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Tax Compliance for Foreign Private Equity Funds

In the Anglo-Saxon region private equity has been an asset class of economic significance for quite some time now and this is also the reason why practical experience in structuring private equity funds and establishing tax compliance for private equity funds has been longstanding in this region.

By contrast, in Germany there are still no uniform tax provisions in place for private equity funds. The longstanding practice of the finance authorities, predominantly exercised in Bavaria, was summarized in a letter on the “Income Tax Treatment of Venture Capital Funds and Private Equity Funds”, issued by the German Federal Ministry of Finance in December 2003, which deals in particular with the distinction between private asset management and trade or business treatment. Subsequently, further sets of rules – partly providing for different kinds of taxation – were created, most recently through the *Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungen* (“MoRaKG”) [German Act for the Modernization of the Framework Conditions for Venture Capital and Private Equity Investments] as well as the introduction of the *Wagniskapitalbeteiligungsgesetz* (“WKBG”) [German Venture Capital Act] alongside the still effective Private Equity-Pronouncement. State aid proceedings have meanwhile been instituted challenging material elements of the WKBG in Brussels.

The BVK [German Private Equity and Venture Capital Association] even takes the view that the attempt to advance the general framework for private equity in Germany based on the MoRaKG and the WKBG has failed. This is why, on September 3, 2009, the BVK submitted a (renewed) recommendation for the creation of a capital markets framework for the regulation of private equity in Germany during the legislative period 2009-2013, allowing Germany to once again catch up with other nations within the international competitive environ-



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ment of private equity funds. The objective was in particular to finally pursue more intensely the target already agreed in the coalition agreement of 2005 – to provide the market with a uniform private equity law – through the creation of an independent capital markets law for private equity or the advancement of existing legislation.

Considering the above and the fact that capital investors doubt the reliability of German tax laws, funds are still now – just as they were in the past – set up in particular in those foreign countries, where private equity has a long tradition and/or where less statutory or administrative rules are in place and where, therefore, there are points of common interest of the parties involved, such as, in particular, tax transparency of private equity funds, VAT exemption of management services and also the reliability of tax and regulatory laws.

In the following, this article will outline some of the material aspects of tax compliance in terms of form and substance, as they come up in day-to-day tax compliance practice, including the latest developments on interacting with the finance authorities.

Tax compliance – requirements as to form

In Germany, investors, who are subject to unlimited tax liability, have an enhanced duty to assist in clarifying the tax-relevant facts in case of income involving a foreign element. Aside from that, there are statutory reporting requirements in relation to participations in foreign companies which serve to detect whether all taxable proceeds and possible further declaration requirements based on other laws have been covered. In the following, the declaration for the separate and uniform assessment of foreign private equity funds in Germany will, therefore, specifically be dealt with. Other declaration requirements will be touched on briefly.

■ **Separate and uniform assessment of income from foreign partnerships with several German resident partners**

In recent times, queries by German resident investors, who have questions or experience difficulties when performing their tax duties in connection with foreign fund participations, have multiplied. Finance authorities increasingly turn to individual German investors asking them to file a declaration for separate and uniform tax assessment.

According to statutory provisions, a German investor in a foreign private equity fund generally has to ensure that income can be assessed as required by the German tax provisions. To the extent that the investor is not the only investor subject to unlimited tax liability in Germany, holding an interest in a particular foreign private equity fund, the following provisions apply in addition.

Taxable income and tax bases related thereto have to be assessed “separately”. This has to be done “uniformly” for all parties involved to the extent these are relevant for taxation in Germany. Regarding all participants subject to unlimited tax liability in Germany, income from foreign private equity funds is assessed vis-à-vis the tax authorities in charge of the district where the most valuable part of the common assets is located. In case income realized abroad is exempt from German taxation, based on a double tax convention (DTC), no assessment is made unless such assessment is otherwise tax-relevant, e.g. for purposes of the exemption-with-progression rule.

Although, in this respect the administration and thus the management of the private equity fund also remains subject to the declaration requirement, the German investor has to fulfill the requirement as well, considering that, in the case of foreign private equity funds, the respective statutory provisions are often without impact due to the foreign management’s failure to respond to such requirement.

In the literature the view is taken that the statutory provision is amiss and ineffective to the extent that it requires the parties to the assessment to do something impossible, which – according to this view – is the case where such parties are subject to a requirement to file a complete declaration of assessment in respect of

all of the resident taxpayers. When exercising their discretion to choose among the parties subject to a requirement to file a declaration of assessment, the finance authorities have to take into consideration to what extent such parties – in terms of the law and facts involved – are able to obtain the information needed to comply with such requirement. As a rule, an investor is, however, not able to file the declaration of assessment in respect of all of the resident investors of a foreign private equity fund, so that, therefore, the finance authorities are limited to requesting such declaration from the partnership’s manager only (discretion limited to only one possible lawful decision). In the context of their possibilities in terms of law and facts, the investors do, however, have to make sure that the manager complies with the declaration requirement.

The term “manager” comprises all of the members of a partnership who are authorized to represent such partnership. Partner status itself is not necessary. In case of a foreign private equity fund, the question of whether or not a person is authorized to manage the affairs is determined based on the respective foreign law and the articles of association and the partnership agreement of the foreign partnership.

Although the remaining resident partners are generally relieved from their duty to file a declaration if one of the parties subject to the declaration requirement files a declaration of assessment, the remaining partners remain subject to such requirement to the extent that an incorrect or incomplete declaration has been filed.

Separate and uniform assessments are generally only admissible if and to the extent that they are relevant for German tax purposes. Consequently, only income attributable to resident taxpayers can be included in the assessment procedure.

An assessment procedure has to be carried out even in cases where there are doubts as to whether several persons sharing in joint income are subject to taxation in Germany or as to whether they are at all identifiable.

In the declaration of assessment, the resident participants have to be named and only the income allocable to such partners and other tax bases related thereto have to be declared.

Since the resident partner is generally not aware of the legal and the factual relations governing the partnership, management teams have in recent years increasingly turned to a German tax advisor for the preparation of a separate and uniform declaration of assessment.

This approach is beneficial to all resident parties to the assessment and/or the management in particular for the following reasons:

- Uniform classification of the income of the private equity fund and avoidance of classification conflicts, if any,
- Identical tax results for all German investors and
- Avoiding that several tax advisors of individual German investors approach the finance/management teams of the private equity funds with identical or at least similar questions.

■ **Further reporting requirements in case of outbound commitments**

Taxpayers subject to unlimited income tax and corporate income tax liability in Germany have to report certain outbound investments and commitments to the finance authorities based on an officially prescribed form. These include, amongst others:

- Interests in foreign partnerships as well as disposals thereof or changes thereto, whereby the disposal of an interest, any increase thereof or any decrease in the interest amount have only been subject to reporting requirements since January 1, 2002. To the extent that resident tax subjects participate in a foreign private equity fund and income has to be assessed separately and uniformly in respect of all resident participants, the finance authorities accept fulfillment of the reporting requirement by the foreign private equity fund, by a nominee or another person representing the interests of the resident participants.
- Acquisition of participations in a foreign corporation, if
 - such acquisition results in a direct participation in the equity or assets of the corporation of at least 10 percent or an indirect participation in the equity or assets of the corporation of at least 25 percent or
 - if the costs of the acquisition of all participations total more than € 150,000.

In this case, the acquisition based on which the threshold is reached or surpassed is subject to the reporting requirement. The reporting requirement is a one-time only and not an ongoing requirement. Therefore, an increase of a participation that has already been reported is no longer subject to a reporting requirement.

The revision of this statutory provision stipulates a term of one month – starting with the event which needs to be reported – during which the occurrence of the event has to be reported. Exceeding this term constitutes an administrative offence and can be punished by a fine of up to € 5,000.

■ **Tax neutrality of return on capital / controlled foreign company legislation according to the German Foreign Tax Act**

Other than a distribution of profits, a pure return on capital from a corporation does not constitute part of the taxable income. For purposes of safeguarding this tax neutrality of a return on capital, corporations who are subject to unlimited tax liability in Germany have to account for contributions not made to the nominal capital on their so-called tax deposit account.

In this respect, comparable provisions are in place for EU corporations in the form of a fixed-term application procedure, whereas in the case of non-EU corporations (such as Cayman Islands and Guernsey resp. Jersey corporations) no statutory provisions on returns on capital exist. In practice, the question of whether evidence of returns on capital should be documented – for instance in respective ancillary calculations – has thus already been given some thought. Insofar as the taxable subject – in the context of his enhanced duty to provide clarification – does not exhaust all the legal and actual possibilities of determining the facts of the case where outbound scenarios are concerned, the finance authorities have to estimate the tax bases.

Tax compliance – requirements as to substance

Concerning tax compliance in terms of substance, the objectives and investigations relating to foreign private equity funds are mostly identical to those relating to German private equity funds:

■ Income classification

The classification of income on the level of the foreign private equity fund is significant for German investors (private investors, on the one hand, and trade or business participants including corporate investors, on the other hand).

In case of *funds engaged in private asset management*, income (capital gains, interest and dividends) is determined in accordance with the principle of inflow/outflow and, in respect of private investors, it is taxed based on the uniform flat tax at a rate of 25% plus solidarity surcharge and, where applicable, church tax since 2009. For trade or business participants in a structure engaged in private asset management (so-called zebra participants), this income is re-classified into trade or business income on such participants' level. In this case, all interest income is subject to full taxation. Taxation of dividends and capital gains is subject to the partial income procedure or – in respect of investors in the form of corporations – generally taking into account a tax exemption of 95% in relation to corporate income tax and trade tax. In the case of non-fulfillment of the inter-corporate tax privilege, i.e. an (indirect) participation of at least 15% in the nominal capital of the foreign corporation, trade tax is due in the full amount regarding these so-called diversified holdings dividends.

By contrast, in case of a participation in a trade or business fund, the principle of inducement generally applies. In respect of private investors, dividends and capital gains are taxed in accordance with the partial income procedure. Interest is subject to full taxation. In respect of trade or business participants, the tax consequences outlined above also apply to trade or business private equity funds. In addition, where trade or business participants are concerned, the full amount of income from participations in foreign private equity funds is reduced in relation to their own trade tax assessment basis, so that, in this case, diversified holding dividends are not subject to trade tax either.

The “grandfathering” of capital investments, codified in conjunction with the introduction of the flat tax, also applies to foreign private equity funds engaged in asset management: Where securities are sold, which were acquired prior to January 1, 2009, such sales are only taxable in the case of holding periods of up to one year, except where significant participations within the meaning of Sec.

17 German Income Tax Act are concerned. Taxation of a significant participation is generally subject to the partial income procedure. Sales of non-significant participations after the lapse of the holding period of one year are not taxable.

In the Private Equity-Pronouncement mentioned at the outset, the finance authorities – taking into consideration the general rules on the distinction between private asset management and trade or business activities in the form of commercial trading in securities – developed a set of criteria for the income classification in domestic and foreign private equity funds, which has already been subject to in-depth discussion and commentary by practitioners.

The material classification criteria are:

- No bank loans/no guarantees
- No own organization
- No exploitation of a market using professional expertise
- Prohibition of public offering/dealing on one's own account
- No short-term participation
- Prohibition of re-investment of sales proceeds
- No active involvement in the management of portfolio companies
- No deemed business/no business "infection"

Deemed business of a German GmbH & Co. KG is usually avoided by granting management authority to one limited partner. In foreign legal systems such management authority may, in some instances, result in the unlimited liability of such limited partner. Where this is the case, deemed business is often avoided using a general partner in the form of a General Partner Limited Partnership (GP-L.P.), which itself is not deemed to be in business based on its structure. A possible business "infection" can generally be avoided by interposing a blocker corporation.

The distinction between foreign private equity funds engaged in private asset management and those engaged in business or trade activities, which was often significant in the past, has become considerably less relevant since the introduction of the flat tax as per January 1, 2009, considering that now all sales –

save in the case of the “grandfathering” of the acquisition of target companies until December 31, 2008 as outlined above – are taxed irrespective of the holding period. For this reason, newly raised private equity funds engaged in private asset management have become increasingly less attractive.

■ **Determination of income**

In context of the determination of income, one is faced with the following challenges in the day-to-day tax compliance practice for foreign private equity funds:

Analysis of participation structure

Annual financial statements prepared in accordance with foreign accounting principles often depict the target companies from a purely economic point of view and do not take into consideration the legal participation structures – e.g. through interposed holding or blocker companies.

Hybrid financing structures

In the context of hybrid financing structures, such as preferred equity certificates (PECs) an investigation as to whether this constitutes an investment in equity capital or debt capital is necessary. Whereas, in US law, these mostly constitute investments in equity capital, such commitments often constitute debt capital investments in German law. The difference in taxes on interest income as well as dividends and capital gains has already been described above.

Further issues

Further issues in connection with foreign private equity funds, which need to be resolved, arise inter alia from the necessary currency conversion into euros of the cases involved, from the calculation of interest that has been accrued or needs to be deferred, from the analysis of foreign legal formats using the method of comparing different types of legal formats and also from the valuation of participations in corporations and partnerships.

■ **Management fees**

The sponsors of private equity funds receive from the investors an annual compensation for their management services, which is generally reduced after the expiry of the investment period.

The tax treatment of this management compensation is currently subject to dispute. According to the finance authorities, the management fee accumulated during the investment period of the private equity fund constitutes part of the acquisition costs such that it does not have any tax impact prior to the time and except in the case of the sale of the financial assets. This capitalization of the management compensation demanded by the finance authorities, which has, however, not been specified in terms of the (exact or percentage) amount in the various published or non-published decrees of the finance authorities of the German federal states, is just wrong from a systematic perspective and is handled differently in the course of tax audits.

The tax effect is different for the various groups of partners: In the case of tax-exempt capital gains in respect of portfolio companies acquired prior to December 31, 2008, the capitalization of the management fee comes to nothing. This is why the capitalization of the management fee has hardly been relevant for private investors to date.

Where participations are acquired after January 1, 2009, things are quite different. Considering that for private investors the amount of capitalized management fees reduces the assessment basis for the flat tax by 100%, this group of investors generally favors a high pro-rata capitalization of management fees. By contrast, investing corporations favor a low pro-rata capitalization of management fees both in the former and in the current legal framework, since the non-capitalized amounts are deductible business expenses.

■ Carried interest

The carried interest (carry) is a performance-linked incentive for the sponsor, who is once again generally structured as a partnership. As soon as the investors have received their contributed capital as well as the typically agreed hurdle rate (often 6 – 8% p.a. on the average committed capital), the fund sponsor is entitled to a disproportionate share (mostly 10 – 30%) of the distributions of the fund partnership.

This article refrains from once again describing the legal and tax treatment of the carry at this stage, considering that such treatment has already been subject

to in-depth discussions in the specialized literature. In the end, for carry purposes, it is necessary to differentiate between the date of the private equity fund's formation and the date on which the underlying portfolio company was acquired.

To the extent that the private equity fund was formed prior to April 1, 2002 and the underlying portfolio company was acquired prior to November 8, 2003 (so-called "pre-existing carry cases"), the finance authorities – at least in Bavaria and in other German federal states where a corresponding administrative practice was in place until the introduction of the "Carry Law" – allow for an original attribution of the carry as a disproportionate profit. Insofar the formerly existing non-taxation of dispositions after the expiry of the one-year holding period led to the non-taxation of the carry in the hands of the carry recipient.

In cases where the criteria of a "pre-existing carry case" are not fulfilled, the disproportionate share of the party entitled to the carry is treated as income from self-employed activity for tax purposes and is 50% tax-exempt. For private equity funds formed after December 31, 2008 the exemption only amounts to 40%.

In recent times, queries by resident private equity managers, who have questions and difficulties when performing their tax duties in connection with foreign carry vehicles, have also mounted. Finance authorities increasingly turn to individual German managers asking them to file a separate and uniform declaration of assessment also in respect of the disproportionate income from participation. In this case, the same requirements apply as have already been outlined above in relation to resident interested investors in foreign private equity funds in the context of the tax compliance – requirements as to form.

■ **Controlled foreign company legislation**

In case of profit retention, it is generally possible to initially shield profits of a foreign corporation from the taxation of the German resident shareholder. However, to the extent that these foreign corporations merely generate passive income, e.g. in the form of interest on loans, the controlled foreign company rules of the German Foreign Tax Act exclude any exploitation of the existing international tax rate gaps.

Conclusion

Participating in foreign private equity structures involves often neglected declaration requirements on the part of investors subject to unlimited tax liability in Germany. In recent times, finance authorities have increasingly pursued and insisted on compliance with such requirements. One of the major objectives is the uniform classification of the income of several German resident participants, e.g. for purposes of avoiding a possible business infection of the remaining asset management capital and of ensuring identical income determination in order to avoid extra work in the form of extensive inquiries during the assessment of various participants.

On the one hand, gathering the necessary information for income determination and, on the other hand, establishing the tax treatment of such information in Germany each constitute special challenges. In this context, it is not too uncommon that individual cases have to be analyzed irrespective of their foreign tax treatment in order to be able to reliably gather any internationally deviating classifications. Practice has proven that an in-depth cooperation and coordination process involving both the management of the private equity fund and the tax advisor, engaged for purposes of preparing the separate and uniform declaration of assessment on behalf of the resident participants, facilitates timely, reliable and cost-efficient income determination.

Aside from German resident participants, the declaration requirements described above in particular affect German resident private equity managers who, in the context of their entitlement to carried interest, typically generate taxable income in Germany via foreign management partnerships, the determination of which requires further separate analyses. Regarding the future development of the private equity asset class, we can only hope that the German legislator becomes even more sensitive to the necessity of company financing through private equity and creates a positive legal framework while at the same time avoiding a Europe-wide or worldwide across-the-board over-regulation.

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TYPE OF BUSINESS | Lawyers / Tax Advisers / Auditors

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YEAR OF FOUNDING | 1988

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