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ENGLISH EDITION

FYB FINANCIAL YEARBOOK GERMANY 2013

PRIVATE EQUITY AND CORPORATE FINANCE

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

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10 Years FYB FINANCIAL YEARBOOK

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Tax Compliance for Private Equity Funds – Current Developments

Unresolved issues as well as various improvements and changes in the area of formal tax compliance are points of focus of resident and foreign private equity funds and their investors on an almost daily basis. In the following we would therefore like to point out the current developments regarding some specific topics of formal tax compliance.

The separate and uniform tax assessment of foreign partnerships with several (resident) partners has become increasingly important, not least due to the Federal Fiscal Court (Bundesfinanzhof, "BFH") decision of August 2011, which is the first time that the BFH has commented on the qualification of the activities of a private equity fund.

Regarding the obligation to report investments in foreign partnerships and corporations made by resident individuals and corporations, it has meanwhile also been possible to resolve further previously open issues following in-depth discussions with the finance authorities.

Concerning the US American Foreign Account Tax Compliance Act ("FATCA"), based on which the U.S. seeks to assess the entire foreign income of all US taxpayers, some simplifications are emerging, based on the draft of an intergovernmental agreement between the U.S. and the ministries of finance of the European G-5 nations.

This summary of the current developments regarding selected topics of formal tax compliance constitutes an update of the articles included in the FYB in previous years.

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Separate and Uniform Assessment of Income from Foreign Partnerships with Several Resident Partners – Relevance of Income Qualification

The development described in the FYB Financial Yearbook 2010, according to which the fiscal authorities increasingly turn to individual German investors asking them to file a declaration for separate and uniform tax assessment, has recently gained momentum. In day-to-day consulting practice a considerable increase in such requests has been noticeable. The fiscal authorities have initiated the practice of referring the addressee to other German investors that they know of and asking them, by reference to the applicable statutory provisions of the German General Tax Code (Abgabenordnung), to file a joint tax return.

Generally, German investors are also showing a greater concern for handling this issue in a systematic and structured manner, since cases of conflicts in income classification have repeatedly arisen in several foreign private equity funds in recent times, with private investors classifying income as asset management and institutional investors (partially in parallel) treating the same income as trade income because of diverging fiscal interests.

First off, it should be noted that, following the introduction of the flat tax for private individuals, the distinction between fund structures engaged in *asset management* and those engaged in *trade or business* has lost much of its relevance in the context of a current comparison of the tax burden. Yet, a "grandfathering" of capital investments was codified in conjunction with the flat tax, which is also applicable to private equity funds engaged in asset management, with the effect that sales of portfolio companies that were acquired prior to January 1, 2009 were only taxable in case of holding periods of up to one year, except in cases involving significant holdings according to Sec. 17 German Income Tax Act.

Nevertheless (or maybe for this very reason?), the consultation process between the different resident investors (investor groups) is very time-consuming in parts and, in a few cases, also tedious, given that this conflict of interests is a natu-

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ral consequence of the different tax objectives, given that many years may have passed since the closing of the fund and the first filing of a tax return before the investors become aware of each other and that the various investor groups are reluctant to give up their own qualification (which, in some cases, may be based on supporting legal opinions). – The best solution for this qualification dilemma – which we have already proposed a number of times in other places – is to have the preparation of the tax return for the German parties assigned by the management of the foreign private equity fund in order to avoid the previously described consultation and coordination problems.

Sec. 138 General Tax Code – Further Progress in Resolving Open Issues

Based on the circular issued by the Federal Ministry of Finance in spring of 2010 regarding the obligation to report foreign investments, our office has dealt extensively with the effects and problems of its practical implementation for private equity companies in the FYB Financial Yearbook 2011. At the same time, we had – as previously described – contacted the fiscal authorities on the federal and state levels to find acceptable solutions – in particular for the private equity industry – regarding the obligations to report foreign investments and to put these solutions into final terms together with the fiscal authorities.

The previous statutory provision specified a reporting period of one month – commencing on the date of the reportable incident, i.e. the date of the investment in the foreign partnership or the date on which the investment limit of a total of EUR 150,000 in foreign corporations was exceeded – for reporting the investments. After we had demonstrated on several levels of the fiscal authorities that, in practice, it is impossible to comply with this time limit because of the difficulties to procure information – in particular in multilayered structures –, the reporting period was at least extended to five months following the end of the relevant calendar year, effective as of November 1, 2011.

During a recent discussion with the Bavarian Ministry of Finance, we had the opportunity to address in person the other yet unresolved questions and issues arising from the daily implementation and to raise the awareness for such is-

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sues, some of which are not yet finally resolved, amongst those responsible. In the course of this discussion we received assurances that the issues that we raised will be addressed. The Bavarian Ministry of Finance confirmed the necessity to introduce a statutory clarification or corresponding general restrictions, conceding that the current wording of the law does not leave the necessary margin of discretion in this context.

Another focus is the question of who has the duty or the right to report – if relevant, with discharging effect – these types of foreign investments.

The fiscal authorities agree that a private equity company, a nominee or another person representing the interests of resident investors is generally also permitted to report with discharging effect on behalf of the investors who are the beneficial owners (taxable subjects). It is questionable, however, whether they each have to obtain the consent of every single investor to proceed accordingly.

In the context of a tax return or a tax audit, indirect investments are also made transparent to the fiscal authorities, since not only direct, but, in the course of the holding structure, also indirect investments have to be disclosed based on the enhanced statutory obligation to co-operate in case of foreign structures. – Accordingly, the fiscal authorities are generally also aware of these indirect investments. Therefore, reporting at least the investments in foreign partnerships pursuant to Sec. 138 para. 2 no. 2 General Tax Code (Abgabenordnung) would not conflict with the tax consultant's professional duty of confidentiality.

If the foreign investments are not reported by the private equity fund, the nominee or another representative, the investors receive – often in conjunction with the tax criteria for their allocable share of the current income – a summary of the respective investment characteristics that are attributable to them. In this case, the responsibility for reporting the facts rests with each investor.

In case of newer private equity structures, a respective notice pursuant to Sec. 138 General Tax Code is often already included in the partnership agreements, so that in these partnerships, authorization is already granted to the management or its tax advisors when the partnership is joined.

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FATCA – Simplified Application based on Intergovernmental Agreement?

On July 27, 2012, the US Treasury Department and the ministries of finance of the G-5 nations (including, besides Germany, France, Great Britain, Italy and Spain) published a draft of a model intergovernmental agreement in view of the prospective implementation of the so-called "Foreign Account Tax Compliance Act" (hereinafter also referred to as "FATCA") on January 1, 2015 ("Model Intergovernmental Agreement to Improve Tax Compliance and to Implement FATCA").

Previous Development and Background

FATCA was introduced due to a sharp increase in cases of tax evasion, where US taxpayers made investments outside the U.S. but then failed to declare the resulting income in the U.S..

Based on FATCA, the US Internal Revenue Service (IRS) directly intercepts all transactions with US sources. The original draft legislation had established the obligation of, amongst others, each private equity company receiving proceeds from US sources to enter into an agreement with the IRS by early 2015 (previously even mid-2013) and either identify all US persons participating in the private equity company and report certain related data or else give a corresponding negative covenant.

Otherwise, from January 1, 2015 onwards, a 30% "(penalty) withholding tax" would be assessed on cash flows (i.e. not only on revenues, but – aside from interest and dividends – also on sales proceeds, i.e. capital gains and return on capital) from the U.S.. Based on current information, a subsequent refund of this tax will not be available. Therefore, this would entail a definite taxation affecting all shareholders of the relevant private equity company irrespective of participation by US taxpayers.

The objective of FATCA is to achieve complete assessment of all US taxpayers with their worldwide, i.e. in particular their foreign income. In the future, reporting all accounts and securities held indirectly by US citizens as well as all investments, including the resulting sales proceeds, shall be required, regardless of whether these accounts are maintained or, respectively, held in the U.S. or elsewhere.

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The so-called Qualified Intermediary (QI) regime, which has existed since 2001, has proven to be insufficient in this regard. According to this regime, banks were already previously required to report US revenues (interest, dividends, but not, however, sales proceeds/capital gains) that were realized by US residents. However, a separate report on revenues from non-US sources as well as assets that were merely held indirectly by US residents in, for instance, structures that were not transparent, was previously not required.

If the documentation and reporting obligations according to FATCA are not fulfilled, as of 2015 all proceeds from US sources (withholdable payments) will be subject to withholding tax in the amount of 30% of the respective revenues. In this context, the respective payment triggering withholding tax does not necessarily have to be made by a US legal entity. The provisions will also apply to transactions carried out between two non-US taxpayers (e.g. a Swiss entity sells a US investment to a German entity) regarding assets that generate payments from US sources.

According to FATCA, not only revenues from US sources such as, in particular, interest and dividends, shall serve as the assessment base for possible withholding tax. Rather, the FATCA provisions provide for retention of withholding tax already on sales proceeds from the sale of assets, based on which interest and dividends from US sources can be realized. Explicitly, this shall include sales proceeds from the sale of US shares or holdings in other US corporations as well as revenues from US bonded debt claims or debenture bonds. – This separation of assessment base and revenue components may lead to asset taxation.

The legal entities that are subject to the reporting requirement are referred to as Foreign Financial Institutions (FFI). Generally, all banks (including savings and loan associations and credit unions) and institutions that hold and manage financial investments for third parties (brokers, depositary and custodian banks) qualify as FFIs. – In addition, the term FFI also includes private equity and venture capital companies (whether structured as funds-of-funds or direct funds), mutual funds and insurance companies. – For more detailed information and specific aspects of the previous FATCA provisions please refer to our article in last year's Financial Yearbook 2012.

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Purpose and Necessity of Model Agreement

The present model agreement was prepared by the US Treasury Department in co-operation with the named G-5 nations with the aim to simplify, in administrative respects, compliance with FACTA by the affected FFIs in each of the countries and to avoid compliance-based violations of statutory law within those countries. According to the original provisions, each FFI would have had to enter into a direct agreement with the IRS and to report to the IRS once a year. The administrative burden would have been enormous for both the FFIs and, especially, for the IRS that would have had to process all of the data. Therefore, this agreement also serves the purpose of bundling, on the level of the G-5 nations, the foreseeable "data deluge" and to pass it on to the IRS after having filtered and compressed it. – However, the main reason for this agreement is that, pursuant to the legal framework of, for instance, Germany, the FFIs that are generally required to report under FACTA are not permitted to disclose certain information, especially on grounds of banking secrecy.

If German FFIs were to comply with the mentioned US requirements, they would violate the laws of Germany and render themselves liable to prosecution. If FFIs were instead to comply with national law, they would expose themselves to a US penalty tax in the amount of 30% on cash flows from US sources. Whichever option the management of the relevant FFI chooses, it would incur a liability, either to the German legal system or to the shareholders of the FFI.

Therefore – leaving aside possible administrative benefits – it is absolutely necessary to enact the planned requirements to report shareholder and/or client data to the US Internal Revenue Service and to define the relevant actions in terms of an intergovernmental agreement thus giving them a legal basis.

Main Contents of the Model Agreement

The agreement contains rules for certain critical issues, which were identified during the attempt to implement FATCA in practice since its enactment in spring of 2010.

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No agreement with IRS necessary

The present model agreement contains a substantial simplification for all German FFIs. Previously, the FATCA provisions required every single FFI to enter into an agreement with the IRS and to present FATCA-relevant information to the IRS on an annual basis.

Now, however, the agreement provides for a standardized exchange of FATCA-relevant information between the respective countries rather than between the individual FFIs and the IRS. – For this purpose, the German FFIs have to report the information required by FATCA to a central office within the German tax administration – presumably the Federal Central Tax Office (Bundeszentralamt für Steuern) –, which, in turn, will pass on the information to the IRS based on the model agreement. In the future, an agreement between the FFIs and the IRS will thus no longer be needed.

If, in the course of implementing the agreement, the reporting requirement is accordingly incorporated into statutory law, German FFIs will be prevented from passing on confidential information directly to foreign authorities and from violating current German statutory law in the course of doing so. In the future, reporting sensitive data to German authorities, as it is currently planned, will in fact be in line with the relevant German statutes.

Bilateral Reporting Obligations

Regarding the reportable information, the model agreement does, however, contain requirements similar to those of the original direct reporting obligations.

It should be noted in this context that the model agreement explicitly provides for reportable elements in respect of corresponding "reporting US financial institutions" to G-5 nations, al-though the relevant requirements are clearly weaker than those documented and demanded for the FFIs of the G-5 nations.

Regarding German FFIs, the following material information has to be reported, without limitation:

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- in case of individuals: name, address, US TIN (tax identification number); in case of US persons controlling a non-US company: again name, address of the company as well as the corresponding data and the US TIN of the controlling person(s)
- account data for the respective accounts
- name and identification number of the German FFI
- account balance, (in the case of insurance contracts including, for instance, the surrender value (!)) as of the end of each calendar or e.g. insurance year, or, as the case may be, if the account was liquidated during the reporting year, the account balance immediately prior to the liquidation.
- in case of nominee accounts: interest, dividends, capital gains and other income during the reporting period, that benefit US persons.

Timing and Method of Application

For German FFIs, the qualification and value assessment of the reportable income depends, according to the model agreement, solely on the corresponding qualification under German tax law. Therefore, a transformation into US tax law is not necessary.

The relevant income has to be reported in the currency in which the respective amounts are realized. In this context, it does not follow from the wording whether this refers to the national tax framework (then reporting in euros) or to the initial currency in which the FFI has realized revenues. However, since the amounts are determined pursuant to national tax law as set forth above, from our point of view the reporting would necessarily have to be made only in euros.

Generally, the first report has to be made as of the 2015 calendar year. If the reportable accounts already existed in earlier years (preexisting accounts), the relevant data for the years 2013 and 2014 has also to be disclosed in 2015.

In each case, reporting has to be made by September 30 of each subsequent year, for preexisting accounts the report has to be submitted by September 30, 2015 for both years. The former draft of the FATCA regulations even set the time limit at three months following the end of the calendar year. Considering that

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the current wording of the model agreement refers to reportable values according to national tax law, this postponement is urgently needed, but can still lead to serious time issues, in particular in case of fund-of-fund structures. It remains to be seen if and to what extent the tax authorities will approve requests for time extensions for the submission of data.

The parties involved have agreed to begin with the standardized implementation process in a timely manner. They, in particular, have plans to revise the necessary national laws shortly in order to lay the ground for a standardized bilateral exchange.

The agreement will take effect on January 1, 2013, provided that all necessary implementation measures have been successfully transposed into national law. Should this not have happened by January 1, 2013, the agreement will take effect once all measures have been transposed accordingly.

The agreement has an indefinite term and can be terminated by one of the participating nations on a 12 months' notice.
The parties also intend to jointly evaluate, prior to the end of 2016, their experiences until such time and to revise the agreement accordingly, where necessary.

Criteria/Testing Catalogue for Identification of Relevant Accounts

The annex to the model agreement is an integral component of the entire paper and includes four separate due diligence procedures that have been drafted in a very detailed manner and serve to identify different account categories. In particular, it provides a specific framework for the type and form of documentation and the documentary depth that is necessary and sufficient to identify the individual account categories.

The individual categories vary mainly depending on the amount of assets kept on such account, and the necessary testing depth varies accordingly.

Furthermore, the annex defines certain limits for current accounts (USD 50,000) and insurance contracts (USD 250,000), which – if not exceeded – do not require

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further identification of the account holder, thus altogether eliminating the administrative burden in respect of a number of accounts.

- **Discontinuation of a 30% Definite Tax on Cash Flow**

According to the provisions of the model agreement, FFIs are now no longer required to withhold a 30% "(penalty) withholding tax" on all revenues (rather than just the pro-rata share that is allocable to US persons). However, institutions previously already classified as qualified intermediary institutions under the former QI Regime have to withhold 30% of withholdable payments (i.e. just revenues, no longer also proceeds!) to so-called non-participating FFIs.

In this way, the model agreement has also served to eliminate the highest risk for all parties involved – a 30% definite penalty tax on all cash flows from US sources.

Outlook

Dealing with the already existing or forthcoming tax compliance requirements on a daily basis requires a permanent concentration of efforts on these topics. Although, following the introduction of the flat tax, the role of the distinction between asset managing or trading private equity structures has declined in terms of current income for private investors, the distinction remains significant, in particular for private equity funds with portfolio companies prior to the introduction of the flat tax due to the statutory grandfathering provision. At the same time, the consequences of the first Federal Fiscal Court Decision on the qualification of private equity funds and the finance authorities' reaction to this decision have to be awaited.

Concerning the obligation to report foreign investments, many previously open questions have meanwhile been answered. As soon as the remaining issues have been resolved, a practical and manageable reporting system should be in place.

Regarding FATCA, the draft of the intergovernmental agreement between the U.S. and the G-5 nations reflects considerable simplifications compared to the

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original plans and provisions. With a prospective effective date of January 1, 2013, the necessary implementation measures will shortly have to be incorporated into national law.

Furthermore, the entire private equity industry also focuses on other subject areas that are not covered by this article, such as contribution accounts for tax purposes and in particular the Alternative Investment Fund Manager Directive (AIFMD) as well as its implementation into national statutory law through the prospective Capital Investment Code (Kapitalanlagegesetzbuch).

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