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PRIVATE EQUITY AND CORPORATE FINANCE

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

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Current Developments in the Taxation of Private Equity / Venture Capital Funds

Fiscal authorities have not yet provided any clarification with regard to the hot topics which have been discussed for years, i.e. the repayment of capital contributions by corporations domiciled in third countries, corresponding eligibility of foreign EU legal structures to file applications, implementation of the new German Investment Tax Act (*"InvStG" – Investmentsteuergesetz*) effective 2018, or value added tax on management fees. We summarise below the current status of selected topics for a better overview.

In past years, we have repeatedly provided updates of current tax-related topics and problems arising in practice in connection with rendering tax advice to private equity and venture capital funds and their investors. These topics and related problems often resulted from the fact that the fiscal authorities either did not provide or did not want to provide clear guidelines, instructions or solutions, or that they simply persistently refused to implement supreme court decisions.

Unfortunately, this has not changed or improved over the past year. Fiscal authorities have sadly not provided any clarification with regard to the hot topics, some of which have been discussed for years, such as the repayment of capital contributions by corporations domiciled in third countries, corresponding eligibility of foreign EU legal structures to file applications, implementation of the new German Investment Tax Act (*"InvStG" – Investmentsteuergesetz*) effective from 2018, or valued added tax on management fees. We summarise below the current status of selected topics.

Apart from the still existing uncertainties in the mentioned areas, the legislator has, moreover, introduced a new requirement with the "reporting obligations for cross-border arrangements" in 2020, the framework and limits of which were de-

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liberately kept open and unclear. However, this in turn poses major challenges for all parties involved since – in case of doubt – the (deliberately) not specifically formulated parameters of the reporting obligations will be sanctioned if (subjectively) not met – as is now almost common practice. The main features of this new regulation are explained and summarised below.

I. Reporting obligations for cross-border tax arrangements – implications for private equity and venture capital funds

Effective 1 January 2020, the law introducing an *obligation to report cross-border tax arrangements ("DAC 6")* entered into force. With this reporting obligation, the legislator pursues the aim to identify tax avoidance tactics at an early stage in order to be able to close any undesired loopholes in the tax laws in a timely manner. It is also intended to enable the fiscal authorities to detect audit-relevant facts.

That is why awareness of possibly existing reporting obligations for cross-border arrangements should be raised among the managers of private equity and venture capital funds.

Which tax types are affected?

The reporting obligation affects all direct taxes, such as income, corporate income, trade, inheritance and gift tax. (Import) value-added tax as an indirect tax is, however, excluded. This also applies to excise, customs duties and social security contributions.

Who is under the obligation to report?

In general, the reporting obligation is vested in the so-called intermediary, i.e. any person who markets, designs for third parties, organises or makes a tax arrangement available for implementation or manages the implementation for third

parties. In case of a private equity and venture capital fund, the fund manager is also typically regarded as an intermediary. In particular, the legal or tax advisors involved in connection with the cross-border tax arrangement will be regarded as intermediaries at the level of the fund partnership or the investors, and they will file the notification with the Federal Central Tax Office (*Bundeszentralamt für Steuern*) if the fund or the investor releases them from their professional privilege of confidentiality.

Apart from the intermediary, the *user* of the tax arrangement and the so-called *other person involved* in the arrangement are also typically implicated in case of a cross-border tax arrangement.

- In case of private equity and venture capital funds structured as a partnership, the fund partnership itself is regarded as user, in general, and may be under the obligation to report, unless a legal advisor or tax advisor involved in the conception of the arrangement assume such reporting obligation as intermediary.

- On the other hand, partners in a personalistic fund partnership are to be regarded as other persons involved in the arrangement and, thus, they are generally not under the obligation to report.

- However, there is an exception if shareholders themselves take part in the conception (for example, under a side letter). In this event, these shareholders are also to be regarded as user of the tax arrangement and, thus, they are under the obligation to report, unless a legal advisor or tax advisor involved in the conception or advice of these shareholders has already assumed such reporting obligation as intermediary.

What has to be reported?

The reporting obligation only applies to cross-border tax arrangements, i.e. those which require an *international context at the level of the fund itself or the investors*. Tax arrangements implemented only in Germany need, not however, be reported within the meaning of DAC 6.

Typical examples of application for private equity and venture capital funds

- *Side letters* entered into in order to obtain tax benefits, such as agreements on "share classes" and relevant "share redemptions" in case of investments in intermediate corporations are regarded as reportable tax arrangements in our view.

- A reportable tax arrangement may already exist during the fundraising, since certain *fund vehicles themselves* and the respective target funds and portfolio companies may be classified as a tax arrangement depending on the structure and financing.

- The tax arrangement also has to be reported if tax benefits are obtained by *structuring the investment* accordingly, both at the level of the fund and the investors or if such tax benefits should be ensured as part of the conception.

- An arrangement that has the effect of converting income into *capital, gifts or other categories of revenue which are taxed at a lower level or exempt from tax* also has to be reported.

  From a German tax perspective, the involved corporations and commercial funds typically enjoy benefits when generating original capital gains so that *special arrangements aiming at the generation of such capital gains* also constitute a tax arrangement within the meaning of DAC 6. Special arrangements are to be assumed in this context if, for example, other income in the form of interest, dividends and the like are requalified as capital gains due to the chosen structure and, thus enjoy a benefit due to the arrangement that would not arise without it.

  Furthermore, any *arrangement to receive dividends* also has to be reported, provided again that income, such as interest and the like, are requalified due to the implemented arrangement and that tax benefits are obtained thereby.

  The reporting obligations also apply to so-called *"hybrid arrangements"* that are assessed differently across borders in the countries involved, so that in-

come may not be subject to taxation in both countries or the same business expenses may be deducted in several countries.

- It should also be noted that reportable events require an influence or the choice of a cross-border tax arrangement that is mainly *motivated purely by tax considerations*.

- **When has the report to be filed?**

Pre-existing tax arrangements	First step was implemented from 25 June 2018 until 30 June 2020	Notification until 31 August 2020
New tax arrangements	upon occurrence of the earlier of the following events (from 1 July 2020): - the arrangement was made available for implementation; - the taxpayer is ready to implement the arrangement or - at least one taxpayer has taken the first step of implementation	within 30 days from the occurrence of the reportable event

Therefore, the new reporting obligation within the meaning of DAC 6 does not apply to any arrangements implemented before 25 June 2018.

In principle, the failure to report new tax arrangements will be sanctioned with a fine of up to EUR 25,000. The failure to report pre-existing tax arrangements will, however, not be subject to fines according to current information.

The fiscal authorities have previously announced that any failure to meet the deadline should not be sanctioned until 30 September 2020. A further extension of the deadline due to the Covid-19 pandemic, which has already been

implemented in most countries of the European Union, was, however, already rejected by the German Federal Minister of Finance on 6 July 2020. After this, at the beginning of August, the Federal Central Tax Office published on its website an amended draft of a BMF circular (*BMF-Schreiben*) dated 14 July 2020. In contrast to the previous drafts, this new draft, however, does not contain any regulations on waiver of objection. Instead, the aforementioned statutory deadlines shall apply expressly and exclusively.

It should be noted that the reporting obligation does not depend on the actual consummation of the arrangement, but that such obligation already exists when the arrangement is *available for implementation*. The actual implementation is irrelevant in this respect.

How should the reporting obligation be implemented?

These cross-border tax arrangements have to be reported electronically to the Federal Central Tax Office via an interface using the officially prescribed data form.

The Federal Central Tax Office assigns various numbers and issues these numbers to the intermediary. These are, on the one hand, the *registration number* for the reported cross-border tax arrangement and, on the other hand, the *disclosure number* for the respective reporting. Any intermediary who is subject to reporting obligations has to forward the assigned numbers to the respective taxpayers.

The taxpayers have to state both numbers in their tax returns for the relevant assessment period, during which the tax benefit of the arrangement is supposed to arise for the first time. In this regard, *all registration and disclosure numbers issued* should be forwarded to the tax advisor of the relevant fund, so that they can be taken into account accordingly in the fund partnership's tax return.

If intermediaries who are subject to reporting obligations have named further intermediaries in their reporting, they have to forward the issued registration number also to them.

Conclusion and outlook regarding DAC 6

As a key point it can be said that, in particular, legal advisors as intermediaries are the main contact for possibly existing reporting obligations within the meaning of DAC 6 in connection with the arrangement, acquisition of a company or underwriting process of a member, since they may also be subject to a reporting obligation and also have the necessary proximity in terms of content and time to the reportable event.

It can be expected that the currently hardly limited and therefore extremely wide scope of application of the individual regulations of some parameters will be concretised by the fiscal authorities in future. It remains to be hoped that the fiscal authorities will generously amend and supplement the so-called "white list" of non-reportable facts after having reviewed the first flood of reports (which will certainly occur due to the vagueness of the parameters) in order to improve the manageability of this issue for all parties involved. In addition, it can be assumed that central questions of interpretation regarding the parameters and the "main-benefit test" under national law will (have to) be discussed on a cross-border basis at EU level due to the EU-wide implementation of DAC 6.

II. Update / status of other tax-related topics

Repayment of capital contributions by corporations domiciled in third countries

The topic of the denial of tax-neutral repayments of capital contributions by corporations domiciled in third countries has already been covered by us in various issues of the Financial Yearbook (cf., in particular, FYB 2019 and 2020).

The long-awaited decision of the First Senate of the Federal Fiscal Court (*Bundesfinanzhof*) was already published in the autumn of 2019. It fortunately confirmed and even clarified the two decisions of the Eighth Senate from 2016. As a result, there now exist various supreme court decisions of different Senates of the Federal Fiscal Court acknowledging that corporations domiciled in third countries can also repay capital contributions in a tax-neutral way and that not

every capital repayment by a corporation domiciled in a third country is to be treated as taxable dividends in general and in principle.

According to settled case law of the Federal Fiscal Court, the amount of the distributable profits (and thus also the amount of the repayable capital contributions) by a corporation domiciled in a third country is to be determined in accordance with the relevant foreign trade and corporate law taking into account the general German principles of fiction of use, i.e. a subordinated repayment of contributions. Consequently, the repayment of capital contributions is tax neutral insofar as the payments (= pay-outs) exceed the distributable profits at the previous balance sheet date.

Therefore, the relevant foreign financial statement would have to be applied as the basis of calculation and the figures gained therefrom be adjusted according to fiction of use under German tax law. We had already adopted precisely this approach to differentiate between repayments of capital contributions and payments of dividends from third-country corporations in the past, which – as long as this was still recognised and accepted by the administration – ultimately led to fair and systematically correct taxation. Moreover, the Federal Fiscal Court emphasized that – unlike with regard to EU corporations – no separate determination procedure with a limitation period had to be observed since the statutory rules of procedure for EU corporations were not relevant, which is an advantage in view of the strict limitation period in case of EU corporations.

However, neither this recent decision of the First Senate issued in the autumn of 2019 nor the two decisions of the Eighth Senate issued already in 2016 have, unfortunately, not yet been published in the German Federal Gazette. Accordingly, the decisions are not yet binding for the fiscal authorities. Consequently, the administration is currently still bound by the self-imposed internal directive not to recognize a tax-neutral repayment of capital contributions in case of third-country corporations for the time being.

Shortly after the Federal Fiscal Court issued its aforementioned decision, competent sources of the fiscal authorities stated that the fiscal authorities will now no longer resist this supreme court decision. However, after many months, the

Federal Ministry of Finance (*Bundesministerium der Finanzen*) has still not issued a clear statement or specification regarding the evidence to be provided. As far as we can tell, the requirements to be fulfilled and the corresponding proceedings should at least already (or rather still) be discussed and therefore, the outcome still remains to be seen.

However, the Federal Ministry of Finance will probably follow the legal requirements applying to applications for a declaratory decision on the repayment of capital contributions by EU corporations pursuant to Section 27(8) of the German Corporation Tax Act (*"KStG" – Koerperschaftsteuergesetz*). According thereto, comprehensive and detailed evidence and documents (all statements of account as proof of the payment and return of capital contributions into the reserves, resolutions, etc.) would have to be provided to the Federal Central Tax Office. However, a lot of companies will presumably not be able to provide this evidence in practice due to the often low ownership interest, as well as due to reasons of data protection.

In tax audits, the current state of uncertainty is often practically resolved in such a way that, for the cases concerned, the income is, on the one hand, determined without taking the tax-neutral repayments of capital contributions into account, and, on the other hand, on the assumption that the tax neutrality of capital repayments is recognised, and that these cases are already taken on file by the auditors for subsequent adjustments.

Based on our experience, the income concerned has normally already been declared as taxable dividends in the tax returns for assessment periods from 2017, and the supposedly and systematically applicable income applied for in opposition proceedings considering the tax-free repayment of capital contributions. Since such application may not be approved for the time being, the proceedings are suspended until the Federal Ministry of Finance will have expressed a reliable opinion on the implementation of the decision of the Federal Fiscal Court at some point in time. In most cases, however, it does not make sense to apply for the legal principle of the suspension of enforcement as the application cannot be limited to the (unlawfully) assessed amount of the repaid capital contributions.

Repayment of capital contributions by EU corporations / Application of the new version of the German Investment Tax Act as from 2018

Another topic area in which the fiscal authorities create uncertainty due to the long decision-making processes is the repayment of capital contributions by EU corporations within the meaning of Section 27(8) KStG, recently also partially in connection with the application of the German Investment Tax Act in its version effective from 2018.

Change of responsibilities within the Federal Central Tax Office

Up to and including 2018, the Federal Central Tax Office in Bonn was responsible for applications for the repayment of capital contributions within the meaning of Section 27(8) KStG. The Federal Central Tax Office created a questionnaire and list of criteria, which was to be used for all cases and which should be completed in full in order to obtain certification of the requested repayment of capital contributions. This questionnaire and list of criteria required, among other things, the submission of all statements of account of the EU corporation and all management resolutions, etc., as already mentioned above. A lot of requirements are, however, not applicable to the arrangements that are prominent and prevailing in the private equity sector since they are not relevant. Consequently, the respective structures have to be explained and the relevant structure-related evidence has to be provided.

Initially and for a longer period of time, this explanation process proved to be very time-consuming as the understanding of such private equity, holding and/or acquisition structures had to be created first also at the level of the Federal Central Tax Office. After initial difficulties and numerous changes of the responsible persons within the Federal Central Tax Office, it was, however, possible, to awaken the necessary sensitivity for the characteristics of and the differences between the various structures in the private equity sector in constructive exchanges with the responsible persons, who then did no longer change so often. Thus, the evidence could be plausibly verified on the basis of the obtainable documents where necessary and was also accepted by the responsible persons of the Federal Central Tax Office. The documentation effort was nevertheless quite high, but it was

at least possible to clear individual hurdles of the non-availability of documents for lack of sufficient influence or reasons of data protection, or to adapt them to the specific situation.

In 2019, the responsibility of the Federal Central Tax Office for the processing of applications for the repayment of capital contributions by EU corporations was transferred to the Federal Central Tax Office in Berlin. The wealth of knowledge and understanding built up among the responsible persons in Bonn over the years could, of course, not be transferred and has therefore demonstrably been "lost". As a result, we are currently in a comparative "development phase", which unfortunately entails repeated increased effort.

Correlation between application for repayment of capital contributions / German Investment Tax Act

Irrespective of this change in the local responsibilities within the Federal Central Tax Office, there are still further uncertainties resulting from the introduction of the new version of the German Investment Tax Act effective from 2018.

According to the wording of the act, all capital investment companies within the meaning of Section 19 InvStG a.v. are to be classified as investment funds within the meaning of the new version of the German Investment Tax Act effective from 2018. This has unquestionably been confirmed repeatedly by several persons in charge at the fiscal authorities, who dealt with the draft of the corresponding letter on the application of the act.

Individual tax offices and/or regional authorities take the view, however, that corporations can only be investment funds if they meet certain criteria of the German Capital Investment Code (*"KAGB" – Kapitalanlagegesetzbuch*). In this respect, the fiscal authorities require the existence of a sufficiently concrete investment strategy, which is binding for the respective management, in order to qualify as investment within the meaning of the German Capital Investment Code and thus as an investment fund within the meaning of the German Investment Tax Act. This investment strategy has to be disclosed to potential shareholders before they join the company so that they accept the investment terms and strat-

egy (and thus set them out for the management) upon their joining. This basic question is currently still being discussed internally in the concerned administrative unit, so that it is to be hoped that all arrangements in the form of a capital investment company will (may) be treated as investment funds nationwide as intended by the legislator once.

However, the described uncertainty regarding the classification as investment fund (or not) creates further need for action as regards the applications for the repayment of capital contributions. Unless there is no ultimate certainty that EU capital investment companies will be treated as investment funds within the meaning of the German Investment Tax Act from 2018 onwards, it is strongly recommended to file an application for the repayment of capital contributions with the Federal Central Tax Office for these EU corporations, as a precautionary measure. Such application must be filed within one year of the end of the company's business year (cut-off period!) and cannot be made retrospectively if the fiscal authorities should conclude after all that the company in question is not an investment fund but a capital investment company subject to the general rules on the repayment of capital contributions. In this case, the application period would be missed in case of doubt with the consequence that the full distributions made in the business year, including the part of the repaid capital contributions, would be subject to taxation as taxable dividends. Although this can be reversed in subsequent years under certain circumstances, the final taxation of assets may remain in place.

III. Conclusion and outlook

This year, we have written about commercial, tax and/or regulatory issues in connection with private equity and venture capital funds for the twelfth time. There are still numerous "long-running" issues that have accompanied us and kept us busy for many years, but have still not been conclusively clarified and regulated. On the other hand, however, we unfortunately also have topics (e.g. fund establishment costs) for which it was previously possible to work out sensible and reasonable as well as feasible and acceptable compromises for all parties in discussions over many years, which are then questioned again a few years

later without any need and reasonable cause and which are subsequently simply changed. The review of our previous articles and the wishes and concerns expressed at the end of each of them leads to insights that are a recurrent theme in the articles of previous years:

- New laws often contain unsystematic and (deliberately?) incomplete regulations.

- Instructions of the fiscal authorities (BMF circulars and/or decisions of the supreme tax authorities of the individual federal states) issued in this respect and/or even isolated instructions of the fiscal authorities often cannot eliminate these uncertainties, since such instructions are usually available only with considerable delays and then still do not address topics (subject areas) that really interest the investors in private equity and/or capital venture arrangements and their consultants.

- Elementary dogmatic principles of tax law are not observed or are simply abandoned (for fiscal policy reasons). This is certainly also due to the fact that the fiscal authorities – as explained, for example, at the beginning of last year's article as well as in connection with the default of capital investments arising in income from capital assets – simply turn back any unpleasant supreme court decisions by corresponding participation in the drafting of new legal regulations and thus simply legally codify their own dogged administrative opinion.

One topic, however, makes us feel like Bill Murray, who is allowed to cover the annual Groundhog Day in Punxsutawney: This topic is about the repayment of capital contributions by corporations domiciled in third countries. Just remember: The first two supreme court decisions made to the benefit of the taxpayers were already delivered in July 2016(!). After that, the fiscal authorities – for a long time – had clung to the hope that further proceedings that were still pending at the BFH at that time would possibly turn out in their favour after all. In the meantime, however, after this decision was issued in the autumn of 2019 and confirmed the opinion of the two previous BFH decisions, there has been the justified hope that the fiscal authorities show an understanding and – after definition of the proofs required for the tax-neutral repayment of capital contributions by

corporations domiciled in third countries – finally permit the logical tax neutrality in particular for administrative and economic reasons as well as for ending the numerous appeals made. In this regard, we express our wish again today to break out of this time loop: Where is Rita (aka Andie MacDowell)?

We would be happy to respond again in detail to any further developments and selected current commercial, fiscal and/or regulatory issues in the FYB Financial Yearbook 2022.

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