

German Investment Tax Reform Act

September 2016
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On 26 July 2016, the German Investment Tax Reform Act (*Investmentsteuerreformgesetz*), dated 19 July 2016, has been published in the German Federal Gazette. The Investment Tax Reform Act provides for the following major changes to the German Investment Tax Act (“**InvTA**”):

- introduction of a general opaque taxation regime for all types of investment funds; and
- continuation of the current semi-tax transparent taxation regime for certain special funds (*Spezialfonds*).

Current Taxation Regimes under the German InvTA

The current version of the German InvTA provides for a semi-tax transparent taxation regime which is generally available for all investment funds if certain tests (including strict investment restrictions) are fulfilled. The rationale behind this regime is that fund investors are treated as if they hold the assets directly, because investment funds are only vehicles to enable investors to invest collectively in risk diversified assets managed by experienced fund managers. The income of such semi-tax transparent investment funds is taxed at the level of the investors and the investment funds are generally exempt from German corporation and trade tax. On this basis, investors are taxed not only on distributed income of the investment fund, but also on so-called deemed distributed income (“**DDI**”) ie certain income of the investment fund (eg dividends, interest and rent),

which is attributed to the investor even if it is not distributed.

If a fund does not qualify as a semi-transparent investment fund and is a company or a separate pool of assets (eg a Luxembourg FCP), it is treated as an opaque investment company which is subject to German corporation and trade tax. The tax treatment of funds structured as a partnership (or equivalent) is based on the general tax transparent regime for partnerships under German tax law, if the partnership does not qualify as a semi-transparent investment fund.

Under the Investment Tax Reform Act, the two existing regimes will be abolished and the semi-tax transparent regime will only be available for special investment funds with the result that all other investment funds (with the exception of partnerships) will be treated as opaque for German tax purposes.

New Opaque Regime

The introduction of a general opaque taxation regime is a **fundamental change** in the German taxation of funds, considering that the regime will automatically apply for all types of German and foreign investment funds including undertakings for collective investments in transferable securities (UCITS) and alternative investment funds (AIF). With regard to partnerships or similar foreign legal forms, the opaque regime will only apply if the fund qualifies as a UCITS or pension asset pooling fund.

Taxation of the Fund Entity

For **German corporation tax** purposes, an investment fund will be treated as opaque with the result that the following earnings may be taxed at a German corporation tax rate of 15% (including 5.5% solidarity surcharge) at the level of the investment fund:

- dividends paid by German tax resident corporations;
- income from real estate located in Germany; and
- certain other taxable German source income as defined in the German Income Tax Act (but not capital gains from the disposal of shares in German tax resident corporations).

As these types of income are also taxable in Germany for foreign investment funds, a German domestic investment fund will be taxed in the same way as a foreign investment fund. The background to this harmonisation is the need to eliminate non-compliance of the current version of the German InvTA with European law.

Dividends paid by German tax resident corporations will be subject to **German withholding tax** at a rate of 15% (instead of the standard rate of 26.38%) if the withholding agent has been provided with a certificate issued by the competent tax office which confirms its opaque status as an investment fund.

The income of opaque investment funds is generally subject to **German trade tax**. The Investment Tax Reform Act provides an exemption from German trade tax for investment funds if the purpose of the investment fund is limited to the investment and administration of its assets for the collective account of its investors and if the fund does not carry on a commercial business with regard to the assets being held by the investment fund. In addition, there is a *de minimis* provision such that the trade tax exemption will still apply if any income from a commercial business is less than 5% of the investment fund's total income.

Opaque investment funds will not need to comply with any **tax reporting requirement** as, under the Investment Tax Reform Act, the administratively burdensome obligation to publish the DDI and other relevant German tax data in the German Federal Gazette (or elsewhere) on a regular basis will be abolished. As a result, the lump-sum taxation regime, which is triggered under the current law at the level of investors in case of non-compliance with the tax reporting duties, will no longer exist.

Taxation of Investors

The following earnings of an opaque investment fund will be taxable at the level of the investors:

- distributions from the investment fund;
- the lump-sum taxation amount; and
- capital gains from the disposal of the fund units.

The **lump-sum taxation amount** will be introduced as a substitute for the abolished DDI system. Similar to the taxation of the DDI under the current version of the German InvTA, the lump-sum taxation amount will be attributed to investors without distribution on an annual basis as of 1 January of the following calendar year. The lump-sum taxation amount is calculated on the basis of the redemption price per share at the beginning of the year multiplied with the so called base interest rate (*Basiszins*) as determined by the German Valuation Tax Act (as from 1 January 2016: 1.10% p.a.) being reduced by a 30% cost component. However, the lump-sum taxation amount will be capped to the actual increase in the redemption price during the year. The lump-sum taxation amount is reduced by actual annual distributions of the investment fund.

With regard to the **taxation of the German investors**, the above-mentioned income from the opaque investment fund will be taxed at the German flat rate tax of 25% (plus solidarity surcharge and church tax, if applicable) in the case of private individual investors or at the personal income tax rate or corporate income tax rate and, where applicable, trade tax in the case of investors holding the fund units as business assets. The German domestic partial tax exemption regimes (ie 95% participation exemption for corporations and the 40% partial income tax exemption for individuals) and tax exemption pursuant to several double tax treaties will not be applicable. However, the Investment Tax Reform Act provides the following **partial tax exemptions** for distributions, gains from the disposals and redemptions of fund units and lump-sum taxation amounts:

- if the fund invests at least 51% of its NAV in stocks (Equity Fund): 30% for private individual investors, 60% for business individual investors and 80% for corporations;
- if the fund invests at least 25% of its NAV in stocks (Mixed Fund): 15% for private individual investors, 30% for business individual investors and 40% for corporations;
- if the fund invests at least 51% of its NAV in real estate or real estate companies (Real Estate Fund): 60% for all investor groups; and
- if the fund invests at least 51% in foreign real estate or real estate companies with foreign real estate (Non-Domestic Real Estate Fund): 80% for all investor groups.

The partial tax exemptions of 60% and 80% with regard to Equity Funds do not, however, apply to life and health insurance companies if the fund units are allocated to their capital investments (*Kapitalanlagen*) or to credit or financial service institutions or finance companies if the fund units are allocated to their trading investments (*Handelsbuch*) or are acquired with the intention to realise a short-term profit.

Transparency for Special Investment Funds

- The **semi-tax transparent regime** as currently applicable under the German InvTA will, generally speaking, continue to exist for **special investment funds** provided that such a fund opts to be treated as semi-tax transparent and complies with certain tests (similar to tests under the current version of the German InvTA in order to qualify as semi-tax transparent investment fund). Status as a special investment fund requires that the number of (institutional) investors is limited to 100.

Taxation of the Fund Entity

German domestic income from shareholdings is exempt from German corporation tax provided that the special investment fund declares to the withholding agent that it opts for the 'transparency option', which means that withholding tax certificates will be issued for investors and the investors are then regarded as the recipients of the dividend income.

The special investment fund will be exempt from corporation tax on German domestic real estate income provided that it deducts and pays withholding tax on distributed and deemed distributed German domestic real estate income and issues respective withholding tax certificates to the investors.

The special investment fund is exempt from German trade tax.

Taxation of Investors

The following earnings of the **investor** of the special investment fund will be taxed:

- distributions from the fund;
- deemed distributed income (which will continue to exist for special investment funds); and
- capital gains from the disposal and redemption of fund units.

The German domestic partial tax exemption regimes (ie 95% participation exemption for corporations and the 40% partial income tax exemption for individuals) will apply to distributions from the fund and deemed distributed income to the extent it can be allocated to capital gains from the sale of shares in corporations.

Treatment of Partnerships

As noted above, the new German InvTA will only apply to partnerships or similar foreign legal forms, if the fund vehicle qualifies as a UCITS or as a pension asset pooling fund within the meaning of the Investment Tax Reform Act. The taxation of other funds structured as partnerships or equivalent foreign legal forms is based on the general tax transparent regime for partnerships under German tax law which already applies to partnership-like investment funds.

Commencement

The proposed amendments will become effective from 1 January 2018. Where an investment fund's fiscal year is not based on the calendar year, the law assumes a fiscal year end as of 31 December 2017 and the relevant German tax data as of 31 December 2017 would need to be determined and published independently from the fiscal year end of the investment fund. Furthermore, the Investment Tax Reform Act assumes a sale of the fund units as of 31 December 2017 at the latest redemption value and, at the same time, an acquisition of the fund units at this level. Taxes on capital gains resulting from the deemed sale of the fund units are deferred until the units are actually sold.

Summary

- Under the Investment Tax Reform Act, the currently applicable semi-tax transparent regime will continue to apply only to special investment funds and only if certain tests (similar to the currently applicable tests) are fulfilled.
- Other investment funds will be treated as opaque for German tax purposes with the result that the income of the fund will be taxed at the level of the investment fund. Partnerships and other similar legal forms will only fall under the scope of the

InvTA if they qualify as a UCITS or pension asset pooling fund.

- The currently applicable German tax reporting duties in relation to, *inter alia*, the DDI will be abolished for public investment funds, which will be a relief for investment funds from an administrative and cost perspective. However, for opaque investment funds an additional lump-sum taxation amount will be introduced which will be attributed to the investor and taxed without distribution (similar to the currently applicable DDI system). Partial tax exemptions at the level of the investors will apply to certain equity and real estate funds.
- The proposed amendments will become effective from 1 January 2018.



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