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GLOBAL TAX CONSIDERATIONS IN PRIVATE FUND FORMATION

Assessing the new tax landscape for private equity fund structuring

Edited by
Jenny Wheater

This chapter was first published in *Global Tax Considerations in Private Fund Formation* by PEI

Carried interest developments in Germany

By Tarek Mardini and Ronald Buge, P+P Pöllath + Partners

The tax treatment of carried interest in Germany shares many similarities with the tax treatment in other main fund jurisdictions, but there are distinct differences. While the effective tax rate paid by carried interest recipients under current German tax law is generally within the range of such other fund jurisdictions, the technical treatment differs. These, and other structural differences, will have to be carefully considered in cases of cross-border carry schemes and when structuring international funds with German-based carry recipients.

Overview of fund structuring in Germany

The general principles of fund structuring are adhered to in Germany. Therefore, funds are generally structured to provide for a transparent tax treatment: avoiding tax at the fund level; allowing for flow-through treatment of the underlying income to the investor without any change in qualification of the income for tax purposes; and making the investor subject to tax only in its place of tax residence. As in many other jurisdictions, and in the absence of a special tax regime for private equity funds, the vehicle of choice to achieve that goal is a limited partnership (*Kommanditgesellschaft*). A German limited partnership is only treated as tax transparent if it qualifies for 'non-business' or 'investment' status (*Vermögensverwaltung*), rather than being engaged in a 'trade or business'. The 'trade or business' status can either be a result of the structure of the fund (so-called 'deemed business' – *gewerbliche Prägung*) or a result of the fund's activities (*gewerbliche Tätigkeit*).

In late 2003, the German tax authorities issued guidelines that provided for the distinction between business and non-business status in an administrative pronouncement (the 'Pronouncement' – *BMF-Schreiben*). The importance of this Pronouncement for the German fund industry is comparable to the Memorandum of Understanding for the UK fund industry. The Pronouncement is still the tax authorities' current practice, though a court decision of the highest German tax court in 2011 questioned whether the criteria used in the Pronouncement would be upheld by courts, resulting in some uncertainty at least in the cases of buyout funds that acquire control investments and use a 'buy-to-sell' strategy. However, the considerations of the court were only *obiter dicta*.

The golden age for carry recipients in Germany until 2004

The fund structuring principles for optimising carried interest tax treatment in Germany have always been in line with general tax structuring principles – that is, structuring the fund to qualify for non-business status in order to achieve tax transparent treatment of the fund.

Prior to the Pronouncement of late 2003, only a number of individual tax rulings (*verbindliche Auskünfte*) in several of the German states (*Länder*) existed. Most of those rulings were issued by the Bavarian tax authorities as most funds were (and often still are) located in Munich. According to those tax rulings, carried interest was associated with the carry partner's contribution to the fund. While the typical 20 percent carry arrangement was considered 'disproportionate' in relation to the paid-in capital contribution (historically around 1 percent), it was declared as being 'proportionate' in light of other 'immaterial' (non-monetary) contributions by the carried interest partner (whether in the form of providing know-how, access to its network of contacts, or other services provided to the fund).

As a general rule, German tax laws respect a disproportionate capital profit distribution for tax purposes to the extent that distribution is in line with corporate/partnership laws and agreed upon at arm's length. As a result, the recipient used to receive his or her carried interest as investment income without any re-qualification of such income for tax purposes. In the case of typical private equity funds, this meant that, ideally, the vast amount of income received would be treated as capital gains (from the sale of a share of the underlying portfolio companies in the case of an exit), and only to a lesser degree would consist of dividends or interest income.

At that time, and already for more than 70 years in Germany, individuals did not have to pay tax on capital gains received from a fund that qualified for non-business treatment, if such gains were 'long-term capital gains' (from shares held for more than a year) and such individuals held less than a 1 percent share in the underlying portfolio company on a look-through basis. It is now easy to understand why the period before 2004 can be considered as the 'golden age' for fund managers in Germany; in many cases the effective tax rate on carried interest was zero!

The new reality: From capital gains to ordinary income treatment

In late 2003, the new reality hit fund managers hard. The Pronouncement, which is generally considered by fund managers as a pragmatic and workable approach to the requirements of tax transparent fund vehicles, also included a new approach to the tax treatment of carried interest received by managers. Two paragraphs addressed the treatment of carried interest, now considered a compensation payment received for services provided by the fund managers of the fund that were merely disguised as a payment for a partner's contribution. In other words, from that moment on, German tax authorities considered carry payments as ordinary income (without taking into account the underlying income qualification applicable to the source from which carry is derived) and denied capital gains tax treatment. Accordingly, the effective tax rate was increased to the highest individual tax rate (approximately 47.5 percent at that time).

This threatened an exodus from the German fund industry, as the resulting tax burden was now far out of line with other fund jurisdictions and managers started to consider moving to other countries. Recognising the important role of private equity in providing growth capital to Germany's *Mittelstand* companies and as a viable funds industry, the German government introduced a new law that came into effect in July 2004. This

law served as a compromise between the zero tax treatment of the past and the full tax treatment under the Pronouncement.

The new law upheld the tax qualification of carried interest as ordinary (service) income. However, it created a special type of service income whereby carried interest was partially exempt for tax purposes. Subject to certain requirements, only 50 percent of the carry received would be taxed at the highest individual tax rate (so-called 'half income' principle). The resulting tax effect was bearable for the industry, meaning that fund managers had to roughly pay 23.8 percent tax on their carried interest. At the same time, the funds industry was not entirely happy with this compromise for three reasons:

1. It resulted in a major shift of the underlying tax treatment.
2. It created new problems in international structures in connection with jurisdictions that continue to apply capital gains treatment.
3. Most importantly, it established a special tax exemption ('subsidy', 'loophole') that made it a potential political target.

Current tax treatment of carried interest in Germany

From 2009, the old rule of individuals receiving tax-free capital gains treatment for long-term shareholdings was replaced by a flat tax (*Abgeltungsteuer*) of 25 percent applicable to capital gains, dividends and interest income in the course of a larger overhaul of the Income Tax Act. In connection with this revision, the carried interest system was also modified to reduce the tax exemption of carried interest. Accordingly, 60 percent (instead of 50 percent) of the received carry payment is now subject to tax at the (highest) individual tax rate, whereas the remaining 40 percent is tax-exempt. As a result, the effective tax rate for carried interest is now around 28.5 percent.

In order to benefit from this special carried interest exemption, several requirements must be fulfilled. This exemption applies only to carry paid by a non-business fund partnership that is investing in equity and equity-related investments. In other words, the special tax exemption is generally not available if the fund is:

- not a partnership, but a corporation;
- invested in assets other than equity and equity-related investments (for example, a senior loan fund); *or*
- treated as a 'trade or business' for German tax purposes.

Further, for a carry payment to fall under the special exemption, it is required that the carry is only paid out when the investors have been repaid their contributions in full. It is doubtful whether a prior carry payment can come under this rule if the carry payment is secured with a clawback mechanism. Generally speaking, whole-of-fund carry schemes, which are most common in European funds anyway, will more easily fulfil this criteria than deal-by-deal carry schemes. In that context, it is important to note that a carry clawback is a taxable event in the year when it occurs, that is, without a 'retroactive effect'.

Treating carry as ordinary income also has certain advantages. From a tax perspective, there is no need to bundle the right to receive carry payments with a capital interest or contribution. New fund management team members can generally be admitted to the carry scheme at any time without the requirement of assessing the value of a new member's share of the carry at the time of joining the scheme. In addition, adjustments are generally possible; each carry holder's carry entitlement can be increased or decreased at any time without adverse tax consequences.

In late 2013, the highest German tax court held that investment income (which, in principle is subject to flat tax) from certain instruments such as shares or *jouissance* rights issued by a company to its executive staff may be requalified as (fully taxable) income from employment if there is a strong link to the employment contract. Such a link could be typical 'leaver' provisions. It is uncertain what impact this may have on the treatment of carried interest.

Carried interest vehicle

As in many other jurisdictions, the vehicle of choice for the carried interest team members is also a (non-business) limited partnership. A partnership carry vehicle allows for tax-transparent treatment and flexibility for company law purposes. Besides, it is also unclear whether German tax authorities would allow corporate carry vehicles to benefit from the special carry treatment.

International carried interest structures and German carry recipients

Several tax issues can arise in international carry structures both involving German fund structures with foreign carry holders and international fund structures with German tax resident carry recipients. These issues are generally caused by different rules on income qualification (capital gains versus ordinary income) and on partnership taxation in general. For instance, other jurisdictions do not apply the 'deemed business' concept and therefore might structure the fund in a way that would be disadvantageous for German carry recipients.

From a German perspective, the permanent establishment rules relating to the characterisation of the carry as compensation for services rendered apply. The carry recipient's place of business is the permanent establishment to which its allocable share of carry is attributable. Therefore, a German resident team member's allocable share of carry from international funds managed outside of Germany is subject to tax in Germany. In certain situations, this may result in the double taxation of income, if the source state applies permanent establishment rules relating to capital gains (for example, carried interest received by a US fund that consists of so-called effectively connected income with a US trade or business or ECI). On the other hand, a non-German team member's allocable share of carry from a German fund managed in Germany is subject to tax in Germany. If this team member's country of residence provides for capital gains treatment, this would conflict with German qualification as service income, as the member's state would assume that capital gains are taxed in the country of residence rather that the country of the income source.

Similarly, if a non-German team member, initially resident in Germany, decides to leave the country, then any carry paid after leaving would remain taxable in Germany on a pro rata basis in the proportion of the number of years spent in Germany to the total number of years of that particular fund. This may again lead to a double taxation, if the new country of residence applies capital gains treatment. If a German team member left Germany and moved abroad, there would initially be no taxation of the carried interest upon leaving the country. However, any future carry payments remain taxable in Germany on a pro rata basis (see above), again leading to potential double taxation.

Hot topics

There are several issues and hot topics that come up in audits. One of those is the tax treatment of carry payments from the investor's perspective. From a pure corporate law perspective, carried interest is structured as an interest in the fund. Therefore, 80 percent of the fund's performance is allocated to investors and 20 percent to the carry recipients; investors only account for 80 percent. Generally, tax rules adhere to the partnership allocation and investors would include in their tax returns only 80 percent of the fund's gains. This notion, however, has recently been challenged by new administrative practice; investors have to include 100 percent of the fund's gains in their tax returns, and carry payments made by the fund are treated as an expense subject to certain limitations as to the deduction for tax purposes. A future hot issue could be the question of whether a carried interest payment is subject to VAT amid its qualification for income tax purposes as compensation for services.

Impact of AIFMD

The German tax authorities have not (yet) published an administrative pronouncement on the impact of the regulatory deferral rules under the AIFMD on the taxation of German resident recipients. As carried interest has been qualified under the German Income Tax Act as compensation for services rendered, there are good arguments that the recognition of carried interest for tax purposes will be deferred in accordance with the regulatory deferral rules.

Outlook

As is the case in the US and the UK, there is political pressure in Germany to modify the current tax regime. Under these proposals, which have been repeatedly made from time to time in the last few years, carried interest would continue to be treated as ordinary income, but the 'partial income exemption' would not apply anymore, making any carried interest income received in full subject to tax. As a result, 100 percent of the carry payment would be subject to the highest individual income tax rate of the respective carry recipient, which is currently around 47.5 percent.[1] □

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[1] There are currently no realistic proposals that stand a chance of being implemented. Proposals come up from time to time, mainly by the opposition parties or by regional governments.

__Tarek Mardini__ is a counsel in the private funds practice group of P+P Pöllath + Partners in Berlin. He focuses on private investment funds, asset management and related tax structuring. Tarek regularly advises on complex secondary fund transactions, and counsels German and international fund sponsors in structuring, marketing and managing private equity, private debt and other investment funds. On the investor side, he often advises German institutional investors and family offices regarding legal, regulatory and tax aspects of fund investments. His special expertise includes advising on fund governance issues (including ILPA Principles), as well as tailored reviews of fund terms. Tarek regularly publishes on the tax, corporate and regulatory aspects of private investment funds and is a regular speaker at international conferences. He studied law in Berlin (Germany), Glasgow (UK) and, with a Fulbright Scholarship, at the University of Connecticut Law School (USA). He is a board member of the German-American Lawyers Association.

__Ronald Buge__ is a partner in the private funds practice group in the Berlin office of P+P Pöllath + Partners. He specialises in providing legal and tax advice to institutional and private investors, managers, and initiators of foreign or domestic private equity and private equity-type funds (such as mezzanine, real estate, infrastructure, energy and natural resources funds), with a focus on domestic and cross-border tax matters and tax litigation. Ronald publishes articles, is a frequent speaker at conferences on tax matters, and lectures at the University of Münster. He studied law at the Humboldt University of Berlin.

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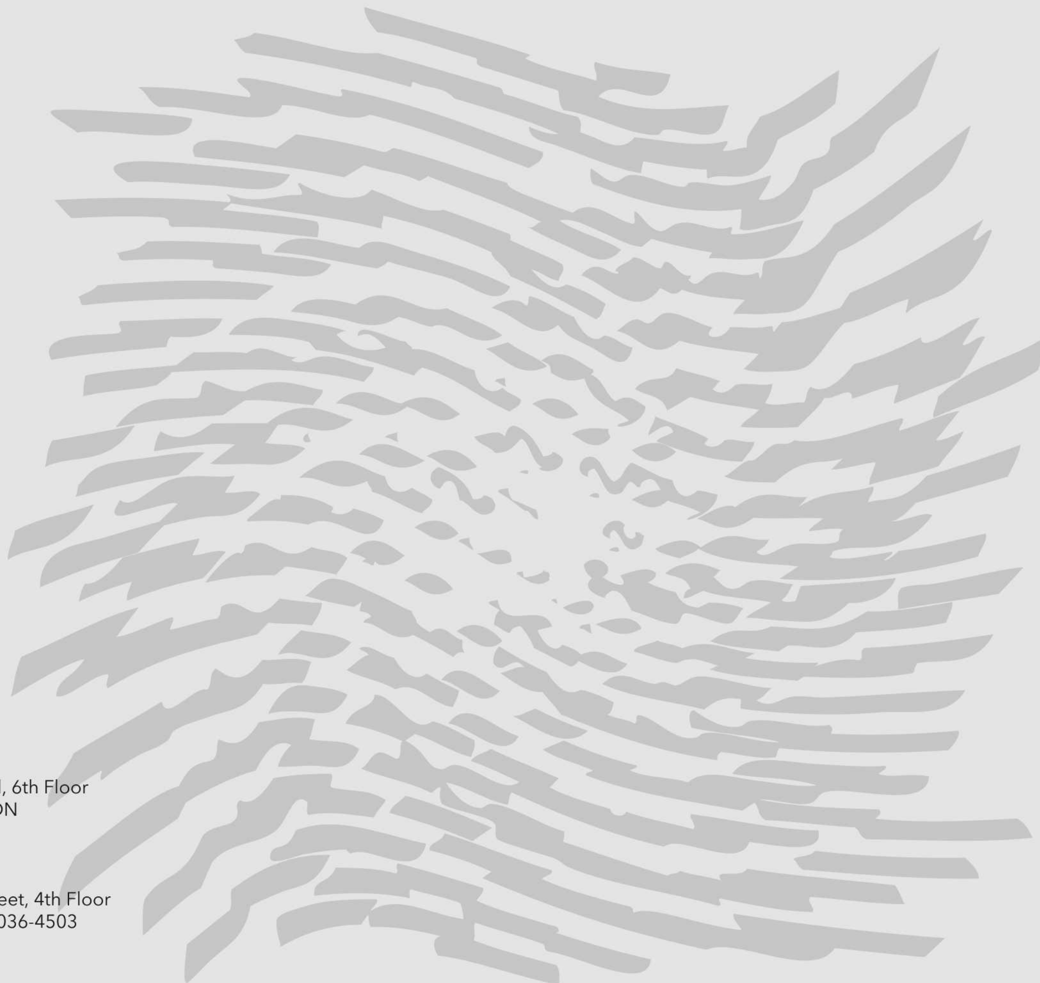

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HONG KONG
14/F, Onfem Tower
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