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# Private equity fund earns trading income

**The Supreme Tax Court has held that a closed private equity/venture capital fund is a trading venture taxable in its country of establishment. If it is exempt there by reason of local regulation, its income does not revert to German taxation by virtue of treaty or statutory provisions on conflicts of qualification.**

A series of German institutional investors (subsidiaries of banks) bought shares in a closed private equity fund in the UK. The fund took up equity shares in start-up companies with the general intention of seeing them through the first four years of their development. It would then either float the company on the stock exchange, or sell the shares as a trade investment. The fund was managed by a management company with appropriately qualified professional staff and operating facilities, but did not have its own staff, or premises. It was organised as a limited partnership, the German investors being the limited partners. The UK authorities exempted the fund's income from taxation under a concession for the encouragement of equity capital; the German tax offices saw the fund's activities as asset management, rendering its income and capital gains immediately taxable in Germany in the hands of the partners.

The Supreme Tax Court has now held that the fund should be viewed as a trading entity, that being its appearance to the outside world. That it had outsourced its investment decisions and, for that matter, its administration, to a management company did not detract from this. Rather, it was bound by the actions taken by the management company on its behalf. The management company employed qualified professionals to select, and then support and encourage, its investments. It thus took part in their internal management affairs. It operated not only with its partnership capital, but also with funds borrowed from banks and other sources. It regularly bought and sold investments in order to earn sufficient profits to pay for its interest costs. From all points of view, it acted as a business in the full ownership of other businesses, trading in securities, and should be taxed as such. Having reached this conclusion based on the operating circumstances, the court went on to add that the fact that as a limited partnership with a limited company as its sole general partner the fund would have been classified as a trading entity by German legal definition was not relevant to the present case. Rather, a German domestic rule on the qualification of income could not affect treaty interpretation.

The court qualification of the fund as a trading entity led, in this case to complete exemption of the earnings of the German partners. Under the treaty they were taxable in the UK on the income from their partnership shares, ranking as permanent establishments. Under a UK concession for the promotion of venture capital, the income was exempt. This double exemption was not the result of a treaty qualification conflict, and so was not caught by the switch-over clause in the treaty (in any case only relevant to capital gains) or by the German anti-treaty abuse provision of Sec. 50d (9) Income Tax Act (treaty override). Accordingly, the court was able to defer yet again a final answer to the all important question of whether the treaty override is in conflict with the constitution or, for that matter, international law.

Supreme Tax Court judgment I R 46/10 of June 30, 2011 published on October 26

**Keywords**

Private Equity, start-up companies, treaty override