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Obstacles for Private Equity Managers in Asset Law

While family entrepreneurs usually deal with questions of asset structure and succession plans at an early stage, this issue is often pushed into the background for investment managers of private equity funds (hereinafter also referred to as „PE managers"). However, it is also crucial for PE managers to deal with this issue in order to avoid unwanted German (tax-)legal encroachment in their assets.

Although PE managers often do not consider themselves classic entrepreneurs, their asset structure is certainly comparable to that of entrepreneurs. PE managers are usually in an employment relationship with the management companies of private equity funds or private equity companies. However, they do not receive their main compensation from their place of employment, but from their share in the private equity funds. These are primarily fund shares (so-called carried interest), which participate disproportionately in the value development of a private equity fund. In addition, PE managers often invest in the fund through so-called co-investments.

It is not uncommon for investors to emphasise the commitment of PE managers in their own fund when assessing the attractiveness of a private equity fund. In the past, especially in US funds, PE managers were virtually expected to invest a large part of their own assets in the fund (so-called skin in the game). As a result, the majority of PE managers' assets are always invested in their own fund. The investment is also characterised by the fact that it can hardly be liquidated during the duration of the fund. In contrast to traditional corporate investments, these investments are also much more volatile. This is due, among other things, to the fact that the carried interest only arises once the fund's assets have grown by a certain amount and then rises disproportionately. In the event of negative asset growth, the value of the carried interest also drops disproportionately. These fluctuations in the value of the PE manager's assets are ultimately book values

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that initially do not appear to have any German tax or legal implications for the manager, as the reporting-date principle ("Stichtagsprinzip") in German income tax law only results in taxation when the PE manager receives compensation.

For the PE manager, however, his fund share already has German tax and civil law consequences of which one is not always aware. The reporting-date principle does not apply to certain asset encroachments of PE managers under German tax or civil law: under German tax law, there is (so far) only a threat of access to the assets in the event of inheritance or donation, as there is currently no wealth tax levied in Germany. Under German civil law, there is a threat of access to assets primarily in the case of inheritance in the form of claims to a compulsory portion and in the case of divorce.

When it comes to asset structures and succession plans, obstacles lurk around every corner. Those affected are confronted with complex questions of inheritance, family, corporate, and tax law that are often overlooked. In addition to economic risks, family risks must also be kept in mind. Family ties can quickly be jeopardised. In the following, some obstacles and structuring options will be pointed out that every PE manager should keep in mind when deciding on his asset structure and succession plan.

First obstacle: claim to the compulsory portion

First of all, (overlooked) claims to a compulsory share ("Pflichtteilsansprüche") cause problems. If descendants or spouses are not or not sufficiently provided for in the will, they are entitled to a compulsory share. In this case, they can claim half of their statutory share of the inheritance as a compulsory share. In the case of a married couple living under the matrimonial property regime of community of accrued gains with two children, the spouse is entitled to a compulsory share amounting to one quarter and each of the children to one eighth of the total value of the estate. The claim to a compulsory share thus guarantees a minimum share in the inheritance. It can be claimed by the heirs once the estate is subject to succession. What is often not considered: The compulsory share claim is a purely monetary claim. In contrast to the heirs, the beneficiary of the compulsory share does not receive a proportionate share of the estate. The heirs must fulfil the claim to the compulsory share immediately after it has been asserted by the beneficiary of the compulsory share. If the estate consists mainly in carried interest and co-investments, the heirs are confronted with a major problem: During the duration of the fund, liquidation is hardly possible; other liquid assets are unlikely to be available.

The only possibility to prevent this risk is a waiver of the statutory right to the compulsory share ("Pflichtteilsverzicht") by all beneficiaries. However, this can only be done with a notarised waiver of the compulsory share agreement with the beneficiaries. This will hardly be possible with underage children. In the case of spouses, this should be regulated within a prenuptial agreement.

Second obstacle: claim to the equalisation of accrued gains

The so-called claim to equalisation of accrued gains ("Zugewinnausgleichsanspruch") is also a purely monetary claim, so that the same (liquidity) problems often arise as with the claim to a compulsory share. If the spouses live in the matrimonial property regime of community of accrued gains, the matrimonial property is divided between the spouses in the event of divorce by means of equalisation of accrued gains. This does not mean, as is often assumed, that the assets acquired during the marriage henceforth belong to both spouses. Rather, the spouse who has accrued more during the marriage is obliged to pay half of the excess increase in assets to the other spouse.

Suitable arrangements should therefore be found within a prenuptial agreement in order to avoid such outflows of liquidity. For example, the statutory equalisation of gains can be modified by agreement (so-called modified community of accrued gains, "modifizierte Zugewinngemeinschaft"). The spouses have a wide range of options at their disposal. In many cases, it is advisable to exclude the private equity investments or to agree on a cap for the equalisation claim. In addition, a deferral of the payment claim can be considered. For tax reasons, however, it is advisable to refrain from agreements in which the claim for equalisation of gains is not to be met by a cash payment but by the transfer of other assets such as private equity holdings. The transfer of tax-encumbered assets is considered a realisation event for income tax purposes!

Furthermore, it is possible to fully exclude the claim to equalisation of gains by agreeing on the matrimonial property regime of separation of property ("Gütertrennung"). In the past, the separation of property was not advisable from a tax point of view, since the claim to equalisation of gains is exempt from inheritance and gift tax and this valuable tax privilege for spouses is completely "given away" in the case of the separation of property. According to the most recent case law of the German Federal Fiscal Court, however, it is possible for spouses to agree on a settlement payment in the event of the separation of property (so-called "Bedarfsabfindung"), which, like the claim for equalisation of gains, is not subject to German gift tax. In contrast to the community of accrued gains, the spouses can quantify the financial settlement in the event of divorce in advance if they agree on a separation of property with a settlement payment, thus avoiding complex valuations of the individual assets. However, as this is not yet established case law, caution is advised when drafting the agreement.

In addition, it should not be disregarded that matrimonial agreements are always subject to a judicial review ("Inhalts- und Ausübungskontrolle"). A prenuptial agreement that is based on unequal negotiating positions and unreasonable disadvantages for one of the spouses may be invalid. The courts review prenuptial agreements to determine whether they were immoral at the time they were concluded ("Inhaltskontrolle") and, if they were not immoral, whether the spouse benefiting from the agreement may no longer rely on it because this would constitute an abuse of his or her legal power ("Ausübungskontrolle").

Third obstacle: inheritance and gift tax

When carried interest and co-investments are inherited or given away, this transaction is subject to inheritance and gift tax. This also applies during the duration of a fund. In order to be able to subject the transaction to inheritance or gift tax, the tax offices undertake a complicated valuation of the investments. The extent to which deferred taxes are deductible in the valuation is still unclear. Even though the valuation for inheritance tax purposes may take some time, the liquidity problem is generally only postponed. Due to the reporting-date principle, there is also the danger that the tax is levied on the estate assets at the time of the inheritance, but the estate assets are greatly reduced in value after the inheritance. There is little grounds to hope for an exemption from inheritance tax due to gross inequity.

For this reason, the aim should be to structure assets in a way that is optimised from the point of view of inheritance and gift tax during one's lifetime. Moreover, flexible inheritance law arrangements should be chosen to ensure that the estate can be adapted to changing life and financial situations at any time. If necessary, the conclusion of term life insurance policies ("Risiko-Lebensversicherungen") should also be considered in order to be able to handle the payments of inheritance tax (so-called "Erbschaftsteuerversicherungen"). However, German insurance companies are sometimes reluctant to insure the deferred inheritance tax on private equity funds.

Lifetime transfers of assets to family: the family company

It often makes sense to transfer assets to family members, especially children and spouses, while one is still alive. On the one hand, this can minimise one's own liability risk. However, the transfer of assets to the family prior to decease is also suitable for tax reasons. By transferring assets to family members during the lifetime, they can benefit from any increase in value without any inheritance or gift tax consequences. The establishment of asset-managing family companies ("Familiengesellschaft") is often suitable for this purpose. In a family company, assets are contributed to a company and then shares are transferred by gift.

The underlying idea is to bundle family assets for all generations. A family company is usually set up in the legal form of a partnership ("GbR"), limited partnership ("KG") or limited liability company ("GmbH"). The choice of the right legal form depends on various factors such as founding costs and expenses, involvement of minors, liability, accounting and publicity obligations, and termination options. Subsequently, the assets, for example the co-investments, are transferred to the company. Usually, the transfer of the carried interest is not advisable for tax reasons. The classic carried interest is (currently) subject to the partial income procedure (“Teileinkünfteverfahren”) and thus only 60% is taxable. It is doubtful to what extent this privilege will continue to exist when the carried interest is transferred to a family company.

The family company enables a gradual transfer of assets to the children, whereby the German gift tax allowances (EUR 400,000 per parent per child) can be utilised every decade. If minor children are involved, the appointment of a supplementary curator and family court approval or family court confirmation that no such approval is required (so-called “Negativattest”) is usually required. It is not necessary that the assets are also “given out of hand”. By means of provisions in the partnership agreement, assets and administration can be separated and far-reaching control over the assets can be achieved. Thus, the voting rights of the children can be reduced or even excluded. In order to gradually introduce the children to the assets, their competences can be successively expanded. Experience shows that dealing with the assets at an early stage and involving one’s own family in asset matters helps to prevent inheritance disputes and strengthen family ties.

Transfers upon death: the super legacy

Typically, spouses determine in their wills to appoint each other as sole heirs and that their children will only inherit afterwards (so-called “Berliner Testament”). In addition to the danger of the (initially disinherited) children asserting their claim to a compulsory portion in the first devolution of inheritance, this arrangement entails serious tax disadvantages. Since the surviving spouse inherits alone and the children only subsequently, there are two taxable transfers. Due to the higher assessment basis, there are considerable progressive tax disadvantages. Furthermore, the personal tax allowances of the children are lost in the first devolution of the inheritance.

The “super legacy” (“Supervermächtnis”) often offers a suitable means of structuring the situation: it secures the advantages of the Berliner Testament under

German civil law (sole heir status of the surviving spouse including free and unrestricted power of disposal over the entire estate) and avoids the associated German (inheritance) tax disadvantages (no use of the children's personal allowances following the death of the first parent, repeated taxation of the estate upon the death of the second parent and progression disadvantages). At the same time, the "super legacy" grants the greatest possible flexibility, in the sense that the tax succession arrangements can be postponed to the time after the death of the first parent.

For that purpose, the spouses appoint each other as sole heirs. The surviving spouse is burdened with a "super legacy" in favour of the children. The surviving spouse should be able to decide at his or her own discretion how much of the assets he or she needs for his or her own living expenses and how much the children should receive immediately upon the first inheritance by way of legacy. For this purpose, the surviving spouse determines whether or which of the children receives "what, when, and how much". The "super legacy" is widespread in practice. Nevertheless, there has not yet been a supreme court decision on the "super legacy". Statements by the tax administration are also not known. However, there are no (tax) legal concerns if it is structured correctly.

Conclusion

To ensure legally effective and tax-optimised asset structures and succession plans, an expertise in the intersectionality of inheritance, family, corporate and tax law is required to remove all obstacles. Particular attention should be paid to the statutory right to a compulsory portion and the claim to equalisation of gains. If carried interests and co-investments are inherited or given away, inheritance and gift tax is due. This can be reduced by suitable arrangements (e.g. setting up a family company or super legacy). If one's own assets consist mainly of private equity investments, the problem of insufficient liquidity should be recognised and solved at an early stage in the event of potential asset encroachments.

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Dr. Christoph Philipp has been a lawyer and partner at Poellath for 20 years. He is specialised in advising on national and international succession planning and asset structuring, including inheritance law and inheritance tax law. In the current Handelsblatt/Legal Success – Best Lawyers® he was ranked among the 40 "top lawyers" for succession and wealth for the ninth time in a row.

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