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PRIVATE EQUITY AND CORPORATE FINANCE

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16 Years FYB FINANCIAL YEARBOOK

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(Denied) Tax Neutrality of Capital Repayments – The Hidden Introduction of Taxation of Capital?

In recent years, the taxation of private equity funds and their shareholders who are taxable in Germany has increasingly moved into the centre of attention of the fiscal authorities. Tax audit divisions have set up specialised teams with corresponding personnel reinforcement, which are intensively trained internally by more experienced auditors with regard to the peculiarities of private equity structures.

In principle, this is to be welcomed from the point of view of the private equity industry and their tax advisors as it enables a constructive exchange in questions of fact, which in most cases also leads to an appropriate agreement on questions of doubt within the scope of a tax audit. Numerous issues have been intensively and factually discussed in recent years and compromises acceptable to both sides have been found in each case also taking into account the different structures of private equity funds. Examples are the discussions regarding the (non-) application of the Building Owner Decree (*"Bauherrenerlass"*) to private equity funds and the resulting activation of an annual management fee for the acquisition of portfolio companies and target funds respectively (we have already described the first discussions of this topic in the FYB Financial Yearbook 2018).

The solutions found together with the fiscal authorities are also of enormous importance because they will be accordingly implemented in the subsequent annual tax returns subsequently to the finalized tax audits and because these issues do not seem to have to be discussed again in the follow-up audits and the investigations and calculations carried out do not have to be adjusted.

However, tax advisors have recently been confronted more and more with extreme positions on the part of the fiscal authorities, which, despite the com-

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plexity of the structures of private equity funds, place purely formal aspects in the foreground in order to achieve an expansion of taxation from the point of view of the fiscal authorities. Although this is the basic task of the tax audit, there are tendencies

a) to request evidence from taxpayers that cannot usually be provided because of the holding structures (and the fiscal authorities are aware of this or should at least be aware of it); and
b) to (analogously) interpret applicable law, especially with regard to foreign matters, in such a way that this necessarily results in (possibly double) taxation of capital. Existing judgements, if any, of the Federal Fiscal Court (*"BFH" – Bundesfinanzhof*) have unfortunately and incomprehensibly been ignored so far.

The latter development according to para. b) can be observed in particular with regard to the tax neutrality of repayments of capital contributions in the case of distributions made by corporations. We have also already addressed this issue in our articles in the FYB Financial Yearbook 2016 and 2018. Due to the fiscal authorities' continued and consistent denial of a tax-neutral repayment of capital contributions in the case of non-EU corporations, we present this complex of issues in more detail below.

(Domestic and foreign) private equity funds normally invest in domestic and foreign corporations. In case of payments made by such corporations to the German or foreign private equity fund, (taxable) profit distributions and capital repayments have to be strictly distinguished. The repayment of equity (registered capital or capital reserves) by a corporation shall/should (as a result) not be taxable in general.

The systematics of the repayment of capital contributions under tax law is based on the statutory provisions of the German Corporation Tax Act (*"KStG" – Körperschaftsteuergesetz*) applicable to a:

- **German corporation**, resulting in corresponding obligations to submit supporting documents (which are also regulated by law) for
- **EU corporations**, which are not considered by the fiscal authorities to be applicable to
- **non-EU corporations**.

The following explanations focus on the treatment of the repayment of capital contributions made by EU and non-EU corporations. Thus, with regard to German corporations, only the main features and the main practical problems are briefly presented.

Repayment of capital contributions by a German corporation

Contributions to the equity (capital reserve) of German corporations (GmbH, AG) have to be separately determined in the form of the so-called capital contribution account for tax purposes (*"steuerliches Einlagekonto"*) (Section 27 KStG) for each assessment period together with the other tax returns if the contributions exceed the corporation's registered capital.

Within the framework of such return, the so-called distributable profit is determined and assessed at the end of the respective assessment period. This distributable profit is to be regarded primarily as distributed in the case of distributions in the following year (so-called fiction of use). The capital contribution account for tax purposes is deemed to have been used only for the distributed amount exceeding the available distributable profit.

If the capital contribution account for tax purposes has not been determined, the distributed amount is to be fully treated as taxable dividends.

In accordance with the use of the determined amounts of distributable profits and the capital contribution account for tax purposes, a corresponding tax certificate (or a summary tax certificate after the end of the assessment period) must be prepared for each distribution. However, a problem may arise from a subsequent change in income, e.g. in the course of a tax audit. A distinction must be made here between the "sign" of the changes, i.e. the direction in which the changes occur: If, for example, the tax audit reveals higher income than previously assessed in the tax assessment notice, the corresponding tax certificate must be compellingly adjusted and the taxable dividends must be certified with the higher amount determined.

On the other hand, the law does not provide for a change in the tax certificate in favour of the taxpayer if, for example, the tax audit reveals lower income than initially assessed and certified. Consequently, the taxpayer must also accept capital gains that were originally certified as too high on the basis of distributable profits of the company determined at that time. An adjustment of the profits at the level of the corporation results in a reduction of the assessment base for corporation income and trade tax. Thus, the distributable profits that could be distributed to the shareholders decreases correspondingly. There is inevitably a correspondingly higher repayment of capital contributions in the amount of the difference to the originally distributable profits (before the tax audit). The distributable profits reduced (after the tax audit) can, however, not be adjusted at the level of the shareholder in accordance with applicable law because of the already issued tax certificates allocating the initially higher amount of capital gains.

In relation to the private equity sector, this issue is, for example, relevant for so-called managed accounts in the legal form of a German limited liability company (GmbH) or for blocker corporations in the form of a GmbH in the case of German limited partnerships (GmbH & Co. KG).

Tax neutrality of capital repayments / (New) regulations regarding capital contribution accounts for tax purposes in the case of EU corporations

The separate determination of the repayment of capital contributions is regulated in Section 27(8) KStG for *EU corporations*. The determination has to be made in accordance with the provisions applicable to German corporations. Accordingly, the distributing EU corporation has to file the application for the determination 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 (cut-off period!). Consequently, distributions not certified to be repayments of capital contributions are deemed to be taxable dividends.

In December 2014, the Federal Central Tax Office abandoned its previous and long-standing administrative practice with regard to EU corporations in connection with the application for the determination 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 (cut-off) period of one year.

At that time, this changed interpretation of the law had led to massive time bottlenecks for the concerned private equity funds with holdings in EU corporations and their tax advisors. By the imminent end of 2014 (cut-off period for applications for the 2013 assessment period), certainly not all of the concerned private equity funds or their tax advisors had in principle submitted the necessary applications by then. Since in the short time until the end of the year the complete and sometimes far-reaching or in-depth information could not be obtained and processed on time in almost all cases, the only feasible way out was the timely submission of a precautionary "comprehensive and broad" application.

On the basis of the legal situation at that time, only this approach had allowed the concerned private equity funds to partially withdraw the timely submitted initial application, if necessary, after receipt of the required documents and information. A comprehensive and broad application may be reduced or withdrawn but it was and continues to be impossible to extend an application that is too brief and specific. We had already expressed our criticism about this short-term and only sparsely communicated change in the previous and long-standing administrative practice in the FYB Financial Yearbook 2016 and 2018.

At that time, we had also mentioned the inevitable disputes with the fiscal authorities due to the severe legal consequences, i.e. the taxation of a payment in full as a dividends instead of a fully or partially non-taxable repayment of capital contributions. To avoid looming disputes, the fiscal authorities explicitly regulated the separate determination of repayments of registered capital by foreign corporations in a corresponding circular of the German Federal Ministry of Finance (*"BMF" – Bundesfinanzministerium*) that also clarified that repayments of registered capital paid 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 competent tax office does or has not qualified the payment as taxable repayment of registered capital.

Recent experience has shown that the Federal Central Tax Office expects an enormous level of detail of the supporting documents to be submitted with regard to the capital repayment applied for – even in relation to already submitted applications for the repayment of capital contributions. This causes further difficulties and problems for German investors in a foreign private equity fund as it could be difficult or hardly possible – in particular with regard to relatively small amounts invested or in case of an indirect investment through a fund of funds – to obtain all supporting documents as a rule, especially complete bank account statements as well as resolutions of the management and further documents of the distributing corporation.

No tax neutrality of capital repayments / Taxation of capital in case of non-EU corporations?

The treatment of payments made by corporations located in a third country, such as the United States, the Cayman Islands, the Channel Islands Guernsey or Jersey and Hong Kong respectively is still controversial in the view of the fiscal authorities. Capital repayments made by non-EU corporations are not regulated by law. The fiscal authorities are – contrary to the system – still of the nonsensical opinion that a tax-exempt repayment of capital contributions by non-EU corporations should not be possible in general and that, instead, any and all payments made by such non-EU corporations, i.e. also capital repayments, have to be qualified and treated as taxable profit distributions.

As a result, even in the case of a special purpose vehicle controlled by a private equity fund (e.g. a non-EU Blocker Ltd.), for which it would even be possible to provide complete documentation of the documents relating to the making and repayment of capital contributions, the submission of such evidence would not at all be permitted.

In further practice, the fiscal authorities have even extended the denial of a neutral capital repayment to the (partial) short-term return of (initially) not or not fully required capital calls. Such (temporary) repayment is made by the management whenever a planned transaction could not be completed or if less liquidity is required for the transaction after the completion of the negotiations than expected. The repayments are then regularly marked as "recallable", correspondingly increase the actually outstanding contributions of the investors of the private equity fund and will presumably be called again – then for first-time investment – at a later point in time. Following the later sale of the investment made and the repayment of the capital contributions made for a second time, the described treatment by the fiscal authorities results in the utterly absurd situation that the capital is insofar subject to taxation of capital for a second time. According to some information, however, this issue should be discussed again by the fiscal authorities. It remains to be seen whether and for how long the fiscal authorities will adhere to this strict and totally erroneous interpretation of the opinion held.

In our opinion, it is therefore recommended to follow the current view of the fiscal authorities in the current tax returns on a regular basis as a precautionary measure until these issues have been resolved. This is the only way to ensure that interest payments, which may ultimately have to be fixed at a later date, can be avoided if the fiscal authorities do not abandon their erroneous legal view and are ultimately right. If, on the other hand, the tax-neutral repayment of capital contributions is possible at a later date, then the tax amounts overpaid on the basis of the current opinion of the fiscal authorities will be refunded and interest will be paid accordingly in favour of the taxpayers.

The suggested approach, however, is problematic for German corporations, such as the aforementioned managed accounts or blocker corporations in the form of a German limited liability company. In case of the subsequent recognition of the tax-neutral repayment of capital contributions by non-EU corporations, the corporate income and trade tax burden would decline at the level of the respective GmbH. But, as explained above, the (excessively high) tax certificates issued for previous assessment periods cannot be corrected. As long as the recipient of the distribution from such a GmbH is no tax-exempt corporation, the distributions continue to be taxable in the amount of the then additional repayment of capital contributions as dividends at the level of the GmbH shareholder. As regards holders of a managed account only 5% of this amount should be subject to taxation due to the application of the so-called participation exemption (participation ≥10% for corporate income tax purposes and ≥15% for trade tax purposes). If the participation in the distributing corporation is, however, <10% and <15% respectively, the repayment of capital contributions continues to be subject to full corporate income and trade tax as a result.

The Federal Fiscal Court has fortunately issued two decisions on the repayment of capital contributions in relation to non-EU corporations already in 2016. It repeatedly dealt with the repayment of capital contributions by corporations located in non-EU countries within the scope of these two decisions of 13 July 2016 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 still not 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 clearly and unambiguously worded decisions of the Federal Fiscal Court.

Currently, a third lawsuit regarding the repayment of capital contributions by non-EU corporations is pending at the Federal Fiscal Court, which may even be decided by the end of 2018. Reliable voices from the fiscal authorities have signalled that the fiscal authorities will not continue to oppose the opinion of the Federal Fiscal Court, provided that the Federal Fiscal Court again affirms the fundamental possibility of a tax-neutral pay-out of contributions from non-EU corporations in this decision. However, it remains to be seen also in this case which formal requirements and hurdles the fiscal authorities will set for the recognition of such a repayment of capital contributions. It is questionable to what extent the structures and (in the case of fund of funds structures) predominantly low ownership ratios of private equity funds in the relevant non-EU corporations are taken into account in this respect. Rather, it is to be feared that evidence and documentation will be required that cannot normally be provided by the private equity funds due to their structure, even taking into account the increased obligation of the taxpayer to cooperate in foreign matters. In this case, further court proceedings are then probably inevitable with regard to the factual issues of "provability" and the "obligation to cooperate".

Future prospects

It can still be expected that the current or moderately increased low-interest environment will continue. The many economic and country-specific aspects are generally considered to allow only small(er) (if any) increases in interest rates at present. The environment for the private equity industry thus remains attractive and institutional and private investors are increasing their investments in domestic and foreign private equity funds due to a lack of suitable investment alternatives.

However, the increasing sensitisation of foreign private equity fund managers by domestic investors, in particular, also the tightened reporting requirements for foreign investments, increasingly lead to the closing of the still existing gaps regarding the preparation of joint tax returns of domestic declarants in foreign private equity funds over time.

There are still considerable difficulties and obstacles in connection with the applications for the determination of a repayment of capital contributions. Be it in the case of German corporations, the only unilaterally provided adjustment in favour of the fiscal authorities, for example, following a tax audit or, in the case of EU corporations, the documents and evidence which the fiscal authorities unknowingly (or even deliberately?) require even for the target companies of private equity structures and which in some cases are hardly or almost impossible to provide. However, the stubborn attitude of the fiscal authorities in connection with a repayment of capital contributions by non-EU corporations currently weighs particularly heavily. This intransigent attitude of the fiscal authorities can hardly be explained to domestic investors and the economic consequences in the form of the sometimes immense subsequent payment of taxes plus the statutory interest on this additional tax claim are enormous. It therefore remains the wish and the cautious hope that the Federal Fiscal Court will confirm its previous case law in its still open proceedings and that the fiscal authorities will then finally accept the possibility of a tax-free repayment of capital contributions by non-EU corporations.

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 2020.

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