P+P PÖLLATH + PARTNERS – 10 YEARS OF GERMAN FUND FORMATION

Structuring for change

German private equity has endured various tax and regulatory woes in recent years. P+P Pöllath + Partners' Dr Andreas Rodin explains how the industry has coped -- and why it's worried about the future

Rodin: *GPs face unprecedented oversight*

The last decade has seen several important shifts in the tax and regulatory treatment of German private equity funds, forcing managers to adapt to an ever-changing landscape.

The intention behind a private equity fund is to achieve tax neutrality through full transparency; i.e. to find the most tax-efficient means of operating in the country where the fund makes its investment. Historically, German funds – in line with those of other jurisdictions – were registered as offshore entities, most commonly in the Channel Islands, and the investment teams' local activities were limited to giving advice.

However, this is not an ideal solution, since the fund still needs to adhere to the rules governing permanent establishment – which means that fund managers need to spend a specified length of time in the offshore location. As the industry has become increasingly complex, it has become more important for investment managers to be fully present in the local community and to work closely alongside their investee companies. That's much more difficult if you're based offshore.

But at the beginning of the decade, significant progress was made in the field of German tax law: safe harbor rules were defined, allowing for German-based limited liability partnerships (LLPs) to be established that would receive fiscal treatment similar to that of offshore vehicles.

This change was the result of negotiations between the private equity industry and the tax authorities. Ultimately, the latter shared the view that it would be more beneficial for the economy, as well as the German fiscal system, to attract private equity management firms and investment. However, the safe harbor rules established by the authorities also included certain restrictions, which funds had to meet in order to be domiciled in Germany.

As Andreas Rodin, a partner at German law firm P+P Pöllath Partners, explains: "Private equity funds that are established as LLPs allow investors from different jurisdictions to invest in a fiscally transparent vehicle. From a German tax perspective, to be regarded as fiscally transparent, fund managers must act purely in a financial investor capacity and not undertake any business activity on the level of portfolio companies. If a private equity fund fulfils this requirement, the vehicle is exempt from any tax. All income is allocated to its partners and taxed at partner level only in their country of residence."

ON CARRY AND FEES

A further fiscal challenge has been the treatment of carried interest. Prior to 2003, it was the general practice of tax authorities to treat carried interest as income from capital investments, mainly capital gain – and as such, it was eligible for either full or half tax exemption. However, in 2003, the authorities announced that carried interest should be treated as "compensation for services rendered", which was taxable at the full rate.

This announcement did not sit comfortably with the German private equity industry, because it was inconsistent with the tax practice applied by all other countries competing for private equity, e.g. France, UK or the US. As a consequence, there was a real concern that many fund managers would relocate abroad.

To counter this, the following year, the German parliament passed an act called 'The Promotion of Venture Capital in Germany' – known more commonly as 'The Carried Interest Act' – which ruled that carried interest from a fund operating within the safe harbor rule would be eligible for a 40 percent tax exemption.

This was a political compromise; the government did not want to force funds and their managers out of Germany. And the compromise still holds today, although there are concerns about its robustness. "If the government should wish to take an aggressive approach again… it is certain that German private equity would not survive," warns Rodin.

The treatment of management fees has also changed. In 2007, the German Federal Finance Ministry announced what became known as the 'New VAT Letter'. In essence, the new rule stated that management compensation from private equity funds established in Germany after 1 January 2008 would be fully subject to VAT. This was unprecedented in Europe; indeed, EU legislation provides for an exemption of VAT on the management of investment funds.

"In my judgment, the administrative practice of the German revenue service violates the European rules as interpreted by the European Court of Justice," says Rodin. "The transposition of the AIFM directive into national law is an excellent opportunity for the German revenue service to reconsider the scope of application of the VAT exemption under the EU rules, and to achieve consistent application of this exemption within the EU to private equity funds."

AIFM WORRIES

Adopted in 2010, the Alternative Investment Fund Managers (AIFM) Directive seeks to introduce a common regulatory environment for alternative investment fund managers. Individual EU member states will be required to adopt its specifications by 2013.

The rationale driving the regulation may be sound, but it will be problematic for German private equity funds to adapt its processes and operations.

Currently, under German national law, the management of private equity funds is relatively unregulated, as managers of closed-end funds are not required to hold a license in order to operate. However, as of 2013 (as it stands), they will have to seek authorisation from the European authorities. This could potentially force some offshore and lead to a decline in the number of German private equity firms.

"For the first time in its history, the German private equity industry will have to come in line with European regulations governing investment funds," says Rodin. "However, as yet we don't know how the directive will be transposed into German law. It is clear that the rules adopted by the EU will apply uniformly to all German investment fund managers. But we are hopeful that Germany will not introduce additional rules specifically targeting private equity funds."

"Private equity is highly international," he adds. "As a consequence, it is so important for the German private equity industry that a single European market for private equity is created."

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