YPOG Briefing:
Carried Interest – a (never) ending story?

July 19, 2024 | Dr. Isabella Denninger, Dr. Tammo Lüken, Dr. Julian Albrecht, Andreas Kortendick, Lukas Engels

In the court ruling dated April 16, 2024 (Ref. VIII R 3/21, published on July 18, 2024), the Federal Fiscal Court (BFH) affirmed its jurisprudence on the classification of disproportionate profit allocations (Carried Interest) in closed-ended funds. The BFH extended the considerations made in another court ruling in 2018 (Ref. VIII R 11/16) for commercial funds to the tax characterization of Carried Interest in mere asset-managing-funds.

At first glance, the BFH's decision to uphold the tax authorities' appeal might suggest that the tax authorities have succeeded in their controversial classification of Carried Interest as remuneration for activities rather than as a share of profits (refer to the Federal Ministry of Finance's letter dated December 16, 2003, margin no. 24, Federal Tax Gazette I 2004, p. 40). However, this decision only addresses procedural violations from the initial ruling of the Munich Tax Court, which the BFH reviewed on its own initiative. Substantively, the ruling is highly favorable to the taxpayer and aligns with expectations:

According to the BFH, a Carried Interest agreement does not necessarily represent an agreement for (concealed contractual) remuneration for activities, contrary to the flat assumption made by the tax authorities. Consequently, it does not imply that investors must first pay tax on all returns (including Carried Interest payments to the initiators) and then, in a second step, treat the Carried Interest payments as non-deductible income-related expenses. Instead, Carried Interest is typically considered part of the profit distribution, which must be recognized for tax purposes within the framework of standard private equity or venture capital fund structures, as specified by the BFH.

In the opinion of the BFH, the special provision of Section 18 para. 1 no. 4 of the German Income Tax Act does not change this.

The main substantive aspects of the BFH ruling are as follows:

1. **In case of doubt, a profit distribution agreement is assumed**: If Carried Interest is specified in the articles of association, it can either be classified as a profit share or as remuneration for activities. The classification depends on the actual handling by the fund. If, according to the partnership agreement, Carried Interest is treated as an expense (under commercial law) at the fund level and is payable regardless of performance, it is considered an activity fee. However, in typical fund structures, this is generally not the case. Therefore, in cases of doubt, it should be classified as a profit share.

2. **If there is a profit distribution agreement, it must be recognized for tax purposes**: If Carried Interest is paid based on a profit distribution agreement (we refer to point 1), it must also be recognized under tax law. Although partners in a partnership generally have the freedom to determine their legal relationships and profit distribution as they see fit, two

conditions must be met for the profit distribution agreement to be recognized for tax purposes:

a) **Inducement in the corporate relationship**: The distribution of profits must be determined solely by the relationships between the shareholders within the company and, specifically, by their contributions to the company's purpose. If other relationships between shareholders or economic relationships outside the corporate structure have influenced the profit distribution agreement, this would invalidate the causation in the corporate relationship. In typical fund structures, such external influences are usually absent, so the requirement of causation within the corporate relationship should generally be met.

b) **Arm's Length Comparison**: It must also be assessed whether the profit distribution was negotiated in a genuine conflict of interest. Such a conflict typically exists between unrelated third parties. If the profit distribution meets the arm's length principle, it is considered appropriate. In typical fund structures, this requirement is generally not problematic.

3. **Deviating asset-based participation irrelevant**: If there is a profit distribution agreement to be recognized under tax law, a (deviating) attribution of income and income-related expenses based on the capital shares in Section 39 para. 2 no. 2 German Fiscal Code is out of the question. Only the profit distribution rules are to be considered.

4. **The provision of § 18 para. 1 no. 4 of the German Income Tax Act leaves these principles unchanged:** The special provision of Section 18 (1) No. 4 of the German Income Tax Act does not result in the reclassification of a profit share – specifically, carried interest – into concealed contractual remuneration for activities. This conclusion is supported both by the wording and the purpose of Section 18 (1) No. 4 of the German Income Tax Act.

Legal Classification and Practical Tips:

The BFH's court ruling is not legally binding. The Munich Fiscal Court, to which the case was remanded due to procedural violations, will need to make a new ruling, considering the BFH's guidance.

However, legal practitioners can gain some certainty regarding the classification of Carried Interest as a profit share even before the final, binding decision in the second instance, as the BFH's substantive statements were notably clear. All key legal issues should now be considered resolved. The recognition of profit distribution agreements in typical fund structures aligns with longstanding practice. It remains to be seen whether the tax authorities will ultimately accept this case law, which would be desirable for legal certainty.

This is positive news for private equity and venture capital funds, their initiators, and investors. Investors holding shares in an asset-managing fund as private assets for tax purposes could have faced undue burdens under the tax authorities' previously rejected stance.

Nevertheless, some questions remain unresolved: While it is now clear that Section 18 (1) No. 4 of the German Income Tax Act does not apply at the fund level, and does not affect profit distribution or income calculation at this level, it is still uncertain whether the reclassification under Section 18 (1) No. 4 of the German Income Tax Act (from capital income to activity income) occurs at the level of the carry vehicle typically participating in the fund (a pure bundling company) or only at the higher level of the carry holder (natural person). The BFH's statement that Section 18 (1) No. 4 of the German Income Tax Act "only affects the level of the Carried Interest holder or a carry holder company" continues to leave room for interpretation. It is not clear whether "carry holder company" refers to the typical carry bundling vehicle or, less commonly, a personal carry holding company of a carry holder. This distinction may be relevant for carry holders operating abroad or those with a relatively small contribution to the fund's investment activities.