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PRIVATE EQUITY AND CORPORATE FINANCE

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19 Years FYB FINANCIAL YEARBOOK

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Current (Non-)Developments in the Taxation of Private Equity and Venture Capital Funds – Little Is Flowing in the Right Direction!

Πάντα ῥεῖ – Everything flows!, was our introductory statement in the FYB Financial Yearbook 2020. The starting point was the fact that the taxation of private equity funds, or rather of the limited partners of private equity funds taxable in Germany had increasingly moved into the centre of attention of the fiscal authorities. At that time, very remarkable and landmark decisions had been issued by fiscal courts, including Germany's highest fiscal court, the Federal Fiscal Court (*Bundesfinanzhof*). Today – two years later – we are no longer so sure whether really Everything flows. Some things do not flow at all, which is tantamount to a standstill in the administration of justice – other things flow in the absolute wrong direction.

Our tax consultancy firm has been dealing with a wide range of tax compliance issues concerning private equity funds and their (German) partners for more than 25 years now. We have addressed a plethora of topics about private equity compliance and presented them to the interested reader in numerous articles starting with the FYB Financial Yearbook 2010. At that time, we started with an article about tax compliance in connection with foreign private equity funds which then awakened or, respectively, put an end to the often still dormant understanding of foreign private equity managers, but to some extent also to the lack of concern or even the ignorance of individual German investors with regard to the existing tax declaration obligations relating to such commitments in Germany.

In the following years, we wrote, among other issues, and sometimes repeatedly, about reporting obligations relating to foreign investments, FATCA, selected issues in connection with the German Capital Investment Code (*"KAGB"*

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– *Kapitalanlagegesetzbuch*), carried interest, the miserable new regulations on fund establishment costs and the default of capital claims, the interpretable (as partly unclear) regulations on DAC 6, and, throughout the years and from the beginning, very intensively and critically about the tax neutrality of capital repayments by EU and non-EU corporations.

As already quoted elsewhere: We still perceive a lot of joy on the part of the financial jurisdiction, particularly the Federal Fiscal Court, but also (not only even more, but actually growing) sorrow at the level of the fiscal authorities or the legislator. In addition to many other topics, the increasing taxation of taxpayers' assets in connection with capital repayments by foreign corporations and distributions from investment funds within the meaning of the German Investment Tax Act (*"InvStG" – Investmentsteuergesetz*) continue to stand out. Contrary to any systematic approach, the fiscal authorities are extremely intransigent in this regard and persistently negate existing supreme court rulings simply to the detriment of the taxpayers concerned.

I. The (creeping) taxation of assets

In the following, we would like to sensitise you once again to the tendency of the German legislator and the fiscal authorities to undermine the fundamental tax principle of mere income taxation and to increasingly introduce or enforce approaches to introduce taxes on assets, which we have already repeatedly highlighted in various articles in the FYB Financial Yearbook in recent years (cf. our articles in the FYB Financial Yearbooks 2019–2021).

Against this background we would also like to share ways, in which investors have been trying to counter these efforts by the fiscal authorities by entering into corresponding agreements and arrangements regarding structural adjustments and alternative approaches included in so-called "side letter" agreements for some time now.

Circumstances of potential taxation of assets

The potential danger of a taxation of assets exists mainly in the following circumstances:

- Repayment of capital contributions by corporations domiciled in the EU
- Repayment of capital contributions by corporations domiciled in third countries
- Distributions from investment funds within the meaning of the German Investment Tax Act

The risk of imminent taxation of assets arises in the respective circumstance from the following particularities:

a) Repayment of capital contributions by corporations domiciled in the EU

The separate determination of repaid capital contributions is regulated by Section 27(8) of the German Corporation Tax Act (*"KStG" – Körperschaftsteuergesetz*) for EU corporations. The determination has to be made in accordance with the provisions applicable to German corporations. Consequently, the EU corporation making the distribution must file the application for a declaratory decision on the repayment of capital contributions with the Federal Central Tax Office (*Bundeszentralamt für Steuern*) within one year upon expiration of the calendar year in which the distribution was made (deadline!). Otherwise, distributions not being declared to be repayments of capital contributions are deemed to be taxable dividends.

Over the last years (and, as already outlined in the FYB Financial Yearbook 2021, following some initial and teething difficulties), the Federal Central Tax Office has created a questionnaire and list of criteria to be used for all applications, which must be fully completed in order to obtain a confirming declaration on the repayment of capital contributions applied for. This questionnaire and list of criteria requires, among other things, the submission of all statements of account of all shareholders of the EU corporation and all management resolutions, etc. A lot of requirements are, however, not reasonably applicable to the arrangements that are prominent and prevailing in the private equity sector since they are not relevant. Consequently, the used structures have to be explained and the respective structure-related evidence has to be provided.

After initial difficulties, it was, however, possible, to create the understanding of private equity, holding and/or acquisition structures within the Federal Central Tax Office and to awaken the necessary sensitivity for the characteristics of and the differences between the various structures in the private equity sector in constructive exchanges. As a consequence, the evidence can be plausibly verified on the basis of the obtainable documents where necessary. This approach is also largely accepted by the persons in charge at the Federal Central Tax Office. Nevertheless, the effort for documentation continues to be very 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.

Where the required evidence cannot be provided to a satisfactory extent (the final determination is generally made by the persons in charge at the Federal Central Tax Office) this may, however, result in a non-recognition of the tax-neutral repayment of capital contributions. In this case, the distribution made by the EU corporation has finally to be assessed as taxable dividend in the determination procedure.

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

We have already described the issue of the denial of tax-neutral repayments of capital contributions by corporations domiciled in third countries in various issues of the FYB Financial Yearbook (cf., in particular, the FYB Financial Yearbooks 2019 and 2020) in more detail. In the view of the fiscal authorities, a tax-free repayment of capital contributions by corporations domiciled in third countries (such as the United States, the Cayman Islands, the Channel Islands Guernsey and Jersey, or Hong Kong) should generally not be possible. Instead, all payments made by such third-country corporations, i.e. repayments of capital contributions, too (including so-called “recallable distributions”), are to be qualified as taxable profit distributions.

The provision of this evidence would be consequently impermissible on the merits according to the current view of the fiscal authorities even in case of a special purpose vehicle controlled by a private equity fund (such as a third-country blocker Ltd.), for which actually complete documentation could be provided in connection with the contribution of capital and also the repayment of the capital contribution.

The long-awaited decision of the First Senate of the Federal Fiscal Court was published already in the autumn of 2019. It 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 also corporations domiciled in third countries can 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 dividend generally 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 the general German principles of assumed application into account, i.e. after the subordinate repayment of contributions. Moreover, the Federal Fiscal Court emphasised that – unlike with regard to EU corporations – no separate determination procedure with limitation period had to be observed since the statutory rules of procedure were not relevant for EU corporations, which is an advantage in view of the strict limitation period in case of EU corporations.

However, neither the decision of the First Senate delivered in the autumn of 2019 nor the two decisions of the Eighth Senate delivered as early as 2016 have, unfortunately, so far been published in the German Federal Gazette. Accordingly, these decisions are not yet binding for the fiscal authorities. Consequently, the fiscal authorities are currently (after more than five years now) still bound unnecessarily by the self-imposed internal directive not to recognise a tax-neutral repayment of capital contributions in case of third-country corporations for the time being.

Competent sources from fiscal authorities stated that the fiscal authorities can no longer resist this supreme court decision now. However, even after several years (!), those responsible at the federal and state levels have still not succeeded in issuing a reliable statement regarding the evidence to be provided and the procedure to be followed to this effect.

The Federal Ministry of Finance (*Bundesministerium der Finanzen*) 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) KStG. 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.

c) Distributions from investment funds within the meaning of the German Investment Tax Act

Application of the German Investment Tax Act

Following the introduction of the new version of the German Investment Tax Act (InvStG) as of 2018, all capital investment companies within the meaning of Section 19 InvStG (old version) are to be classified as investment funds within the meaning of the new version of the German Investment Tax Act according to the legal wording.

As outlined in our article in the FYB Financial Yearbook 2021, individual tax offices and state offices are of the opinion that capital investment companies only qualify as investment funds if they meet certain criteria provided for in the German Capital Investment Code.

Apart from that, the Federal Central Tax Office still discusses internally whether all foreign capitalist legal forms, such as a Luxembourg S.C.A., fulfill the requirements to be classified as investment funds within the meaning of the German Investment Tax Act.

Unless and until 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, these EU corporations are therefore still strongly advised to file an application for the repayment of capital contributions with the Federal Central Tax Office within the period of one year upon expiration of the corporation's fiscal year (deadline!), as a precautionary measure. Should the fiscal authorities finally draw the conclusion that the respective corporation is not an investment fund, the deadline would have been missed otherwise in case of doubt, with the effect that the full distribution made in this fiscal year, including the part of the repaid capital contributions, would be subject to taxation as taxable dividend. Although this can be reversed in the following years under certain circumstances, the final taxation of assets may remain in place.

Classification of distributions from investment funds under tax law

The taxation system of the German Investment Tax Act follows the assumption that investment funds provide for a return option for the investor (as is the case with listed investment funds) and that only income is distributed during the holding period of the investment. Consequently, all distributions made by a (domestic or foreign) investment fund must be recognised as taxable investment income under capital income.

Insofar as (especially foreign) capitalist private equity funds distribute available cash, for example, due to an exit of a portfolio company, to investors – as is customary –, this distribution, including the acquisition costs contained therein, would be fully taxable.

The fiscal authorities and the legislator are aware of such possibility of taxation of assets according to their statements. However, no change in the legal provision is planned currently and for the time being.

Solutions to avoid taxation of assets

For some years now, investors have been trying to counter these risks of having to pay taxes on invested capital by entering into appropriate agreements in "side letters" with the respective private equity fund.

In this context, the following two main structural considerations have evolved:

a) Sale of blocking corporations ("HoldCo")

A private equity fund often does not acquire the respective portfolio companies directly, but indirectly by using an acquisition company in the form of a corporation ("HoldCo").

The easiest way to avoid the obligation to file an application for a declaratory decision on a tax-neutral repayment of capital contributions (by EU corporations) or even the (current) taxation of assets in third-country HoldCos is, from a tax point of view, the sale of HoldCo in the course of an exit of the target company held through the respective HoldCo.

Such a sale ensures the deduction of the acquisition costs incurred by HoldCo; the German investors are thereby only allocated the capital gains resulting from its sale. At the level of "commercial" investors in the form of corporations, such capital gains are also (still) subject to the tax exemption of 95% under Section 8b KStG.

In practice, however, this possibility of selling HoldCo often fails due to the underlying structural conditions of an exit. Since it is usually not only the private equity fund in question that holds (and sells) the shares in the target company, but also other shareholders, a purchaser is usually interested in acquiring the shares in this target company or any holding company thereof, which in turn holds all the shares in the portfolio company to be acquired. In contrast, experience has shown that an acquisition of a HoldCo of an individual (indirect) shareholder of the target company is of no interest to a purchaser.

b) Share redemption

Since the sale of a HoldCo is frequently ruled out in practice, the instrument of share redemption has become established in the market. For this purpose, HoldCos issue a separate share class for the individual investments in the relevant target company. When an investment is sold, the sales proceeds are not distributed by HoldCo to the private equity fund. Instead, the shares of the relevant share class are redeemed.

Such share redemption is to be regarded as a sale transaction for tax purposes. Therefore, the acquisition costs paid at the issuance of the corresponding shares are to be deducted from the income when calculating the capital gain. Accordingly, an otherwise occurring taxation of assets can be avoided when distributing the sales proceeds from an exit by means of a share redemption.

An important prerequisite for the recognition of a share redemption is, however, that the issuance and redemption of shares are already provided for in HoldCo's articles of association and that the required formal processes are strictly observed and precisely adhered to. In particular, the respective resolutions on the issuance and redemption of shares as well as the related calculations of the issue and redemption prices must be drawn up in detail and passed in their entirety, and the corresponding documentation must be made available to the German investors.

Currently, the redemption of shares is the only suitable means to repay contributions in a tax-neutral way (also) for investment funds. The instrument of share redemption has now become established, particularly in the case of investment funds in Luxembourg, but also already in other jurisdictions.

c) Side letters and reporting under "DAC 6"

Also due to the above-described continuing uncertainties over the recognition of a tax-neutral repayment of capital contributions, German investors, in particular, are pushing for the implementation of corresponding structures in side letters in order to avoid any harmful taxation of assets.

Insofar as such structural characteristics are negotiated, the reporting obligation pursuant to the law introducing an obligation to report cross-border tax arrangements ("DAC 6"), which entered into force on 1 January 2020, should be observed in the following (cf. our article in the FYB Financial Yearbook 2021). In these cases, not only the German investors themselves but also their structural consultants who negotiate the relevant side letters are under the obligation to report.

II. Developments going in the wrong direction

In addition to the numerous tax issues and problems, in which the fiscal authorities persistently stick to their incorrect interpretation of the law and refuse to develop the law further, they, the fiscal authorities, together with the legislator, are unnecessarily opening up new playing fields elsewhere. A practice that has been settled and well established for years is being abandoned and turned upside down without necessity.

Value added tax on management fees

Many of us well remember or rather have bad memories of the introduction of value added tax (VAT) on management fees. In practice, management tasks in connection with private equity funds were often structured as non-taxable shareholder contributions for many years, until the fiscal authorities imposed VAT on management contributions with effect from 1 January 2008, irrespective of how they were structured.

Such VAT burden on the management fee drives up costs at the level of the German private equity fund, since the fund itself is not entitled to deduct input tax. At the same time, this leads to distortions of international competition for German fund structures, as management fees are not subject to VAT in foreign structures. The relocation of the fund to (neighbouring) foreign countries as well as the advisory structures partly associated with the respective fund lead to different rules of the game and partly, unfortunately, to other massive problems, too.

The more recent case law of the European Court of Justice (ECJ) on the VAT exemption for investment funds is also of only limited help, as the German legislator has solely very "sparingly" implemented this VAT exemption for (investment) funds provided for by European law in Section 4(8)(h) of the German Value Added Tax Act (*"UStG" – Umsatzsteuergesetz*). It is to be expected that the VAT exemption will be granted to German venture capital funds (for example, those being subject to the EUVECA regime), but not to the other German private equity funds.

Capitalisation or non-capitalisation of fund establishment costs

The capitalisation or non-capitalisation of fund establishment costs (including management fees) have intensively concerned the private equity sector – as described in more detail in the FYB Financial Yearbook 2020 – for many years. After a lengthy process, an arrangement was largely reached with the fiscal authorities and – at least in Bavaria – the so-called 'Munich Model' of a partial and pro rata capitalisation of alleged acquisition costs was implemented as an acceptable compromise. The Munich Model, however, was explicitly rejected in some German states, where a (more) comprehensive capitalisation of acquisition costs was exercised.

After the Federal Fiscal Court issued a landmark decision in 2018 in connection with tax deferral models (Section 15b of the German Income Tax Act (*"EStG"* – *Einkommensteuergesetz*), there was brief hope as to the possible prospect of a then uniform approach regarding the capitalisation or non-capitalisation of fund establishment costs throughout Germany. Unfortunately, this joy lasted only very briefly, as the Electric Mobility Act/Annual Tax Act 2019 (*Elektromobilität-Gesetz/JStG 2019*) codified the comprehensive capitalisation of fund establishment costs in law.

Questioning asset-managing fund structures

The circular of the German Federal Ministry of Finance of 16 December 2003, which became known as 'Fund Decree' (and which is still valid) summarised the general characteristics developed over many years to distinguish private asset management from commercial operations in a list of criteria and thus provided guidance on the qualification of income from private equity structures. Apart from a so-called *obiter dictum* in the decision from 2011, the Federal Fiscal Court did also not comment on the qualification of income of private equity funds any further.

In the course of tax audits, domestic and foreign private equity structures have been examined since the beginning and the respective fund structure classified as asset-managing or commercial on the basis of the criteria of the Fund Decree.

Recently, we have noticed an increasing tendency on the part of tax auditors to push (German) structures into the "commercial corner", even if they clearly and indisputably qualify as asset-managing according to the criteria of the Fund Decree. As one tax auditor put it in his own words, this is intended to "subject the foreign taxpayers participating in the (asset-managing) partnership to limited tax liability in Germany". Cases are even known from the market in which tax auditors (partly with the assistance of the tax investigation office and the public prosecutor's office) attempt to move the place of management of foreign private equity funds to Germany. In the case of foreign commercial structures, this directly leads to limited tax liability for non-residents; in the case of foreign asset-managing structures, approaches are also sought to push the fund into commercial status in order to induce limited tax liability of non-residents as described above.

Conclusion and outlook

This year marks the thirteenth consecutive year that we have contributed to the FYB Financial Yearbook on a set of tax compliance issues. In doing so, we note that in some tax areas "nothing flows anymore" (a departure, so to speak, from πάντα ῥεῖ – Everything flows), while in other areas the direction of the flow is not right (πάντα ῥεῖ – Everything flows, but just in the wrong direction).

The hope expressed several times in previous years for the recognition of the tax-free repayment of capital contributions in the case of third-country corporations with moderate and attainable requirements of evidence is still virtually in a state of shock, even after many years. The financial risk for the fiscal authorities increases permanently and notably since currently almost all of the private equity structures we know declare returned capital contributions from third-country corporations as taxable dividends. At the same time, however, the relevant tax assessments are being kept open so that, in the event of a subsequent recognition of the tax-free repayment of capital contributions by the fiscal authorities, the investors will recover the respective tax payments made, including the full interest payment provided for also for tax refunds under the German Fiscal Code (*Abgabenordnung*).

On the other hand, existing opportunities to avoid a further weakening of Germany as a fund location are not being exploited (due to fiscal policy and tax revenue-driven motivation). Otherwise, it is not possible to explain the option granted by the ECJ, but not used, for a broad value added tax exemption of management fees for all private equity structures, the missed opportunity for a systematic and balanced legal regulation on the capitalisation of fund establishment costs and the latest attempts to reclassify asset-managing partnerships.

And in the sight of the cineaste again this year: Bill Murray on Groundhog Day in Punxsutawney. The wish to break out of the noticeable and painful tax time loop remains: Where is Rita (aka Andie MacDowell)?

In this article, we have referenced articles of previous years frequently and in many places to avoid repetitions. If you do not have the referenced articles of the FYB Financial Yearbook at your disposal (anymore), e.g. because older issues of the FYB Financial Yearbook are out of print and no longer available, please do not hesitate to contact us. We still have some older issues of the FYB Financial Yearbook available or can at least send you the desired article(s) electronically.

We would be happy to respond to the further developments and selected current commercial, fiscal and/or regulatory issues in detail again in the FYB Financial Yearbook 2023.

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