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PRIVATE EQUITY AND CORPORATE FINANCE

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

FOR YOUR BUSINESS

17 Years FYB FINANCIAL YEARBOOK

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# Tax Compliance for Private Equity Funds – *πάντα ῥεῖ*

***πάντα ῥεῖ* – Everything flows! In the introduction to our last year's article, we remarked that the taxation of private equity funds or rather the partners of private equity funds taxable in Germany had increasingly moved into the centre of attention of the fiscal authorities over the last years. However, these topics have long since reached the highest fiscal court in Germany, the Federal Fiscal Court (Bundesfinanzhof), as, in particular, some very remarkable decisions of the Federal Fiscal Court in recent months show.**

To make it clear at this point: We perceive a lot of joy on the part of the Federal Fiscal Court and (even more?) sorrow at the level of the fiscal authorities or the legislator. Even clear and unambiguous as well as dogmatically well-founded decisions are either simply ignored by the fiscal authorities or they end in a ministerial draft of the Federal Ministry of Finance (*Bundesministerium der Finanzen*), which then turns back unpleasant case law by legislative amendment correcting an absurd interpretation of law by the fiscal authorities and simply codifies the fiscal authorities' initial opinion. On 08 May 2019, the Federal Ministry of Finance published the *"Draft Act on Further Tax Incentives for Electric Mobility and the Amendment of Further Tax Regulations"* (*"Electric Mobility Act"* or more precisely *"Annual Tax Act 2019"*), which the German Cabinet brought in as draft legislation almost unchanged on 31 July 2019. The title of the law is misleading. The majority of taxpayers can certainly find a lot of positive aspects in a law on further tax incentives for electric mobility. However, this is once again a so-called omnibus bill, by which numerous other tax regulations are to be massively changed or introduced for the first time, but which is clearly lost in the naming of the law.

In the introduction to last year's article, we also emphasized the constructive exchange with the fiscal authorities and mentioned, for example, the discussions as to the (non-)applicability of the Building Owner Decree (*Bauherrenerlass*) to

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private equity funds and the resultant capitalisation of an annual management fee for the acquisition of the portfolio companies and/or target funds. Our optimism in this respect has unfortunately caught up with us in the meantime, since a recent – for taxpayers positive – decision of the Federal Fiscal Court has uninhibitedly been made null and void by the Electric Mobility Act and the proposed amendment of the German Income Tax Act, which we will discuss in more detail at a later point.

In this article we follow up with the following decisions regarding:

- repayment of capital contributions by corporations domiciled in third countries;
- carried interest at private equity funds;
- capitalisation of fund establishment costs including management fees;
- default of capital investments arising in income from capital assets;

as well as the response or rather non-response of the fiscal authorities and/or the legislator in this regard so far.

## Repayment of capital contributions by corporations domiciled in third countries

We have already addressed the treatment of the repayment of capital contributions by corporations in previous issues of the Financial Yearbook and systematically presented and heavily criticised this topic in FYB Financial Yearbook 2019 because of the stubborn denial of a tax-neutral repayment of capital contributions by corporations domiciled in third countries by the fiscal authorities.

After a promising hearing of the issue before the Federal Fiscal Court in the spring of this year, the long-awaited decision of the First Senate of the Federal Fiscal Court expected by late summer/autumn was adopted immediately before the completion of this article. This decision fortunately confirms and even clarifies the two decisions of the Eighth Senate of 2016.

As a result, there now exist various supreme court decisions of different Senates of the Federal Fiscal Court, which confirm that also corporations domiciled in third countries can make a tax-neutral repayment of capital contributions 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. This is a clear rebuff to the intransigent and negative attitude of the fiscal authorities regarding a tax-neutral repayment of capital contributions by corporations domiciled in third countries so far.

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 (= fiction of use) into account, i.e., after the subordinate 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 record date.

Therefore, the relevant foreign financial statement would have to be applied as basis of calculation and the figures gained therefrom be adjusted according to assumed application under German tax law. It was precisely this approach that we previously – i.e., before the view of the fiscal authorities, which has now been rejected by the Federal Fiscal Court, flared up – followed in the determination to differentiate between repayments of capital contributions and dividend payments from corporations domiciled in third countries.

Moreover, the Federal Fiscal Court emphasized that – unlike with regard to EU corporations – no separate determination procedure with 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.

This is the first step in the right direction. But since neither the recent decision of the First Senate nor the two previous decisions of the Eighth Senate of 2016 have been published in the Federal Gazette, the judgements are not yet binding for the fiscal authorities. Henceforth, it remains to be seen how the fiscal authorities will respond to this/these decision(s) and which evidence precisely will have to be furnished in order to prove a tax-neutral repayment of capital contributions by corporations domiciled in third countries.

It is therefore to be hoped that the “reliable voices” from the fiscal authorities quoted in FYB Financial Yearbook 2019 are proved right. At that time, they indicated that the fiscal authorities will not further oppose the decision of the Federal Fiscal Court if, by the present decision of the First Senate, the Federal Fiscal Court affirms again the general possibility of a tax-neutral repayment of contributions by corporations domiciled in third countries. In this case there would also be no motivation for the legislator triggered by the fiscal authorities to counteract a positive case law and development for taxpayers by superfluous changes in law – unlike in other of the following issues.

## Carried interest at (commercial) private equity funds

Carried Interest is an essential element of every typical private equity structure. In the past, the views on the fiscal treatment of carried interest differed in relation to the parties entitled to the carry and private equity funds and their partners. First, we briefly want to discuss the taxation of the party entitled to the carry and then explore the possible impacts on the private equity fund (engaged in asset management) and its partners.

### Taxation of parties entitled to the carry

As already described in FYB Financial Yearbook 2010 (see page 111 et seq.), carried interest was classified as a disproportionate profit share for the so-called *“pre-existing carry cases”* (formation of the private equity fund prior to 01 April 2002 and acquisition of the portfolio company triggering the carried interest prior to 08 November 2003), so that the taxation of this disproportionate profit share was based on the taxation of the underlying income (capital gains, dividends and interests). In the so-called *“Private Equity Decree”* of 2003, the fiscal authorities subsequently took the view that carried interest at private equity funds engaged in asset management had to be re-classified as (hidden) remuneration.

In 2004, this administrative opinion was codified with regard to private equity funds engaged in asset management in Section 18(1)(4) of the German Income Tax Act (*"EStG" – Einkommensteuergesetz*) and at the same time tax privileged – to reduce the otherwise full tax liability – by allowing the so-called partial income procedure (according to which 40% of this income is exempt from taxation). For a long time, however, it was a matter of dispute of how carried interest was to be treated in case of commercial private equity funds and whether it was to be classified as (hidden) remuneration or profit share.

By decision dated 11 December 2018, the Federal Fiscal Court ruled that carried interest is not a (hidden) remuneration in relation to commercial private equity funds but a disproportionate profit share. Therefore, the partial income procedure applied to the party entitled to the carry insofar as the carried interest comprised capital gains or dividends.

**Potential impacts of taxation on private equity funds (engaged in asset management) and their partners**

Although the fiscal authorities treat carried interest as (hidden) remuneration in relation to asset management private equity funds also at fund level, the party entitled to the carry, benefits from the partial income procedure because of the aforementioned legal framework. Due to the non-recognition of the disproportionate profit distribution at private equity funds engaged in asset management, the partners – if they are individuals – pay taxes on their capital-weighted share in the capital gains, dividends and interest. The statutory non-deductibility of income-related expenses with regard to capital income prevents the recognition of carried interest allocated to the party entitled to the carry as a reduction of income.

The Federal Fiscal Court's remarks on the disproportionate profit distribution at the level of the (commercial) private equity fund in the meaning of an *obiter dictum* may be ground-breaking. Should the Federal Fiscal Court adhere to this view and this legal position and apply it to asset management private equity structures if a corresponding case is submitted, there is no more scope for the aforementioned discrimination of individuals being investors of a private equity fund engaged in asset management due to the non-deductibility of income-related expenses. In this case, carried interest would then systematically be attributed to the party entitled to the carry in advance and thus consequently reduce the assessment basis for the taxation of the individual. Therefore, it remains to be hoped that, as soon as a corresponding case is submitted to the Federal Fiscal Court for decision, the disproportionate profit distribution at fund level is also allowed (again) in case of asset management private equity structures.

## Fund establishment costs including management fees

The capitalisation or non-capitalisation of fund establishment costs (including management fees) have already kept the private equity sector busy for over a decade and essentially stem from the so-called *"Fund Decree"* of the fiscal authorities of 2003, which itself is based on the even older Building Owner Decree of the 1980s and 1990s. According thereto, the acquisition costs of a fund generally include all expenses that arise in the economic context of the completion of the project during the investment period.

Various Regional Finance Offices adopted these fundamentals in 2006 and 2007 and established also for private equity funds that, in particular, organisation expenses, liability remuneration of the general partner, management fees of managing partners, remuneration of trustees, costs of the drawing up of a prospectus, conception and project costs, marketing expenses, commission for the procurement of equity and legal fees were considered acquisition costs. The various practical problems in connection with the basic assumption that all expenses should be acquisition costs, even though there is a dogmatically improper capitalisation of pseudo overheads and non-consideration of, for example, broken deal expenses in case of a private equity fund as a so-called *"blind pool"* unlike a one-object fund in case of a building owner model, are not dealt with in more detail here. The private equity industry had initially largely come to an agreement with the fiscal authorities and – at least in Bavaria – developed the so-called *"Munich model"* of a partial and proportionate capitalisation of perceived acquisition costs as an acceptable compromise.

However, some German states explicitly refused the Munich model and insisted on the (more) extensive capitalisation of acquisition costs. This led to some very intensive consultations and discussions with the local tax offices on our part and for the private equity funds advised by us with local tax jurisdiction in these states.

As already mentioned before, the Federal Fiscal Court adopted a – for taxpayers positive – decision during the ongoing process. By decision dated 26 April 2018, the Federal Fiscal Court ruled that the case law based so far on the abuse of tax-planning schemes within the meaning of Section 42 of the German Fiscal Code (*"AO" – Abgabenordnung*) can no longer be applied with the coming into force of the regulations on the limitation of losses in connection with tax deferral models (Section 15b EStG). As a result, the fund establishment costs are recognised as directly deductible business expenses – contrary to the previous administrative practice.

The joy and possible prospect of a now nationwide uniform treatment of fund establishment costs by the fiscal authorities did unfortunately not last very long. With the submission of the *Electric Mobility Act/Annual Tax Act 2019*, the Federal Ministry of Finance proposed a change in law according to which the capitalisation of fund establishment costs should now be codified. On 31 July 2019, the German Cabinet adopted the proposal of the Federal Ministry of Finance and thus the original Fund Decree in the draft legislation of the German government without changes. In its justification given for the act, the legislator referred to a *"long-standing and established legal view"* and considered this new legal regulation necessary due to the Federal Fiscal Court's decision cited above and the associated change in case law.

## Default of capital investments arising in income from capital assets

In recent years, not only the Federal Fiscal Court but also various local fiscal courts have dealt with numerous scenarios in connection with the default of capital investments arising in income from capital assets and passed numerous decisions that are positive for taxpayers.

On 24 October 2017, for example, the Federal Fiscal Court ruled in a landmark decision that the default of private loan receivables is to be recognised as loss in income from capital assets – contrary to the fiscal authorities' existing view. The beneficiaries are taxpayers who hold a consolidated share of less than 1% in the target corporation, which is usually the case for private equity funds. In its decision of 12 June 2018, the Federal Fiscal Court also ruled in favour of taxpayers that the sale of shares at a selling price that only corresponds to the transaction costs also triggers an appreciable loss in income from capital assets.

Due to the two decisions referred to above, it can also be assumed that the Federal Fiscal Court (in proceedings still pending) will also recognise a tax loss in income from capital assets in this respect in the event of a loss of capital investments as a result of the insolvency of the corporation for shareholders who in turn hold a consolidated share of less than 1% in the target corporation.

This positive development of the Federal Fiscal Court's case law is also made null and void by the *Electric Mobility Act/Annual Tax Act 2019.* The Federal Ministry of Finance and the German Cabinet following it have defined expressis verbis for several transactions classified as sales by the Federal Fiscal Court that precisely these circumstances do not constitute sales and that defaults and losses suffered by taxpayers should therefore be irrelevant for tax purposes.

**Future prospects**

Joy and sorrow: What may or must we prepare ourselves for, what can possibly still be prevented?

According to settled case law in connection with the repayment of capital contributions by corporations domiciled in third countries in favour of taxpayers, there only remains the pious hope that the fiscal authorities will now finally accept these decisions and that they will not require excessive evidence in this respect.
The decision on the privileged treatment of carried interest from commercial private equity funds and the remarks made by the Federal Fiscal Court on the profit distribution at fund level let us hope that – as soon as the Federal Fiscal Court has to decide a corresponding case – these systematics are also applied to private equity funds engaged in asset management and that the disproportionate profit distribution is also systematically recognised in these cases.

There is a very high probability that the capitalisation of fund establishment costs including management fees will be codified; well-informed sources from the fiscal authorities have already indicated an amendment of the regulation in the legislative procedure compared to the current draft legislation. An improvement of the regulation in favour of taxpayers can, however, not be expected. In future, only non-investment related expenses, for which corresponding evidence has to be provided, may be deducted. The chances for a "flat-rate" solution like the known Munich model appear to be rather bad. A Circular of the Federal Ministry of Finance on the topic of the fund establishment costs is also planned according to information.

Uncertainties exist with regard to the planned legislative amendment in respect of the default of capital investments arising in income from capital assets. While more recent case law has intended to recognise profits and losses in connection with capital investments after the system change to flat income tax, fiscal authorities hold their existing position of non-recognising losses from private loans, losses from options held as private assets or losses from the derecognition of shares having become worthless with which the shareholder holds less than 1% of the corporation and they justify this by arguing that *"highly speculative transactions should not be conducted at the expense of the general public"*. Since the various German states disagree on this topic, there is still a chance that there might be changes in the existing draft legislation in this respect

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 2021.

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