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# TAX ASPECTS OF THE ACTIVITIES OF PRIVATE EQUITY AND HEDGE FUNDS IN GERMANY

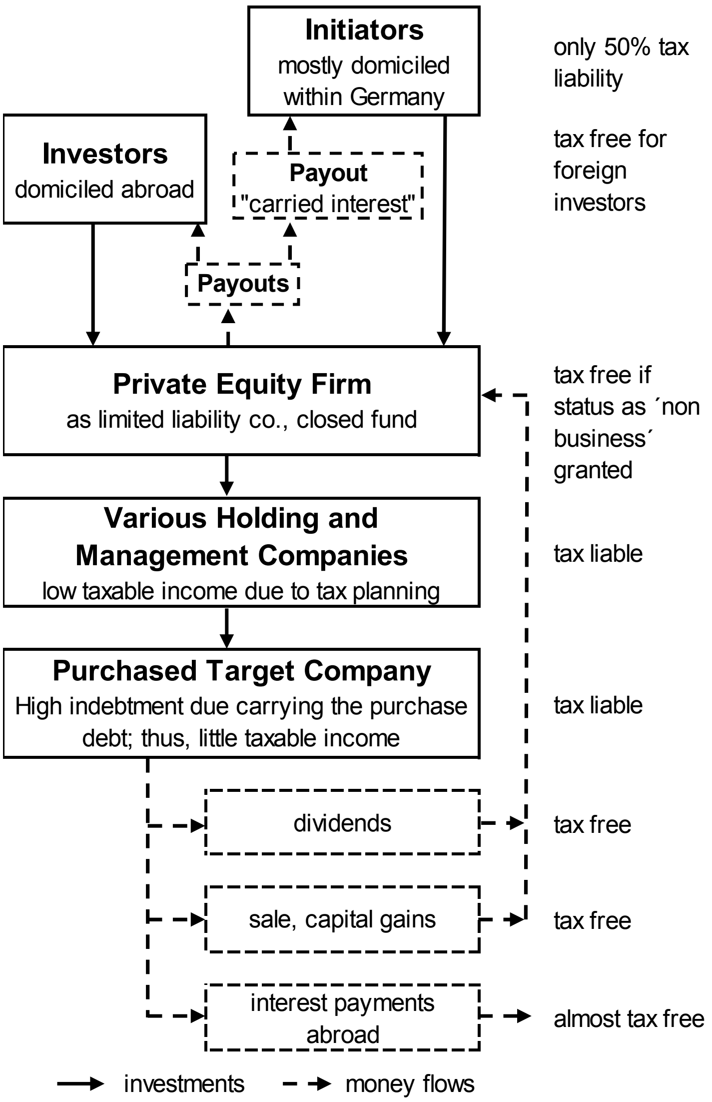
An Expertise for the Hans-Boeckler-Foundation, Düsseldorf, Germany

## EXECUTIVE SUMMARY

Full Expertise available (in German) at www.JARASS.com, taxes; draft of translation R. MOORE, Wiesbaden

**A)** What are and what do Funds do, in particular the two, much discussed, Private Equity and Hedge Funds, which have been compared to beasts of prey and locusts? Does the German national economy need such equity investors, perhaps due to a shortage of capital? And then, the central question: are they so urgently needed, that at the expense of other taxpayers they must be provided with massive tax advantages, as their sector and it's affiliated research institutes claim? And: which target group - if any - should receive tax advantages to promote the formation of start-up enterprises in areas of innovative technology?

**Business Model of Private Equity Funds**




**B)** Hedge Funds, largely domiciled in tax paradises, protect the money entrusted to them, as the word states, by means of spreading the risk for the investors, for example, arranging purchases of goods secured against currency exchange rate volatility; but, in fact, they live from high risk speculation with futures contracts and currency. Often it works, sometimes not: billion dollar collapses in the last years have shaken not only the international banking system but also its regulators in important countries; thus international regulation of these funds is sought for. The taxation of their yields generated in Germany is in principle possible via their German financial partners.

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Private equity funds have a branch in the target country in order to use the largely foreign money of anonymous investors to purchase firms with high cash flow, to subsequently burden the purchased firm with debt in order to refinance the original purchase. The graphic shows their typical business model. It results in a double tax advantage: the taxable profits of the purchased firm are driven down to zero by interest payments on debt, high consulting costs, and loss carry forward. In case the firm can no longer support the debt costs, it is “restructured,” which means, piece for piece sold off, employees fired. Additionally the funds attempt, so far with success, to attain the tax status of administrators of property such that all of the income from within Germany and the resale gains are tax free and can be paid out tax free to the largely foreign investors.

**C)** The German Private Equity and Venture Capital Association (BVK) argues that the German economy needs the money of Equity Funds and “…without the availability of tax transparency,” i.e., without tax exemptions for the cash flow of the funds transferred abroad, “foreigners will not invest in Germany.” On the basis of the criteria elaborated in the accompanying box, one must conclude: providers of financing, who offer additional financing to a German economy which is not suffering from a shortage of capital, should in no way - including regulation and taxation - be privileged over investors who domestically finance factory buildings or install production machinery.

**Five Questions and Answers to the Proposal for Extensive Tax Exemption for the Funds Industry**

(1) Does there exist a need for more finance capital which only the funds can fill?
**Answer**: As often emphasized by the German Bundesbank, there is no shortage of finance capital within Germany.

(2) Do the funds generate benefits which clearly compensate for the social costs?
**Answer**: There is no statistically significant proof for this.

(3) Does the special status of the funds produce a negative distortion of competition?
**Answer**: Yes, due to privileges, they can pay higher prices for their targets than the regulated tax-obligated competition.

(4) Are in principle similar tax relevant facts treated unequally in terms of taxation?
**Answer**: Yes, other financial service providers are not given such tax privileges for the same services.

(5) Does the funds branch provide an important and irreplaceable contribution for the promotion of new innovative companies for instance in the high tech area?
**Answer**: No, most of such financing is covered by government development banks or specialized large companies; for the funds, such investments are a small side-business.

**D)** According to the proposals of the branch and their associated institutes, the extensive tax exemptions should be secured by legislative regulations, which define the funds as mere asset managers, in stark contrast to their actual business activities, which consist in largely foreign financed company takeovers, short term holding of the companies, consulting and massive actual control of the targeted company. The desired result: no business tax, no tax on resale gains, and, from 2009 on, for their domestic finance partners only a 25% lump sum tax instead of the 45% top income tax rate, for foreign investors no taxation at all in Germany.

**E)** On June 29, 2007 a ministerial working group has published a proposal for a venture capital law. Unfortunately – due to pressure from the CDU/CSU Bundestag faction and the

Economics Ministry – this proposal does by no means exclude the possibility of “tax planning and free riding” properly feared by the Federal Finance Ministry. The proposal sets the limits on equity and age of the enterprise to be financed by the venture capital fund so wide – at most 20 million Euro equity and 10 years since set-up – that any larger enterprise can be structured in such a way by splitting or founding new follow-up companies and by creating debt that it fits the criteria for “venture capital financing” according to the proposal. The resulting annual loss in revenue is estimated to approach 20 billion Euro. It is also highly doubtful that the founder of an innovative technology firm should really be supported by granting tax privileges not to his firm, but to its financing equity fund. Were a venture capital law to be passed, it is essential to minimize possibilities for tax avoidance and free riding: The support must be strictly focused according to purpose, size and age of the firm to be supported - “innovative,” “high tech,” “recommended by expertises,” not older than 5 years and with an equity below 2 million Euro at the time of the fund´s entering. This guarantees fair competition for all other financing enterprises not engaged in the risky business of venture financing.