' places of residence. According to the tax authorities there will generally be no separate examination or revision of the provided data.

As a result thereof, the PE fund's tax advisor is urgently required to verify and/or actively assist in the determination of such informational trade or business in-

come so that this income is correctly determined. The tax office at the corporate investor's place of residence will not accept any declarations deviating therefrom because of the virtually binding effect of the notices. Insofar, the responsibility to determine the correct newly qualified income is factually transferred to the level of the non-business PE fund.

The company agreements of young non-business PE funds have already governed the determination of the additional trade or business income by the PE fund because of the regular participation of institutional members (so-called "zebra members/investors"). Older and/or foreign structures do normally not have such agreements which is why the engagement of the PE fund's tax advisor is to be agreed individually in each case. Due to the inclusion of this informational trade or business income in the respective notices – be it within the scope of the tax audit or already by the assessing office of the non-business PE fund's tax office – the PE fund's tax advisor is, however, affected by issues under professional and liability law which must be imperatively clarified with the fund's management.

The trade or business income shall be uniformly presented in Germany as agreed between the German states. The chosen form of presentation has, however, turned out to be problematic and strongly prone to errors in practice.

Instead of the primary allocation of investment income to all members including a subsequent potential informational allocation of trade or business income, there is a rigid qualificational allocation solely on the basis of the member's legal form. It has partly been determined without further differentiation that the investment is held in the business assets and that the resulting trade or business income is thus to be assessed. The undifferentiated allocation is also made in cases where there are explicit doubts with regard to the economic attribution of the income to the respective investor only because of the company name, such as "xy trust company with limited liability" ("XY Treuhand GmbH").

In these cases, a wording would be much more constructive according to which it cannot be excluded that the investment is held in the respective investor's business assets or a member's behind him and that in these cases the following informational trade or business income may be relevant, if applicable.

We have already intensively and repeatedly discussed the need for a clear presentation with the competent offices at all levels of the Bavarian tax authorities, namely that capital income general exists and that the informational trade or business income determined may be relevant possibly only in individual cases within the scope of a new qualification. The tax authorities definitely share our concerns but the given wording is binding at the federal level because of the agreements between the states. Regionally feasible exceptions are thus not possible according to the competent offices of the tax authorities. An amendment of the federal requirements as to forms has already been suggested according to information. If and when this amendment will be implemented is currently not yet foreseeable.

For the time being, the following measures have thus to be taken because of the unclear presentation of the informational trade or business income in the notices of the non-business PE funds:

- Monitoring of the determination of income by the non-business PE fund's tax advisor as well as his respective engagement by the PE fund and/or the affected members;

- Increased attention is to be paid by the respective investors' tax advisors as to which income is actually attributed to the respective investor by the tax office at his place of residence within the scope of the assessment and whether the attribution of the trade or business income by the tax office at the respective investor's place of residence, if applicable, is correct as the danger that qualified income is wrongly assessed increases due to the tax authorities' current practice.

Depositary – Particularities in case of PE Funds

The implementation of the so-called Alternative Investment Fund Manager Directive ("AIFMD") has significant effects on PE companies ("AIF") and their managers ("AIFM") in many areas. The requirements of the EU Directive and its interpretation and implementation have been intensively discussed in many

committees and working groups for several years and finally resulted after all in acceptable and manageable results for the PE sector compared to the first drafts.

In addition to numerous other administrative requirements and demands, which are not further illustrated herein, the legislator imposed the interposition of a new institution on PE funds: the so-called AIF depositary according to Sections 80 et seq. of the German Capital Investment Code ("KAGB").

Who may act as depositary?

The AIF capital management company (in Germany: "Kapitalverwaltungsgesellschaft" or "KVG") may either engage a typical custodian or alternatively a trustee who performs the tasks of a depositary within the scope of his professional or business activities (auditors, tax advisors, lawyers). By circular dated 18 July 2013 the German Federal Financial Services Supervisory Authority, BaFin, commented in more detail on this issue for the first time in its "Circular regarding the requirements for trustees acting as depositaries in accordance with Section 80 (3) KAGB".

It is true that the engagement of a trustee is subject to certain requirements but especially typical PE funds may appoint such trustee as depositary according to statutory provisions and the BaFin. According to the BaFin, the trustee has to prove that he has the required experience to assume the function of a depositary, that, for example, he has worked as trustee in similar structures for several years, as controller of funds or consultant of a closed-end fund or in the management of closed-end funds. The trustee is, moreover, supposed to have "relevant legal and economic expertise with regard to the assets to be acquired for the funds as well as the legal and actual situation within the countries where they would be located". Furthermore, the proved ability to control the organisation and the operations within a company required to exercise the duty of control assigned to the trustee may support the trustee's qualification. Even in consideration of the close interaction between the fund management and the depositary described below, the relevant expertise of the persons in charge at the depositary should thus be indispensable for PE funds.

Depositary's tasks

The depositary/trustee ("depositary" or "trustee") significantly interferes with the individual activities of a PE fund manager ("AIFM") with the tasks to be performed by it/him. The trustee's material tasks are as follows:

General control functions
The trustee has to assume various control functions according to the KAGB. The KAGB assigns the following functions to the trustee: the monitoring of the issuance and redemption of units (in the field of the PE fund in accordance with the acceptance of subscriptions), the valuation of units and the correct carrying out of transactions on account of the AIF. According to the provisions of the KAGB, the trustee also controls the legitimacy of all directions given by the AIF capital management company.

Deposit of financial instruments
If the depositary itself cannot deposit certain depositable financial instruments, it has to enter into a corresponding sub-contract of deposit with licensed credit institutions/depositary banks and ensure that the financial instruments are entered into the corresponding deposits. In this regard, the trustee has a right of inspection regarding the books of the depositary and may also have entered a blocking note in his favour. This means that the AIF/AIFM may only dispose of the deposit after consultation with and with the assistance of the trustee.

Deposit of funds
The above applies accordingly to the AIF's current accounts which are maintained by the AIF and/or the AIFM. The trustee, however, has corresponding rights of inspection also in this regard to perform his duties of control. A blocking note may also be entered in the current accounts (by defining basic threshold values, if applicable) so that significant transactions may only be carried out by the AIFM with the trustee's assistance. The free disposability of the AIF's liquid funds by the AIFM and/or the KVG is thus materially restricted.

Verification of title
Insofar as a trustee or controller of funds may still be familiar with the previous

tasks, the requirement of the verification of title is a new task of the depositary particularly in the field of PE funds.

According to the KAGB, the depositary has to verify the AIF's title to so-called other assets – as opposed to financial instruments which may be deposited according to the KAGB – and provide a corresponding documentation. In this regard, the assessment whether the AIF has acquired the title shall be based upon information and documents provided by the domestic AIF or the KVG as well as upon external proofs, if available.

The verification of title also includes the monitoring of third party rights, if any, which basically exists with regard to any asset or which may restrict its availability (the latter is arguably rather the case in the real estate sector). If the trustee cannot sufficiently evaluate the legal situation by himself, he has to engage a qualified and independent third party.

With regard to the PE sector, extensive questions of interpretation arise which could not sufficiently be clarified so far. The assessment of an effective acquisition of a participation in a foreign target fund of a fund-of-funds, for example, cannot be compared with the direct acquisition of a participation in target companies by a direct fund.

The effective entry into a foreign target fund may be relatively manageable on the basis of the signed subscription documents. A confirmation of the effective indirect acquisition of a participation in a target company of the target fund is, in contrast, not part of the trustee's tasks particularly as this would arguably not be realizable in practice.

In case of the management of a direct fund, the verification of title is, however, different. According to the BaFin, the trustee has to provide for sufficient certainty with regard to the procurement of the title to an asset (= participation in a target company) by the AIF on the basis of the information, deeds, expert opinions and other documents provided by the AIF. If the provided documents are not satisfactory, the trustee has to obtain further documents from the KVG. According to information, the trustee may also use the works of and/or engage

third party experts. Within the scope of his assessment, the trustee may, consequently, rely for example upon certificates or expert opinions from lawyers and auditors involved (unless he has justified doubts as to the reliability of the involved parties) or subsequently engaged. This option might be elected by the trustee generally in case of transactions subject to foreign law.

Contract of deposit

The trustee has to enter into a written contract of deposit with the capital management company. This contract has to document the organisational procedures as well as the rights and obligations and contain other explicit provisions with regard to the effective exchange of information which enable the trustee to perform his duties as depositary, particularly his control functions.

According thereto it has to be stipulated that the trustee is to be notified of amendments, if any, of the investment terms and the intended acquisition of assets already at an early stage so that he may take the necessary actions within the scope of his duties. In this regard it is intended that the trustee coordinates closely with the KVG as to the chronological sequence so that he is able to take and organise the required measures, if applicable, before the amendments are implemented or the intended acquisition of a participation realised. According to the contractual provisions the trustee has, thus, to be consulted in each case long before the transaction is carried out.

The trustee is to be notified of the competent and qualified persons in charge at the AIF/KVG already within the scope of the contract of deposit. It has also to be stipulated in writing that the trustee is granted access to all information and documents, which he needs to perform his tasks, kept on the premises of the KVG and the engaged companies, if applicable. According to the BaFin (Federal Financial Supervisory Authority), a so-called escalation process is, furthermore, to be agreed upon in case the trustee is not granted access at all or not in due time to these information and documents or if he identifies evidences of a breach of the KVG's statutory or contractual duties.

Future firm establishment by way of practical experience

The statements made by the BaFin so far with regard to the application and interpretation of the new provisions of the KAGB are merely a first rough assessment of the practical questions to be expected. To what extent the individual requirements can actually be implemented in practice and/or which other specific issues may arise within the scope of implementation is currently not yet foreseeable. The BaFin, hence, admits that a specific administrative practice may only develop within the scope of the practical application for a longer period of time.

As a close cooperation between AIF/AIFM/KVG and the depositary is necessary because of the aforementioned extensive tasks and duties of the depositary as defined by the KAGB, the previous experience and expertise of the acting persons should generally be taken into consideration when selecting them to ensure a reliable and feasible process of the daily operations.

Future prospects

Private equity funds and their management may expect new requirements in this sector and – after the introduction of the German Capital Investment Code – also numerous other regulatory requirements in addition to the already known tax compliance issues which have partially been dealt with in previous articles in the FYB Financial Yearbook (including the differentiation between non-business and business PE structures, reporting of foreign participations, FATCA, capitalisation of management fees, etc.).

We have, for example, explained the effects of the (partial) capitalisation of management fees during the investment stage and at the later sale of the financial assets already in the FYB Financial Yearbook 2010.*

This specific issue significantly gains in importance within the scope of current tax audits and affects the various groups of members in the way outlined in the

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aforementioned article. At least in the area of the Bavarian tax authorities uniform standards of procedure become apparent with regard to this issue, which are a compromise considering the different interests of the investors in a well-balanced way in our opinion.

From a regulatory perspective, the provisions of the KAGB as well as the circulars issued by the BaFin so far are still too new so that we cannot give an account of authoritative procedures and administrative practices yet. In the course of the further application of the German Capital Investment Code, precisely this practice will develop step by step as well as the handling of the regulatory requirements which are quite complex in detail.

The planned AIFM Tax Adaptation Act was supposed to adapt the previous German Investment Tax Act to the new investment law (German Capital Investment Code). The final failure of the proposed law prior to the elections to the Bundestag has been commented in detail on many parts. The tax authorities thus ordered by decree to further apply the provisions of the repealed Investment Tax Act for tax purposes even after 21 July 2013.

The entire private equity sector expects that this necessary proposed law will be resumed and implemented after the elections to the Bundestag and the completion of the upcoming coalition talks.

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