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YPOG Briefing

Shadow Directors in Private Equity Fund Structures: Concept Misunderstood

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Overview

These days, German prosecutors are increasingly setting their sights on private equity (PE) fund structures. While the structures that are the subject to these investigations are quite different, the proceedings tend to revolve around the same core issue, namely the "place of management." Given the clear case law of the German courts, the accusations raised against German managers and advisers of PE funds are completely baseless. And yet, the lengthy investigations are bound to seriously harm Germany as a location for PE funds and managers. Capital commitments may not be forthcoming, PE managers may leave. This cannot be in anyone's interest.

Allegations of tax evasion raised against German PE fund managers

German managers and advisers of both domestic and foreign PE funds - all of which are tax-transparent partnerships under German and foreign law (GmbH & Co. KG / Limited Partnerships) - are accused of evading corporate income, trade and capital gains tax for the benefit of foreign corporations - indeed, even for the benefit of foreign general partner corporations that do not have any income at all. These corporations are involved in cross-border PE structures that frequently are of a highly complex nature:

- Foreign investors and their capital are pooled in a foreign blocker corporation, which – in lieu of multiple investors – becomes the limited partner of a German PE fund partnership. Even seasoned tax officials frequently recommend the interposition of this type of foreign company in an intermediary or preliminary role, since having fewer foreign parties involved in the German partnership income assessment means that the assessment procedures for determining and attributing income are significantly simplified.

- As a general partner corporation, typically without relevant income, of a foreign fund partnership.

The German authorities allege that the German-resident managers/advisers of the German PE fund were to qualify as so-called "shadow directors" and would "control" everything, including the corporations abroad as well as their foreign directors. They are deemed "shadow directors" of the foreign corporations, since, in the prosecutors' opinions, cross-border PE fund structures with companies in Germany and abroad are allegedly to be looked at (and assessed) as a whole (i.e., at the "overall actions" of all entities involved in the cross-border fund structure) rather than by looking at the facts and circumstances of each individual company.

By reason of the German PE managers and advisors being deemed "shadow directors", they are thought to establish a German place of management of the foreign companies (corporations), entailing German tax obligations of the foreign companies and their directors, shareholders or partners. The domestic PE managers/advisers allegedly failed to inform German tax authorities of this in willful breach of their duty to inform the tax authorities of facts relevant for German tax purposes within the meaning of Section 370 (1) No. 2 of the German Fiscal Code (AO). They are accused of tax evasion through omission.

Tax evasion allegations contradict case law

However, these allegations are inconsistent with the clear case law of the German courts. The German courts have repeatedly held that:

- Each company and its day-to-day business must be assessed separately (BFH, Dec. 7th, 1994 – I K 1/93).

- In the context of tax evasion accusations under Section 370 (1) No. 2 AO, Sections 33, 34 and 35 AO replace the legal concept of the "shadow director". By its decision of August 23rd, 2017, the German Federal Court of Justice (BGH) confirmed its judgment of April 9th, 2013. In said ruling, the BGH had found that other than the taxpayer and the legal representative, only the person with powers of disposal as defined in Section 35 AO may be a tax evader in case of Section 370 (1) No. 2 AO ("failure to inform"), but not the shadow director, who lacks any legal power to dispose of the funds of the other (concurring: Madauß in a comment on the BGH judgment of August 23rd, 2017 - 1 StR 33/17, NZWiSt 2018 p. 498 and reference to BGH in NZWiSt 2013 p. 311, marg. no. 79; also see BGH, July 13th, 2018 - 1 StR 34/18, NStZ 2018 p. 673: in the case in dispute, the public prosecutor's office took the view that the position of a shadow director cannot give rise to complicity in the commission of the offence).

Tax evasion allegations out of touch with reality

However, the allegations do not only contradict case law. They also are out of touch with reality. If the alleged tax evaders had intentionally and in breach of their duties failed to inform the German tax authorities of allegedly tax-relevant facts (the alleged German place of management of the foreign companies) and obligations of these companies to pay tax in Germany, they would also have undermined their own business without any advantage for themselves. This is a rather far-fetched scenario, especially since direct investments by foreign investors frequently are more favorable without such foreign blocker companies. However, just as almost all German investors interpose a GmbH (limited liability company) between themselves and investments abroad as a protection from

unknown risks, foreign investors, too, tend to invest not directly but through holding or intermediary foreign corporations.

Shadow management limited to outlier cases

The hurdles set by the courts for assuming a shadow management (in German and in the cases at hand: "faktische Geschäftsführung") are extraordinarily high and thus have, unsurprisingly, been found to have been met only in exceptional cases.

German civil and penal law only require identifying a shadow director as an "unseen orchestrator", artificially "assigning" responsibility to them and holding them liable for the acts of the represented entity, if there are no formal directors with sufficient capacity who are representing the company in external dealings. The question of responsibility "like a director" only arises if there is no "real" director, i.e. no natural person who has been appointed and is acting as director. Under German penal law, cases where parties are acting alongside a duly appointed director acting as such can be dealt with by relying on the penal law concepts of accomplices or accessories or the civil law concept of joint and several liability. However, neither the legislator nor the courts do so in the cases of Section 370 (1) No. 2 AO (see under 2.: "tax evasion through omission").

In tax law, for the past century, fiscal case law has assumed a domestic place of management by reason of the management being performed by a German resident qualifying as a shadow director only in outlier cases. These cases concerned controlling (sole) shareholders who also had a share in the assets and income of the relevant companies.

- The question whether a person has de facto assumed the functions legally ascribed to the (managing) director and, consequently, is to be held responsible for their conduct similar to a properly appointed (managing) director, is determined based on the overall impression given by their actions, especially in external dealings.

- The de jure director's reliance on or susceptibility to instructions is not as such sufficient to assume that another person acts as a "shadow director" ("faktischer Geschäftsführer").

- The crucial aspect here is that the person concerned has taken charge of the company's affairs - going beyond internal influence on statutory management - by acting in external dealings in a way that by law is reserved to the legally appointed members of the company's management body.

- The courts have found that the internal coordination of important decisions between the formal directors and other persons - in this case the German PE managers/advisers -, their potential influence on the de jure directors and their decisions are not sufficient to assume that someone is in the position of a shadow director, even in circumstances where business decisions require the consent of these persons.

- These activities merely represent internal influences and instructions on the company's statutory management, whereas, any qualification as a "shadow director" requires external actions, i.e., the person actually represents, or at least gives the impression to the outside world to represent, the company in its external dealings.

- According to case law of the highest courts, such internal decision-making processes and any consultation of the statutory directors with external advisers (e.g. prior to the disbursement of funds) merely represent intra-corporate influences which do not at the same time establish a position as shadow director. This is true even if the intensity of such influence or instruction were to degrade the statutory directors to mere "subordinates, receiving orders" (also see BGH II ZR 196/00 marg. no. 10 = SGHZ 150 p. 61).

- The concept of shadow management cannot be summarily applied to all actions with an effect on external relationships, even if these actions carry significant weight. By way of example, the actions of advisers in external relationships with regard to the initiation of business for the commissioning company, the identification, selection and calculation of investment objects do not establish a position as shadow director, and neither does the provision of data that are essential for a decision by the relevant company.

- The German courts do not even consider a potential right of co-decision of advisers in the purchase and sale of investment objects sufficient to establish shadow management. Similarly, it is not enough for advisers to lead contract negotiations and participate in pricing. The Higher Regional Court of Munich has ruled that such activities are usually not reserved for the statutory directors alone, especially if the business transactions are legally concluded by the statutory directors, who thereby indicate that they represent the company.

It is inexplicable how, given such clear case law on "shadow management", the aforementioned investigative proceedings could have come about.

PE funds with passive capital income are not comparable with globally operating corporations

Furthermore, the investigations against PE fund managers can also not be justified with reference to the recognized rules of transfer pricing that may be applicable to globally operating corporate groups with risky large-scale projects and multi-state relations, where the focus is on value, function and risk of entrepreneurial activities in a corporate group with companies in many countries. The rules that apply there are of no relevance for the tax assessment of cross-border PE fund structures with merely passive capital income. Considerations of transfer pricing do not decide the place of management.

The compensation of third-party directors of foreign blocker companies is low because their day-to-day business (processing of capital inflows and outflows and their proper accounting) is quite straightforward and requires little work. Moreover, this type of compensation is not agreed between related companies in a global corporate group, but between unrelated third parties. Transfer pricing is not an issue.

The same applies to the management compensation received by active PE managers from the PE funds for asset management. These fees are paid indirectly at the expense of the passive capital investors, who are in a third-party relationship with the managers. For decades, passive capital investors across the globe (including highly sophisticated institutional investors) have agreed and accepted to pay a management fee of approx. 2% p.a. relative to the amount of capital commitments or invested capital according to normal market practice. Again, transfer pricing is not an issue here either.

The investigative proceedings also cannot be justified by reference to performance-related compensation of third-party directors, such as board members of DAX companies. Performance-related compensation contractually agreed by board members of DAX companies are evidently irrelevant for the case at hand, not least since the contractual compensation agreements and corporate structures, including performance-related payments, follow completely different "rules of play" in PE "partnership structures" compared to those in DAX corporations with a capitalist structure. Comparing PE managers with board members of DAX companies paid on a performance-related basis is also flawed, since - endorsing the concepts applied by investigating officers - this inevitably leads to the question of whether board members of DAX companies also establish a place of management in Germany for the group's foreign affiliates, with the consequence that for decades, they have been criminally evading corporate income, trade and capital gains tax for the benefit of all of these foreign companies and at the expense of the German municipalities. A downright absurd notion!

Fast and furious

Despite the serious misunderstandings (and continuing lack of understanding), investigations against PE fund managers and advisers are expected to gather momentum. Evidently without distinction, a broad range of structures would be taken up. Innocuous agreements, documents and harmless e-mails would be "tuned up" so as to set them up as incriminating material by referencing rules from altogether different areas. In the so-called Goldfinger case, the chief judge of the Regional Court of Augsburg described the investigations at the time as a "waste of resources." This is certainly also true for the investigative proceedings addressed here, especially as it is not a matter of tax optimization, but one of investing assets of (typically tax exempt) institutional investors, primarily insurance companies and pension funds, which merely use these investments to generate income for the benefit of the insured and of pensioners.

It is high time for those acting fast and furiously to take their foot off the accelerator and for the proceedings to be brought to a halt as quickly as possible. Any tax issue that may remain (if any) should be calmly discussed and resolved by professionals in the course of ordinary tax procedures. Strength is born of calmness. To put it once again in the language of the world of movies: There is no need for speed.

We are happy to support you and open for further exchange.

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