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Carried interest as profit distribution under German tax law

In its decision of November 17, 2020 (case no. 12 K 2334/18), the Munich Fiscal Court agreed with the claimant's view and confirmed that carried interest is part of the profit distribution as agreed in the partnership agreement at the level of a private equity fund. Hence, carried interest does not constitute hidden payments by the investors to the carry holders. POELLATH represented the claimant in the appeal proceedings.

In particular, private investors in a private equity fund structured as an asset management partnership benefit from this decision, as carried interest is not to be treated as a non-deductible expense pursuant to § 20 (9) German Income Tax Act.

SUMMARY

- Carried interest, as a disproportionate distribution of profits, is in principle to be recognized for German tax purposes and is therefore treated as a profit share of the carry holders at the level of the fund and reduces the income of the investors.
- The special tax provision of § 18 (1) No. 4 German Income Tax Act, which reclassifies carried interest from private asset management funds as income from self-employment at the level of the carry holders, does not affect the tax treatment of disproportionate distribution of profits at the level of the fund.
- Contrary to the view of the tax authorities, carried interest is not a limited deductible expense of the investors.

A. The case: Treatment of carried interest in asset managing private equity funds by the tax authorities

In the course of tax audits of private equity funds, the German tax authorities did not consider carried interest as part of the profit distributions as agreed in the relevant partnership agreement.

Instead, the tax authorities allocated the fund's profits proportionally to the capital: In a first step, the tax authorities increased the income of the investors in the amount of the carried interest received by the carry holders. In a second (fictitious) step, the tax authorities assumed that the investors would pay these amounts to the carry holders as service fees. However, since the investors actually only receive a profit share reduced by the carried interest, they assumed that the carried interest had been paid by direct payment from the fund to the carry holders (so-called "abbreviated payment method"). In this respect, the fund's income was initially attributed to the investors in accordance with their participation quota and hence is part of the taxable income of the investors.

Since the fictitious payment of carried interest to the carry holders was only partially deductible pursuant to § 20 (9) German Income Tax Act, but had to be fully taxed by the carry holders, this resulted in double taxation.

B. Core statement of the Fiscal Court

In principle, carried interest is to be qualified as a disproportionate distribution of profits and thus, must be accepted under German tax law. This is because the distribution of profits for tax purposes is based on the distribution of profits as agreed in the partnership agreement. Due to the conflicting interests of the shareholders of a private equity fund, there is often no reason to doubt the profit distribution agreement and not to recognize it for tax purposes. Furthermore, there is no hidden remuneration, since carried interest is not accounted as an expense at the level of the fund and the carry holders are only entitled to it in case of sufficient profits. At the level of the fund, the carried interest is therefore to be treated as a profit share.

Further, the special tax provision of § 18 (1) No. 4 German Income Tax Act does not affect this result. According to this provision, carried interest from an asset managing private equity fund is reclassified as income from self-employment at the level of the carry holders. However, this does not affect the tax qualification of the profit distribution at the level of the fund. The very wording of the rule argues in favor of classifying carried interest as a share of the fund's profit, since the carry holders receive carried interest because they promote the fund's purpose. This also speaks against the assumption that the carry holders would provide services to the investors. In this respect, Sec. 24 of the Private Equity Circular (German Federal Ministry of Finance, letter of December 16, 2003) is also outdated.

Finally, neither § 39 AO (German Fiscal Code) nor § 1 (19) No. 7 KAGB (German Capital Investment Act) change the tax classification of carried interest. According to § 39 (2) AO, the investors are ultimately allocated the proportionate income generated by the fund in accordance with the profit distribution key. § 1 (19) No. 7 KAGB also speaks of a “share in the profits” of an AIF and, moreover, only applies to the KAGB. Consequently, the KAGB also assumes that carried interest represents a share in the fund’s profits.

C. Classification and perspective

With its decision, the Munich Fiscal Court is in line with the case law of the Federal Fiscal Court (decision of December 11, 2018; case no. VIII R 11/16) and the dominant opinion in the tax literature. Fortunately, the Munich Fiscal Court pointed out that carried interest is not a limited deductible expense of the investors, but part of the profit distribution agreement for private equity funds and that such distribution must be accepted for tax purposes.

This decision takes the wind out of the sails of the nationally known approach of the tax authorities of reclassifying carried interest as an expense. Due to the importance of the decision, an appeal to the Federal Fiscal Court has been allowed.

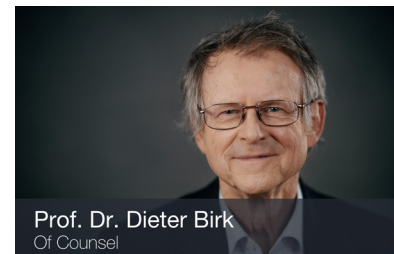
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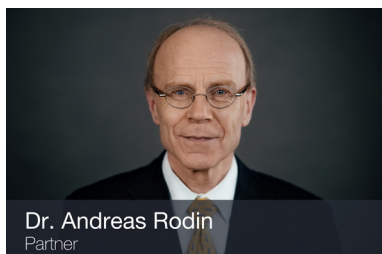
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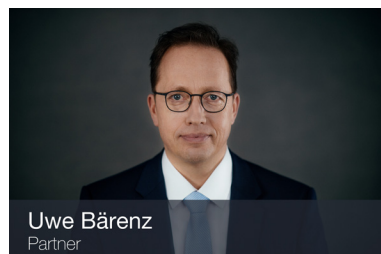
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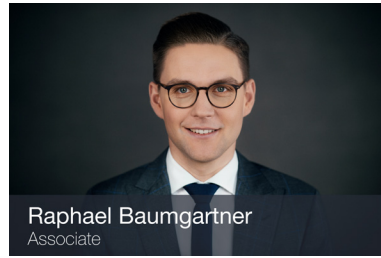
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