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FEATURED PERSPECTIVES

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In Shakespeare's play *The Taming of the Shrew*, the protagonist tames his beloved one. Lately, German politics has presented *The Taming of the* Heuschrecken (grasshoppers). *Heuschrecken* is the politically incorrect description for private equity companies, so named by Franz Müntefering, the leader of the Social Democratic Party. Müntefering's outcry was related to the private equity takeover of a company producing bath armatures in his electoral district.

For years, major private equity firms have been investing in many German midcap companies, often unnoticed by the general public, sometimes drawing the attention of those in politics.

There has been a major debate over whether private equity is good or evil. Contrary to the widespread negative perception in society (sparked by populist politicians), the lawmakers joined the choir of economists that have been emphasizing the overall beneficial economic effects of international private equity investments in Germany. Soon this insight emerged into legislative attempts to draft a legal framework that endorses private equity activities in Germany but restricts the scope of target corporations to young and innovative companies.

Framework of the Private Equity Act

On August 19, 2008, the Private Equity Act (Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungen, hereafter the Act) entered into force. Its core purpose is to financially strengthen young innovative companies by granting tax benefits to private equity companies.

Under the Act, specific private equity investments can be established. To benefit from the new regime, the private equity company, the target corporation, and the scope of investments must fulfill several prerequisites.

Status of a Private Equity Company

The German Investment Services Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, or BaFin) recognizes an entity (corporation or partnership) as a private equity company under the Act if the following requirements are met:

- the entity must have a seat and place of management in Germany;
- according to its statutory purpose, the entity must purchase, hold, manage, or sell private equity investments (target corporations);
- the entity must have a minimum equity of €1 million;
- a minimum of 70 percent of the portfolio of the private equity company must be invested in target companies; and
- the entity must employ two competent and qualified directors.

Moreover, restrictions apply regarding the creation of groups. Private equity companies are not permitted to be held as subsidiaries in a group, and no shareholder may have a shareholding of more than 40 percent. Compliance with these two conditions must be brought about within a five-year limitation period. If any violation of these and the following criteria occurs, the BaFin may withdraw recognition of an entity as a private equity company.

Target Company

The most important restriction of the Act concerns the nature of the target company. To receive the tax benefits, only those investments qualify that relate to target companies with less than €20 million equity and that were established not more than 10 years before the date of purchase by the private investment company. The target company must not have issued any stocks or must not have any direct or indirect participation in a company older than the target company. The target company must not be a group parent or a partner of a group parent. To qualify as a target company under the Act, the investment must not be held longer than 15 years.

Scope of Investments

The scope of investment is also restrictive. Beyond investments in target companies, the Act permits other forms of investments, like the participation in corporations with their seat and place of management in a European Economic Area member state, the provision of consulting services to companies whose shares are held by the private equity company, the issuance of bonds and coupons, and the borrowing of money. The latter enables the private equity company to debt finance an investment, which creates a leverage effect. However, the Act does not permit investment in real estate. The share of participation in a private equity investment entity must amount to at least €25,000.

Tax Benefits

If all prerequisites are met, the Act grants the following tax benefits.

First, a partnership that qualifies as a private equity investment entity and exclusively holds shares in target corporations is treated as an asset management entity from the 2008 assessment period onwards. The qualification as an asset management entity is important because profits of these entities are not subject to trade tax. In the past, this subject matter has only been dealt with by a circular of the Federal Ministry of Finance, released on December 16, 2003. The passage of a statute will provide for more legal certainty.

However, the private equity company jeopardizes its tax status of an asset management entity if it is involved in other business activities such as the provision of consulting services to corporations whose shares are held by the partnership or in the case of a short-term sale of private equity investments. In that case, a private equity company is tested according to section 15, paragraph 2 of the German Income Tax Act, whether or not the partnership generates income from business operations. The only way to avoid the detrimental effect is if the services are fully provided by a 100 percent subsidiary of the private equity company. The subsidiary must be a corporation.

Second, the Act increases the tax allowance for capital gains derived from the disposal of privately held stocks. In German tax law, 50 percent (starting in 2009, 60 percent) of these capital gains are taxed if the shareholder has held more than 1 percent of the share in a corporation within the preceding five years. The new tax allowance amounts to €200,000 for a disposal of 100 percent. If less stock is sold, the tax allowance is lowered accordingly. Moreover, the tax allowance decreases by the amount that the capital gains exceed €800,000 by the proportion corresponding to the shareholding. However, the tax allowance requires that the shareholding must be between 3 percent and 25 percent at the time of disposal or in the preceding five years and that the shares must not have been held for more than 10 years.

The legislative reasoning behind this tax allowance is to attract ''business angels,'' wealthy and experienced individuals that provide the target company with capital, know-how, and a personal network that contributes to the success of young and innovative companies.

> **The legislative reasoning behind the tax allowance is to attract 'business angels.'**

Third, the Act has amended the Corporate Income Tax Act in section 8c, paragraph 2 by loosening for private equity companies the detrimental effects of the tightened change of ownership rule. As pointed out in one of our previous columns,[1] the German change of ownership rule provides that if more than 25 percent and less than 50 percent of the loss entity's shares are directly or indirectly transferred to a single acquirer or a person related to that acquirer, the loss carryforward will be eliminated pro rata. If more than 50 percent is transferred, the loss carryforward will be fully eliminated.

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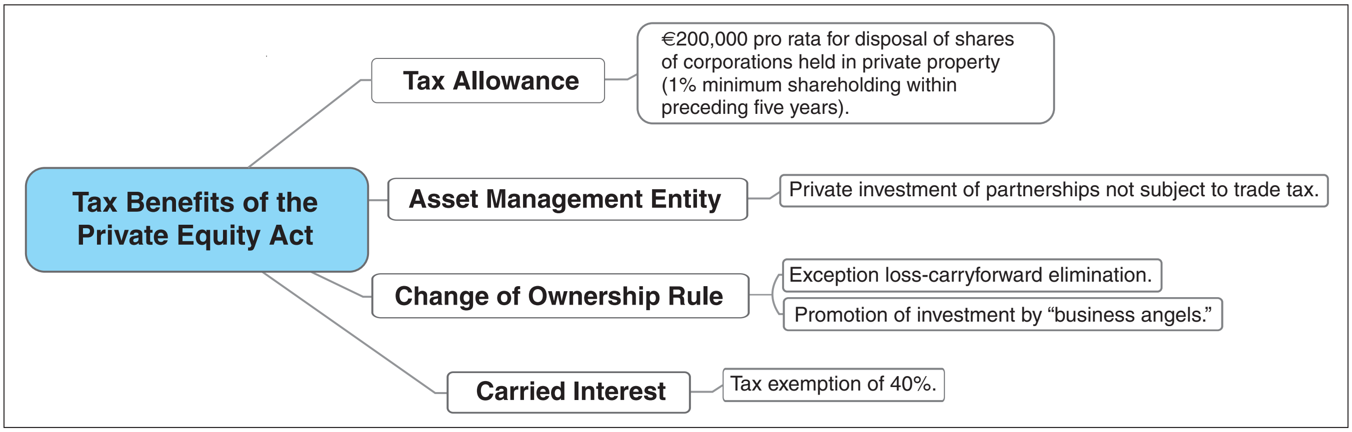
[1] *See* ''Losing the Losses — The New German Change-of-Ownership Rule,'' *Tax Notes Int'l*, Dec. 10, 2007, p. 1045, *Doc 2007-26131,* or *2007 WTD 242-14.*



As the only exception, the rule does not apply to private equity companies that purchase shares of a target company. In that case, the target company will retain its losses and must deduct them equally over the following five years. The same benefit is granted if the participation in the target company is sold by the private equity company to another investor, if the investor's equity does not exceed €20 million, if the target company's equity does not exceed €100 million, and if the amount exceeding €20 million has been generated by balance surpluses within the preceding four years. The legislative logic behind the last alternative is to promote young companies with intense research and development activities. Typically, the equity of these companies decreases because of R&D activities, and especially in the early stages of existence, but profits potentially increase within a short time later.

Carried Interest

The Act has also changed the tax treatment of carried interest. A carried interest is the remuneration paid to the initiator of an asset management company investing shares in corporations in addition to the profit share. Before the Act entered into force, carried interest was 50 percent tax exempt. To finance the tax benefits described above, the exemption was reduced to 40 percent, applicable to carried interest paid by an asset management company established after December 31, 2008. Also, only 60 percent (compared with 50 percent in 2008) of business expenses connected with that carried interest is deductible for tax purposes.

Act on Investment Companies

The Private Equity Act must not be confused with the regime established by the Act on Investment Companies of 1986 (Gesetz über Unternehmensbeteiligungsgesellschaften, or UBGG), which has been amended by the Private Equity Act but does not contain any tax provisions. Moreover, the UBGG is broader than the Private Equity Act and does not restrict investments by size or age. There is a strict distinction between the two acts, as a company can only be subject to one of the regimes. As a result, the German private equity legislation is scattered in two independent regimes.

Ups and Downs

There is some cause for celebration as the German legislature endorsed and functionally adopted the merits of venture capital and business angels in its legal framework. Tax benefits for venture capital are the right way to respond to an innovative and diversified economy. It is a pity that the scope of application has been narrowed so much for budget reasons. Therefore, only a special type of investor will be able to take advantage of the new regime. ◆