The German Investment Tax Act (InvTA) has been adopted

8 July 2016

In brief

Finally, the new Investment Tax Act has been voted on.
The final amendments made during the parliamentary process do not constitute significant changes to the draft issued back in December 2015. They rather aim at clarifying matters of detail within the respective articles. Therefore, the key points of the big reform remain unchanged:

- As from 1 January 2018, there will be three categories of collective investment schemes with different taxation rules applicable:
    1. Investment funds (**mutual/retail funds**) are all investment schemes, which are neither a special fund nor a partnership.
    2. **Special funds** are all AIF where the number of investors is limited to 100 non-individual investors. The new law also excludes individuals investing indirectly through partnerships.
    3. Income from investment schemes in the form of **partnerships** will no longer be taxed according to the InvTA but according to the regular German tax regime, i.e. they will have to file a partnership tax return on behalf of their German investors.

In detail

Taxation of mutual/retail funds

1. *Fund level*

Contrary to the current practice, which applies the transparency principle at fund level, under the new law, mutual/retail funds will be in principle opaque and therefore subject to tax. A corporate tax of 15% (plus solidarity surcharge) will be applicable on German sourced income, i.e. dividends, German rents and gains from the sale of real estate, income from securities lending and repos with German shares/participations. There will be no tax benefits for dividends under the new law.

Good news for non-German funds is, that the tax position of foreign funds does not change in practice, as a German withholding tax has in practice always been applied on German income.

German funds, however, can be subject to trade tax, depending on their structure and commercial activity, whereas foreign (non-German) funds cannot be subject to German trade tax.

Any other income – especially interest and income from non-German sources – is excluded from any tax liability in Germany.

2. *Investor level*

According to the new legislation, the following changes will be implemented:

- The requirement to calculate daily figures (Zwischengewinn/Aktiengewinn/ Immobiliengewinn) will be abolished as of 2018.
- Generally, tax should only be due upon distributions or the redemption of fund units as of 2018. However, an annual lump-sum tax will be levied regardless whether the fund is distributing or accumulating.

The basis for this lump-sum tax is calculated as follows:

- The value of the fund unit at the beginning of the calendar year is multiplied by 70% of the legal basis interest rate (currently 1.1%), but limited to the actual increase in value during the calendar year (including distributions). Hence distributions will be deducted from the tax basis of the annual lump sum amount.
- Partial tax exemptions of income are available for distributions, the annual lump sum tax and capital gains from redemption of units of certain type of funds. Depending on the type of the funds the exempt income shall amount to
  - 30% / 60% / 80% for private / business / corporate investors for securities funds
  - 60% / 80% for real estate funds depending on whether the fund is predominantly invested in German or non-German real estate
  - 15% / 30% / 40% for private / business / corporate investors for mixed funds
- In order to apply these tax exemptions, the fund must be invested predominantly (at least 51%) and on an ongoing basis in either securities or real estate. Mixed funds need to be invested for at least 25% in securities.
- This lump-sum amount will be due each calendar year end regardless of the business year of the fund. The time wise inflow of the lump sum tax has to be differed from calendar year end to the first business day of the following year in order to facilitate the tax deduction process, since at the beginning of the year the full allowance amount is available, which investors can offset against their tax liability.

A fund, which is subject to the tax regime for mutual funds, cannot switch to the special fund tax regime at a later stage.

Taxation of special funds

In general, the tax treatment of special funds will be equal to mutual funds, unless the special fund opts for a transparent regime.

When opting for transparency, there will be no taxation at fund level. The special fund will have to calculate the taxable income on an investor-by-investor basis applying the specifics of the different types of investors, e.g. regular corporations, banks, insurers, tax-exempt investors.

According to the new law, the well-known Sec. 5 InvTA reporting and the respective tax certificate will no longer be required. The fund will have to perform a tax filing on behalf of its investors with the competent tax office, in a way, which is comparable to a partnership tax return.

Special funds only qualify as such if no individuals are invested in, be it directly or indirectly. Individuals are in principle no longer allowed to invest indirectly into special funds. There is, however, a limited grandfathering for special funds with individuals being indirectly invested in, if the fund was set-up prior to the resolution of the German Parliament.

In addition, vehicles shall also qualify as investment funds from a tax perspective, if the number of investors is limited to one.

Conclusion

As a conclusion, this new law will change the fund investments' environment in Germany and produce a shift towards institutional funds and non-fund investments.

On the other hand, there will be no dramatic change for institutional funds, as their transparent tax regime remains mainly the same as under the current legislation.

The reporting of the tax figures to the tax office would become more burdensome for special funds though as the new tax filing will be investor specific and has to display the tax consequences for each investor separately.

Cum-Cum trades

Along with the amendments of the Investment Tax Act, the German legislator has introduced new rules regarding the taxation of so called Cum-Cum trades. These rules apply regardless of respective trades being performed directly by investors or via fund structures.

To apply for a tax credit on German sourced income received after 31 December 2015 investors have to meet certain requirements under the so called "45-day rule". Accordingly, shares must be held for at least 45 days during a period of 45 days before and after the dividend ex-date. Also the beneficial owner of the shares must bear at least 70% of the economic risk from these shares during this period.

The rule also applies to German funds with respect to the tax exemption on German dividends.

German shares need to be captured according to the First In-First Out principle for documentation purposes and the impact of corresponding hedging positions needs to be quantified.

Given that the rule applies retroactively from 1 January 2016 also transactions as of beginning of 2016 should be reviewed and their tax treatment analysed.

What you should do now

The new legislation will come into force as of 1 January 2018 so there is still one and a half year left for the fund industry to adopt the new legislation. Nevertheless, as of that date no grandfathering shall exist for funds established before 2018, hence all funds will be treated in the same way.

Nevertheless, as some strategic and operational actions have to be taken prior to 2018 which will involve discussions with third parties and investors, any action at fund or investor level should be evaluated within the next 18 months to ensure the most beneficial set-up.

- Fund managers should review the investor basis of their mutual funds and determine whether institutional investors, especially insurers and pension schemes are invested in these funds.
- Fund managers should evaluate whether a relocation of institutional investors into "tailor-made" special funds or non-fund investment schemes may be an appropriate reaction.
- In specific cases, also the analysis, whether the conversion of a mutual fund into a partnership may be an appropriate reaction.
- Any fund manager should run on a fund by fund basis an analysis which tax regime (mutual fund/special fund) is more beneficial for its investors.
- Assess who would perform the tax reporting as from 2018 onwards.

In any case, it is highly recommended to analyse what needs to be done to be best prepared for the big changeover.

We are pleased to explain the potential changes in German investment taxation to you and together with you analyse the next steps within the next months. We would also be happy to assist you in organising a workshop with a detailed analysis of the implications of the reform to your funds and the respective German investors.

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