Private Equity

Jurisdictional comparisons **Second edition 2014**

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Contents

Germany

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1. MARKET OVERVIEW

1.1 Types of investors

The common sources from which private equity funds in Germany obtain their funding are corporate investors, private investors, public sector, banks, insurance companies, pension funds, family offices, funds of funds and capital gains for re-investments.

According to the German Private Equity and Venture Capital Association (*Bundesverband Deutscher Kapitalbeteiligungsgesellschaften*), in 2013, new funds in the amount of EUR 1.1 billion were raised, around 44 per cent less than in 2012 (EUR 1.97 billion). Thus, in 2013, the level of fundraising dropped back to the levels of the years 2009 and 2010. The main sources of funding were private investors and family offices (together 41 per cent), funds of funds (15 per cent), insurances (13 per cent) and pension funds (11 per cent).

Due to the German pension system, fewer pension funds exist in Germany than in other countries. Thus, pension funds have a less important role as investors in private equity funds in Germany compared to their roles in other countries.

1.2 Types of investments

According to the German Private Equity and Venture Capital Association, after three years of increase, the investments decreased in 2013. In 2013, the private equity investments in German target companies reached EUR 4.68 billion, which is a third less than in 2012 (EUR 6.63 billion). German investment companies invested EUR 3.85 billion and foreign investment companies EUR 0.83 billion of the total investment volume of EUR 4.68 billion in Germany in 2013.

As in previous years, the bulk of investments were made in buy-outs (77 per cent). The buy-out volume totalled EUR 3.59 billion. Furthermore, of all transactions in which private equity funds invested in Germany during 2013, 14 per cent were venture capital (seed, start-up and later-stage venture capital), 7 per cent growth capital and 2 per cent different transactions.

The largest portions were invested in industrial products (38 per cent), followed by communication technology (14 per cent), computer and consumer electronics (12 per cent), life sciences (10 per cent) and consumer goods and retail (9 per cent).

2. FUNDS

2.1 Fund structures

The domestic legal structure most commonly used as a vehicle for domestic private equity funds is the 'GmbH & Co. KG'. This is a limited partnership (*Kommanditgesellschaft* (KG)) with a private limited liability company (*Gesellschaft mit beschränkter Haftung* (GmbH)) as the general partner and with the investors as the limited partners. In order to establish non-business status of the partnership for German tax purposes, the partnership must have a managing limited partner, who typically is affiliated with the general partner/sponsor. The partnership is formed in accordance with the provisions of the German Commercial Code (*Handelsgesetzbuch* (HGB)).

Occasionally, other legal structures such as a limited liability company (*Gesellschaft mit beschränkter Haftung* (GmbH)), a public limited company (*Aktiengesellschaft* (AG)) or a partnership limited by shares (*Kommanditgesellschaft auf Aktien* (KGaA)) are used as a vehicle for domestic private equity funds. Under German law, a very specific investment company (Unternehmensbeteiligungsgesellschaft) exists (Gesetz über die *Unternehmensbeteiligungsgesellschaft, the UBGG), but du*e to various constraints it is an unpopular legal form.

The German limited partnership has certain advantages over other legal entities, eg:

- the assignment of interests in the partnership does not require notarisation;
- the accession of new investors as limited partners is uncomplicated and cost-efficient;
- the partnership agreement is not publicly available;
- the rights of the limited partners are restricted by law to certain information rights; and
- there are beneficial tax rules if the partnership is not engaged in business activities for German tax purposes.

Beside domestic legal structures, foreign legal structures are often used as vehicles for private equity funds investing in Germany, such as limited partnerships, in particular based in Luxembourg, Guernsey, Jersey or Delaware.

2.2 Regulation of fund raising and fund managers

The regulatory framework for private equity funds in Germany changed immensely with the transposition and implementation of Directive 2011/61/EU on alternative investment fund managers (AIFM Directive) into national law. The German Capital Investment Act (*Kapitalanlagegesetzbuch*, KAGB) became effective on 22 July 2013 and replaced the German Investment Act (*Investmentgesetz*). The KAGB is now the main legal framework for all German fund structures (including closed-ended funds).

The introduction of the KAGB has increased the administrative burden for market participants. From now on, all alternative investment fund managers (AIFMs) wishing to manage and/or market funds in Germany are subject to registration or authorisation requirements and hence under the supervision by the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsungsaufsicht*, BaFin).

Management

As a general rule (and subject to certain exemptions), AIFMs with their principal place of business in Germany seeking to manage an alternative investment fund (AIF) are required to obtain a full licence from BaFin prior to the commencement of management activities. The licence requirements include, among others, the following:

- internal organisation and risk management requirements, including conduct rules and reporting requirements;
- capital maintenance rules;
- asset stripping prohibition;
- remuneration rules;
- depositary requirements; and
- disclosure obligations towards investors.

An exemption exists for German managers of so-called 'Spezial-AIF', ie funds in which only professional or semi-professional investors are invested, provided certain thresholds regarding the assets under management are not exceeded. Those thresholds are:

- EUR 100 million (including assets acquired through use of leverage); and
- EUR 500 million when the portfolio only includes unleveraged funds with no redemption rights within five years following the date of initial investment.

If these requirements are met, the German AIFM is only subject to a registration with BaFin and is exempt from most of the requirements applicable to fully licensed AIFMs.

The 'semi-professional investor' mentioned above is a type of investor which Germany opted to include in the KAGB beside the professional and retail investors mentioned in the AIFM Directive. Semi-professional investors are persons for whom there are certain requirements (eg minimum commitment, sufficient knowledge and experience), and in many instances they are treated very similarly to professional investors.

If an AIFM has received a full licence from BaFin, it may, unlike a merely registered sub-threshold AIFM, also raise and manage funds on a cross-border basis in other EU countries (passport option), provided that the fund is marketed to professional investors only.

Marketing

All AIFMs wishing to market funds in Germany will need to obtain marketing approval from BaFin or – in the case of an EU AIFM marketing an EU AIF – from its EU home authority, prior to conducting any marketing activity in Germany.

'Marketing' is defined as any direct or indirect offering or placement of fund interests at the initiative of the fund manager (or on behalf of the fund manager) to investors domiciled or having a registered office in Germany.

The requirements which must be fulfilled to obtain marketing approval vary depending on whether the AIF and AIFM is domiciled in or outside the EU/EEA, as well as the kind of investor at which the AIF is aimed (retail/semi-professional/professional).

Requirements include:

- non-German AIFMs (ie EU and third country AIMFs) must be subject to public regulation for investor protection purposes;
- non-German AIFMs must have their registered office in the same country as the non-German AIF;
- non-German AIFMs and the management of their AIFs must comply with the requirements of the AIFM Directive;
- non-German AIFMs must appoint a representative and a paying agent in Germany:
- AIFs must comply with the product rules of the KAGB; and
- the marketing documents must be translated into German language.

German also has specific new requirements for third country AIFs. For example, if a third country AIF is marketed to professional investors only, the third country AIFM must not only comply with the requirements under Article 42 of AIFM Directive, but must also appoint a 'depositary-lite', ie one or several persons or entities assuming the depository functions set out under Article 21(7)–(9) of the AIFM Directive for the third country AIF. In addition, the third country AIFM must also abide by the anti-asset-stripping provisions implemented in the KAGB. The requirements are more burdensome if the marketing is addressed to semi-professional or even retail investors.

The KAGB now also provides for a lighter regulatory regime for EU sub-threshold AIFMs, under which they can market their AIFs to professional and semi-professional investors in Germany on a cross-border basis provided that all of the following apply:

- they are registered as a sub-threshold AIFM in their home member state;
- marketing of AIFs managed by sub-threshold AIFMs is allowed under the rules of the home member state and is not subject to stricter requirements than those under the KAGB ('reciprocity requirement'); and
- the sub-threshold AIFM has notified the intended marketing to BaFin.

2.3 Customary or common terms of funds

The customary or common terms of German private equity funds are similar to those in other jurisdictions and typically address the same issues that investors know from other jurisdictions.

3. DEBT FINANCE

3.1 Means of financing

Most transactions include a great variety of debt instruments: senior loans provided by banks, second-lien loans, mezzanine instruments provided by banks or specialised lenders in general with equity kickers or similar remunerations, and payment in kind (PIK) instruments.

If the financial structuring is only possible after the transaction, senior loans can be provided as working capital facilities or bridge loans.

Mezzanine finance is usually structured as a junior loan. Alternatively, other forms of mezzanine finance are used, such as vendor loans, usufruct rights (*Genussrechte*), silent participations and bonds, including high-yield bonds in large transactions.

3.2 Restrictions on granting security

German law contains several provisions that restrict financing banks of the purchaser to use the assets of a target company to collateralise debt financing. In particular, stock corporations and private liability limited companies established under German law are subject to provisions dealing with the raising and maintenance of capital.

In a stock corporation, the contribution of a shareholder must not be returned (section 57 paragraph 1 of the Stock Corporation Act (*Aktiengesetz*, AktG)). Therefore, stock corporations are prohibited from giving any benefit to the shareholder unless it is from the profit retained or exceptionally permitted by law. Consequently, the stock corporation must usually not give any loans to shareholders or other securities to collateralise loans of a shareholder for the purpose of acquiring shares of the stock corporation by such shareholder.

In a private limited liability company, the regulations of raising and maintaining capital are less strict. However, according to section 30 of the Limited Liability Company Act (*Gesetz betreffend die Gesellschaft mit beschränkter Haftung* (GmbHG) the stated share capital (*Stammkapital*) must not be paid out to the shareholders. Thus, loans to the shareholders are forbidden if the redemption claim is not fully adequate and the stated share capital is affected by it. These capital maintenance rules, however, do not apply to shareholders with whom the GmbH has entered into a domination and profit and loss transfer agreement.

Section 30 of the Private Limited Liability Company Act also applies analogue to a GmbH & Co. KG.

If the target company is a general partnership (*offene Handelsgesellschaft* (OHG)) or a limited partnership, the use of the assets of the target company as collateral for debt of a partner is not directly addressed by law but may be limited under the provisions of the partnership agreement

3.3 Inter-creditor issues

Similar to other jurisdictions, inter-creditor agreements determine the ranking of claims of different creditors. Such an agreement may, inter alia, address the following issues:

- declarations of some creditors to subordinate their claims to other creditors' claims;
- prohibition for junior creditors to amend or change their loan agreements with the banks to the detriment of the senior creditors;

- declarations by junior creditors not to satisfy their claims unless the senior creditors' claims are executed – usually, the accruing interest is exempt from this provision;
- suspension of some rights of junior creditors until the fulfilment of the senior creditors' claims, such as the termination of credit contracts, the prohibition of an offset or a debt settlement, or to file for insolvency;
- warrant of special rights to the senior creditors in the case of insolvency of the debtor or the guarantor;
- duty of senior creditors to sweep payments wrongly received; and
- sole power of enforcement of the security trustee and the use of the proceeds by the security trustee.

When formulating inter-creditor agreements, section 489 paragraph 4 of the German Civil Code (Bürgerliches Gesetzbuch (BGB)) should be considered. According to this provision, the debtor's right of termination may not be excluded or impaired by contract.

3.4 Syndication

Credit institutions may syndicate their loans during or after a transaction.

The legal structure of syndication with a third party is usually the partial assumption of rights and obligations under a facility agreement from the old creditor to the new creditor. The assignment of loan claims to a new creditor is permitted by law, but might be limited by the terms of the loan agreement.

In the case where the loan is assigned to another credit institution that already participates in the consortium, this is legally considered an amendment of the agreement and thus needs the permission of all parties. Often the agreement already provides the permission for these types of syndications.

To simplify syndications, many loan agreements between banks and debtors are drafted in accordance with the standards of the Loan Market Association (LMA). The LMA developed a sample loan agreement in accordance with German law. This results in loans which are subject to German law being more fungible.

4. EQUITY STRUCTURES

4.1 Role of management

Obviously, the management of the target company plays a significant role. Hence, in addition to restrictive covenants on non-compete, non-solicitation and confidentiality, managers' service agreements often provide for, among other compensation components, variable payments in order to incentivise the management. The variable payments usually depend on the performance of the target company or the individual performance of the manager. For determining the amount of the bonus, the payments may be related to key financial figures, such as earnings before interest, taxes, depreciation and amortisation (EBITDA) or the economic value added, or to the fair market value of the target company.

When determining the remuneration of the management board of a stock corporation, section 87 paragraph 1 AktG and section 4.2 of the German Corporate Governance Code (the Code) must be complied with. According to these rules, the supervisory board of the stock corporation has to ensure that the aggregate remuneration bears a reasonable relationship to the duties of the members of the management board as well as the condition of the company, and that it does not exceed standard remuneration without any particular reasons. Pursuant to section 4.2.3 of the Code, the amount of compensation shall be capped, both overall and for variable compensation components.

4.2 Common protections for investors

A private equity fund commonly seeks to receive statutory and contractual control over the activities of the target company.

If the target company is a GmbH, the shareholders can largely instruct the managing directors to take or refrain from taking certain measures. The shareholders can also remove the managing director at any time.

In addition, the management of the target company is often bound by the rules of procedure adopted by the shareholders of the target company. These rules subject certain business activities to the prior consent of the shareholders' meeting or, if any, the shareholder's committee.

If contractually agreed, delegates of the private equity funds can take seats in the target company's body, such as in the supervisory board, the advisory board or the shareholders' committee.

Due to German corporate law, the corporation's articles must be filed with the commercial register and are open to the public. Thus, protective provisions are often inserted into a confidential private shareholders' agreement and not into the articles of association itself (see below).

4.3 Common protections for management

The management also usually benefits from an equity participation in the target company. Such equity participation is often indirect through a common vehicle which pools the interests of management and which is controlled by the private equity investor.

The equity participation is always subject to a shareholders' agreement providing

- control of the private equity investor over shareholder decisions relating to the target company;
- sometimes, veto positions for the management with regard to substantial decisions to be taken in the shareholders' meeting;
- anti-dilution protection for the management, in particular with respect to future financing and/or refinancing (recaps);
- for a prohibition of the management to dispose of its shares without the consent of the private equity investor; and
- exit provisions such as tag- and drag-along rights.

4.4 Management warranties

Private equity funds usually request comprehensive protections from the sellers and management through warranties which cover all relevant aspects of the target company. While sellers' warranties usually include information about the past and the current business, management warranties may also refer to the future development of the target company.

The management of the target company usually develops a business plan prior to the transaction. Therefore, the investors may expect a management warranty that the business plan was prepared thoroughly and in due manner. However, it is typically not expected to be warranted to reach the goals of the business plan. Besides the business plan, manager warranties can also reference other information provided by the management such as management presentations, due diligence documents, vendor due diligence reports or buyer due diligence reports if known to the management.

By receiving these management warranties, investors attempt to obtain complete and correct information prior to the purchase of the target company. The damage compensation in the case of a breach of such warranties is usually limited to the amount of the participation of the respective managers in the company, and the private assets of the manager are usually not affected or only affected to a limited degree. Claims based on a warranty breach are usually subject to the statute of limitation, typically 12 to 24 months following the transaction. Legal proceedings concerning the breach of management warranties are rare.

4.5 Good leaver/bad leaver provisions

One of the most important elements of a management participation programme is the leaver scheme, which makes provisions concerning the compulsory transfer of the manager's shares if the manager ceases to be active for the company. Technically, this is structured by call and/or put options. If, for example, the manager terminates his/her service contract or resigns as the managing director of the target company, the private equity investor is granted the right to acquire the (indirect) share of the respective manager in the target company. Further option events are insolvency of the manager, execution measures against the manager, breach of contractual obligations by the manager and disability of the manager. Sometimes the manager is granted a put option to be exercised in case of disability or death.

The purchase price payable to the leaving manager usually depends upon the circumstances of the leaver event. A 'good leaver' is commonly a manager who leaves the company because of retirement, death, disability or termination without fault of the manager. A 'bad leaver' departs because of termination through the company with good cause or termination by the manager themselves during a specified initial period.

The calculation of a manager's compensation often depends on the acquisition costs and the market value of any shares acquired by the manager as part of the transaction or management contract. A good leaver usually receives the market value of their shares; a bad leaver typically receives the lower of acquisition costs of the shares and fair market value.

Under German corporate law, compensation clauses that do not consider the market value of the shares are not always enforceable. In particular, courts have decided that clauses may not be valid if they provide compensation only in the amount of the book value of the company. Such jurisprudence should be considered when formulating good leaver/bad leaver provisions. Furthermore, compensation clauses could be found to be void if, at the time of the agreement, the market value of the shares clearly exceeded the amount of the compensation. If compensation clauses are valid at the time of the agreement but invalid at the time of the departure of the manager, courts may also adjust the compensation clauses.

For the determination of the amount of the compensation, other parameters than the good leaver/bad leaver provisions may be taken into account such as time vesting or performance vesting.

4.6 Public to private transactions

Public to private transactions have become a common way for private entities to invest in public listed companies.

Going-private transactions often involve a transformation of the legal form from a stock corporation to a limited liability company and thereby permitting greater flexibility and tighter control by the new owners over management. Additionally, costs for complying with stock exchange requirements can be avoided.

Another important device for a public to private transaction is the domination and profit and loss transfer agreement. This instrument allows the majority shareholder to control the management of a publicly listed stock corporation, including the right to give specific instructions to management regarding certain business transactions. In deviation from the standard model, the management of the stock corporation loses its relative independence *vis-à-vis* its shareholders.

Both a transformation and a domination and profit and loss transfer agreement require an offer to minority shareholders of the dominated company to acquire their shares against payment of a consideration in cash.

Prior to the above, public to private transactions are typically affected by the Takeover Act of 2002 (*Übernahmegesetz* (WpÜG)). This Act regulates all public offers whereby a bidder wishes to acquire substantial stakes in a publicly listed target company. Thus, it provides a detailed schedule for the going-private transaction: for example, provisions for how a bidder can make an offer to acquire shares of a target company, how the minimum purchase price is to be calculated, what other formal requirements a bidder must comply with (providing offer documents, securing sufficient financial resources, etc) or when a bidder must issue a mandatory offer.

There are also disclosure issues in connection with going-private transactions. The requirements of the Securities Trading Act (*Wertpapierhandelsgesetz* (WpHG)) must be complied with. According to the Securities Trading Act, whenever an investor ownership reaches, exceeds or falls below 3, 5, 10, 15, 20, 25, 30, 50 and 75 per cent of the voting rights in a listed company, a notification to both the company and the Federal Financial Supervisory Authority is required.

5. EXITS

According to the German Private Equity and Venture Capital Association, exits of German target companies in 2013 amounted to a volume of EUR 5.73 billion, which is an increase of nearly 50 per cent compared to 2012 (EUR 3.88 billion). The highest increases were recorded in trade sales (2013: EUR 1.35 billion; 2012: EUR 0.86 billion) and secondary sales (2013: EUR 1.46 billion; 2012: EUR 1.2 billion). The two types of exit channel together constitute 49 per cent of the whole exit volume.

5.1 Secondary sales

The secondary sale is the sale of the target company from a private equity investor to another financial sponsor. A secondary sale may be an exit option if a second stage of development can be started in the development of the target company with another financial sponsor. Consequently, the target company should have enough potential to warrant to the new investor an increase in value by operative improvement. For a successful secondary sale, the management should also be willing to invest a substantial amount of its proceeds received in the exit together with the new investors (roll over).

5.2 Trade sales

A trade sale is the sale to a strategic investor. The purchaser usually expects to benefit from synergy effects. As a result, it is necessary for the purchaser to acquire a controlling interest in the target company. In this case, the private equity investor may make use of its drag-along rights *vis-à-vis* minority shareholders, eg, management.

5.3 IPOs

IPOs in Germany usually command higher costs and more effort than secondary and trade sales, but often create better overall returns. Furthermore, IPOs allow spreading the divestment over time, whereas other sales allow a full immediate divestment.

Thus, IPOs were often the preferred exit channel. Due to the credit crunch, the market for IPOs has not been very active in Germany since 2009. In 2013, private equity investors took advantage of the positive development of the stock markets in order to take three companies public through IPOs and to reduce their holdings in listed companies.

For an IPO it is required that the target company is organised in a structure capable of sale of shares in capital markets. A common method is a tax-neutral reorganisation into a stock corporation or a partnership limited by shares according to the German law on the Regulation of Transformations (*Umwandlungsgesetz* (UmwG)). If the IPO involves an increase of capital, a shareholder resolution is mandatory. If the IPO involves only the existing shares and no new shares are issued, a shareholders' resolution might still be necessary. According to a decision of the German Federal Supreme Court, a withdrawal from the stock market requires a shareholders' resolution. It can be argued that a shareholders' resolution is needed for an IPO as well. It is debated if a simple shareholders' majority is sufficient for such a resolution.

To be permitted into the regular market, a prospectus in accordance with the Takeover Act (*Übernahmegesetz* (WpÜG)) approved by the Federal Financial Supervisory Authority has to be issued. Additionally, the requirements of the German Stock Market Act (*Börsengesetz*), the listing regulation (*Börsenzulassungsverordnung*) and section 35 of regulation 1278/2006 (EG) must be fulfilled. For instance, the annual financial statements of the last three years need to be disclosed, a sufficient spread of the shares need to be shown, etc. The listing regulation requires a written application for permission with some attachments, eg excerpts from the public register and articles of association.

If the shares should not be traded on the regular market but in the unofficial market instead, the guidelines of the respective stock exchange must be met.

5.4 Refinancings

Refinancing is the new structuring of debt. Recapitalisation (recap) is the repayment of equity in part or in total to the financial sponsor. Recapitalisation and refinancing were often used devices to finance leveraged buyouts before the financial crisis. After a decline during and following the financial crisis, improving debt availability and market conditions today again result in increasing activities in refinancing and recapitalisation

Since the deterioration of the debt markets in the course of the financial crisis, the new term 'reverse recap' was implemented, meaning that a financially weak target company is recapitalised with equity.

The recapitalisation allows a private equity fund to realise a partial exit from an economic point of view. After a certain period of time, the private equity fund uses the improved operative results to receive a return financed by debt through surplus dividends, repayment of shareholder loans or repurchase of shares. Important features of the recapitalisation process are the increase of cash flows, the degree of debt relief and the leverage arbitrage.

5.5 Restructuring/insolvency

In the case of insolvency, the Insolvency Code (*Insolvenzordnung* (InsO)) determines the order of priority in insolvency proceedings. Both debt providers and shareholders are insolvency creditors. Debt providers are generally given priority over shareholders unless a creditor agreed to subordinate their claim to all other forms of financing. However, in insolvency proceedings, the creditors typically only realise a marginal portion of their claims.

Sometimes, financial investors specialising in turnaround situations and restructurings are interested in buying an insolvent target company, either immediately before or during insolvency proceedings.

6. TAX

6.1 Taxation of fund structures

As a result of the implementation of AIFMD into German domestic law and the fundamental changes in the regulatory environment resulting therefrom, significant amendments to the tax legislation had to be made as well. Therefore, the German Investment Tax Act (*Investmentsteuergesetz*) has been amended by the German AIFM Tax Adaption Act, which entered into force on 24 December 2013.

The German Investment Tax Act, as amended, distinguishes between investment funds (*Investmentfonds*) and investment companies (*Investitionsgesellschaften*).

Investment funds within the meaning of German Investment Act are open-ended funds (typically UCITS) which fulfil certain criteria, including a specific tax product regulation. Such investment funds and their investors continue to be subject to a special tax regime under the German Investment Tax Act; this tax regime has not materially changed.

Due to their investment policies and the fact that they do not grant redemption rights to investors, private equity funds typically do not qualify as investment funds. Thus, we will not dwell on the details of their taxation.

Any investment vehicles other than investment funds (as defined in the German Investment Tax Act) qualify as investment companies; they are broken down into two categories, viz. partnership investment companies (*Personen-Investitionsgesellschaften*) and corporate investment companies (*Kapital-Investitionsgesellschaften*).

The vast majority of private equity funds are structured as limited partnerships and thus qualify as partnership investment companies. Partnership investment companies and their investors are subject to the general rules of taxation for partnerships and their investors. These rules are summarized below.

Private equity funds set up as a limited partnership allow investors from different jurisdictions to invest in a fiscally 'transparent' structure for tax purposes. To be regarded as fiscally transparent, it is required that the activities of the private equity fund are limited to passive asset management rather than to business activities. From a German tax point of view, certain criteria must be met in order to avoid the private equity fund qualifying as a business. In order to qualify as passive asset management rather than as a business, a private equity fund has to be managed, at least partly, by one or more of its limited partners if only a corporation (or a so-called deemed-business partnership) is acting as its general partner; it may not hold an interest in a business partnership unless the investment is made indirectly through a corporation; and it has to qualify under the guidelines provided by the German Federal Ministry of Finance (*Bundesfinanzministerium*) in its administrative pronouncement dated 16 December 2003. Due to this pronouncement, a non-business partnership can be expected to:

- not use bank loans (except for short-term bridge loans);
- not have an extensive organisation to administer the fund's equity;
- use the equity funds' expertise only for inserting on its own account;
- only administrate and realise investments for its own account;
- not have short-term-holdings;
- not reinvest sale proceeds (except as cover for investors' capital initially used to pay managing fees);
- not have active involvement in the management of target companies; and
- not have entrepreneurial investments in the target company.

If a private equity fund fulfils these requirements, the German fund vehicle is neither subject to German corporate income tax nor subject to German trade tax. All income is immediately allocated to its partners and taxed at the level of the partners. The taxation of each partner depends on its individual tax status.

In a decision of 24 August 2011, the German Federal Tax Court raised, in an obiter dictum, doubts whether the non-business criteria in this aforementioned administrative pronouncement are too generous, but did not explain these doubts in more detail. The German revenue service has not announced that it will review the non-business criteria as set out in the administrative pronouncement, but representatives of the Federal Finance Ministry informally confirmed in seminars that it does not intend to do so. As a consequence, the non-business criteria as summarised above should continue to apply.

Thus, if the partner in the German non-business fund vehicle is a German individual, since 1 January 2009, the income (capital gains, dividends, interest) is subject to withholding tax in the amount of 25 per cent plus a solidarity surcharge thereon at a rate of 5.5 per cent and – where applicable – church tax. The withholding tax may be (partially) refunded if a double taxation agreement is applicable. Nonetheless, a withholding tax of 15 per cent will usually remain applicable to dividends.

If the partner of a German non-business fund vehicle is a domestic corporation, such as a GmbH or an AG, it is subject to corporate income tax and trade tax, regardless of its shareholders. This implies that 95 per cent of the dividend received and capital gains from the sale of a shareholding of the fund are generally exempt from corporate income tax, provided such partner holds – indirectly through the fund – more than 10 per cent of the target company's share capital as of the beginning of the calendar year. In addition, 95 per cent of the dividends are generally exempt from trade tax if the corporation indirectly holds more than 15 per cent of the target company's stated share capital from the beginning of the assessment period. Special tax rules apply to capital gains realised by companies active in the financial and insurance sectors as well as by pension funds.

If the partner is a foreign individual or a foreign corporation, subject to taxes on dividends, it is generally not taxed in Germany, but in its home jurisdiction. However, if the foreign individual or the foreign corporation indirectly holds more than 1 per cent of a German target company's stated share capital, capital gains are subject to German taxation in the same manner as a German individual or a domestic corporation, unless it has protection under an applicable double taxation treaty.

If the private equity fund is qualified as a business, it is subject to trade tax. Additionally, if the partner of the German business private equity fund is a German or foreign individual, according to the part-income tax rule (Teileinkünfteverfahren), 60 per cent of the capital gains and dividends received by the partner are taxable. Interest and other income of the business private equity fund will be fully taxable as well. If the partner of the German business private equity fund is a domestic or foreign corporation, the corporation is subject to corporate income tax as described above, but not to trade tax (with the exception of companies active in the financial and insurance sectors as well as by pension funds).

Private equity funds set up in the legal structure of a German or foreign corporation qualify as corporate investment companies (see above). The income on the level of a German corporate investment company is subject to corporate and trade tax. Income derived by an investor from its investment in a corporate investment company is basically fully taxable and not subject to the participation exemption or part income rule (*Teileinkünfteverfahren*). Only if the investor can prove that the corporate investment company is resident in an EU or ECA state, is taxed according to that state's law and is not exempted from tax, or if the corporate investment company is resident outside the EU or the ECA and is taxed at least at a rate of 15 per cent, is the participation exemption or part income rule applicable. In addition, the German PFIC/CFC as set out in the German Foreign Tax Act (*Außensteuergesetz*) may apply.

6.2 Carried interest

In Germany, it was in dispute for a long time whether carried interest qualifies for tax purposes as remuneration for service or as partnership income. Finally, in 2004, the Act for Promotion of Venture Capital came into force. Under this Act, carried interest is qualified as remuneration for services if the interest is paid by a private equity fund partnership that is not engaged in a trade or business.

Following this, 40 per cent of the carried interest received from such a private equity partnership can be tax exempt from German income tax. For private equity funds set up before the end of 2008, 50 per cent of the carried interest can be tax exempt.

It is debated whether the same rules apply for carried interest that is paid by a private equity fund engaged in business, or structured as a corporation.

In the international context, the qualification of carried interest as remuneration for services can cause double taxation issues.

6.3 Management equity

The basic tax consideration of the management participation programme is that the management receives capital gains and dividends are distributed tax exempt. This requires that the management has economic ownership straight away with its participation, meaning that the managers bear real value risks from the investment. If this is not the case, the appreciation is subject to taxation as ordinary income. Otherwise, the following tax rules apply.

The taxation of capital gains depends on whether the shares were acquired before or after the end of 2008. Concerning the sale of shares acquired before the end of 2008, capital gains are tax exempt if the holding period of the shares is at least 12 months and if the total investment in the target company is less than 1 per cent. Otherwise, according to the part-income tax rule (*Teileinkünfteverfahren*), 60 per cent of the capital gains are taxable.

Concerning the sale of shares acquired after the end of 2008, capital gains are subject to withholding tax of 25 per cent plus a solidarity surcharge (and – where applicable – church tax) if the management total investment in the target company is less than 1 per cent. Otherwise, the part-income tax rule as described above, applies as well.

The taxation of dividends depends on whether the dividends are distributed before or after the end of 2008. Dividends distributed before the end of 2008 are subject to the half-income tax rule (*Halbeinkünfteverfahren*). Dividends distributed after 2008 are subject to withholding tax.

Due to a change in the administrative practice of German tax authorities, since the beginning of 2008, the management fees paid by the target companies are subject to value added tax (VAT) regardless of whether such management fee is structured as a priority profit share in the balance sheet profit of the receptive partnership. Thus, the fees are regarded as an additional fee, not as part of the contribution as partner or shareholder.

6.4 Loan interest

The interest payable on non-hybrid loans to the private equity fund is usually not subject to German withholding tax.

Interest expenses of the target company are partly tax deductible. Since 2008, the interest barrier regulations (*Zinsschranke*) limit the tax deductibility of interest expenses of German companies. This rule is complex. In short, the deductibility of interest expenses is capped at 30 per cent of the EBITDA of the relevant company. However, companies are able to build up an EBITDA reserve in business years where 30 per cent of the EBITDA exceeds the negative interest balance. This reserve can be used in the following five business years if the negative interest balance exceeds 30 per cent of the EBITDA in one such business year. The restrictive provisions do not apply if the interest expenses do not exceed the interest income by more than EUR 3 million.

6.5 Transaction taxes

Under German tax law, the sale of all of a company's assets is not subject to VAT. However, in the case of the sale of less than 100 per cent of the company's assets, VAT is applicable.

The purchase of shares of a company is VAT exempt or not subject to VAT at all.

If an asset deal includes the transfer of property, land transfer tax (*Grunderwerbssteuer*) is raised in the amount of 3.5 per cent to 6.5 per cent. The tax is based on the proportional purchase price.

In a share deal, land transfer tax is only raised if the purchaser consolidates 95 per cent or more of the shares of a corporation or a partnership that owns property in Germany. The 95 per cent will not only be reached if the fund holds the interest in the company directly or indirectly, but also if the fund is only beneficial owner of the interest. The tax is based on the fiscal property value.

The same tax rules apply if 95 per cent or more of the partners of a partnership that owns property change within five years. To avoid land transfer tax, a purchaser might acquire less than 95 per cent of the partnership shares and receive a call option for the rest of the shares that can be exercised five years later.

7. CURRENT TOPICAL ISSUES/TRENDS

According to the latest market outlook of the German Private Equity and Venture Capital Association, investors are focusing increasingly on Germany and private equity as an asset class. Nearly 50 per cent of the respondent investment companies are basically optimistic about the asset class private equity and Germany as a preferred investment location for private equity investors. This is also reflected in their mainly positive expectations on the development of their investment activity in Germany.

Better macroeconomic conditions than in previous years, large amounts of committed capital ('dry powder'), historic low levels of interest rates and improvements to the legal framework conditions for investment companies in Germany are factors that indicate an increase in investment activities in Germany. Furthermore, the positive economic prospects and the expected short- to mid-term interest rate policy of the ECB might facilitate further improvements in financing conditions in the near future.

The German transaction landscape is expected to be dominated by acquisitions of and divestments in small and medium-sized companies. In this context, according to the German Private Equity and Venture Capital Association, secondary buy-outs, carve outs and minority and majority shareholdings in family-owned companies are considered to be the most attractive sources of investment. The preferred industries for investments are anticipated to be software/IT, internet/media/communications and biotechnology/pharmaceuticals/medicine.

The exit environment may be dominated by trade sales, ie sales to strategic investors. Other exit channels, such as secondary sales/secondary buy-outs and IPOs, are expected to trail behind considerably.

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Since 2010, when the first edition of *Private Equity* was published, the private equity landscape has changed significantly. Economies are growing once again, deals are being completed, exits are up and the future is looking brighter.

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