

Does your investment vehicle still qualify as fund according to German law?

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Foreign investment funds distributed in Germany usually report tax information to German investors under the Investment Tax Act. Although the rules to be respected in this context are complex, it is an established route, meeting investor expectations.

However, the Investment Tax Act reporting requires that the foreign vehicle qualifies as fund in the German sense. Foreign investment vehicles, which do not qualify as funds according to the German Investment Act, are subject to different tax reporting and filing obligations. As the German rules have changed significantly, numerous foreign investment funds will need to review whether they still qualify as funds under the Investment Act and are still subject to the Investment Tax Act reporting.

Applicable tax rules

A reporting under the Investment Tax Act (InvTA) is the most common and suitable way of providing German investors with information required to account for income from their investments in foreign investment funds in their individual tax declaration. For foreign investment funds this broadly implies that reportable income for German investors needs to be determined under German tax rules, that the compliance with applicable German tax rules is to be certified by an auditor or tax advisor and that the tax relevant income is published in the electronic version of the German Federal Gazette ("Elektronischer Bundesanzeiger") on a per share basis. Although the German rules to determine reportable income are complex, the fund will need to make only one publication on a per share basis to meet German reporting requirements. The further supply of taxable income to "WM Datenservice" will ensure a smooth and highly automated processing of the tax relevant information, which fully meets investor expectations.

The InvTA reporting requirements apply to all funds distributed in Germany under the UCITS directive and all foreign investment vehicles qualifying as funds under the German Investment Act (InvA). For those funds, the Investment Tax Act reporting is mandatory; very disadvantageous tax consequences will arise to the investors in case reporting obligations are not met.

For funds which are not distributed under the UCITS directive or do not qualify as funds under German rules, the tax reporting and filing obligations in Germany depend on the legal form and the tax status of the fund. This may require the fund to file a tax declaration in Germany (either under general rules and/or under German CFC rules) or to provide investors with detailed information to allow them to declare income from their investments. In comparison to the tax reporting under the InvTA, this may cause tax disadvantages to the investors (several tax advantages granted to investment fund investors are not available in case the InvTA is not applicable) and result in an increased administrative burden for both, the fund and the investor. Sophisticated investors might be used to funds not reporting under the InvTA, although most likely, they do not appreciate the related additional administrative work. For retail clients it will be a real challenge to cope with the filing requirements implied by an investment in a fund which is not reported under the InvTA. Ultimately, investment funds reporting tax information under the InvTA may have a competitive advantage over those to which the InvTA does not apply.

Scope of application

UCITs Funds

As set out above, all funds distributed under the UCITs directive are entitled to report taxable income to German investors under the InvTA. This applies even in case they do not meet the obligations for other funds summarised below.

Non-UCITs Funds

Non-UCITs funds, such as Luxembourg SIFs and Part II funds, are entitled to report under the InvTA only under the condition that they qualify as investment funds in the meaning of the InvA. This means that they need to:

- Represent a pool of assets for collective investment;
- Have the registered office abroad (foreign investment company);
- Grant the investor the right to redeem the investment unit at least once within two years at net asset value or the vehicle is subject to investment supervision in the country of origin comparable to BaFin;
- Be invested according to the principle of risk diversification in eligible assets as defined by the InvA;
- Define certain investment restrictions (mainly related to derivatives, participations and debt not represented by securities) in the prospectus.

The criteria to qualify as fund under the InvA have been revised last year; further interpretations and clarifications have been issued since then by the German Supervision Authority (BaFin) and the Ministry of Finance. They represent a major change to the previous rules and will likely result in numerous funds not qualifying as fund under the InvA which are therefore not eligible for a tax reporting under the InvTA.

A transition period has been introduced for all funds which were falling within the scope of the InvTA under the previous rules, but which do not qualify as investment funds under the new Investment Act rules. These funds can still report taxable income under the InvTA for financial years commencing before 31 May 2011.

Client challenge

The change in the definition of investment funds under the InvA impacts a broad range of funds. Next to Private Equity and Real Estate Funds, funds holding major investments in certain derivatives and debt which is not represented by securities (loans) are impacted as well. In practice, it can be difficult to determine whether certain assets meet the eligibility criteria. Furthermore, even if all criteria are actually met, funds qualify for the new definition only in case certain investment restrictions are defined in the fund's investment policy. Due to the precise nature of investment restrictions required, it is very likely that a large number of funds do presently not comply with them.

Need for Action

As the transition period granted by the German tax administration will expire soon, we strongly recommend investment funds having German investors to assess whether they still qualify as foreign investment fund in the German sense. In case an investment fund does no longer fulfill the requirements but wants to continue making tax reporting under the InvTA, potential options include:

- Restructuring of the fund (e.g. holding structure, debt financing)
- Rewording of investment restrictions
- Setting in place a side letter including the investment restrictions as per the InvA

It is highly recommended to verify the status and related tax reporting obligations for all Part II and SIF funds which either have a German investor base or are targeting the German market. This might be even more time critical for newly launched funds, as those cannot benefit from the grace period until May 2011 mentioned above.

Next to tax implications, the InvA revision can also impact the registration of Part II funds (and in theory also SIFs) for public distribution in Germany. For all funds registered under the previous InvA rules, BaFin could withdraw the permission for public distribution in Germany in case the new rules have not been implemented in the funds prospectus.

How PwC can support you

A "Health Check" has proved to be the most suitable first step. This comprises a workshop during which the main requirement for a qualification as foreign investment fund under the InvA will be discussed. As a result of the discussion, the scope of funds potentially at risk of not qualifying anymore should be defined. In a second step, the funds defined during the workshop will be analysed in more details and all potential risks, such as wording in the funds' investment restrictions not fully compliant with German rules, as well as potential solutions, will be presented. Those should be discussed during a second workshop, which ultimately leads to a decision on further steps.

With industry leading teams in Frankfurt and Luxembourg, PricewaterhouseCoopers has already supported numerous clients in analysing whether products are compliant with German requirements and, if necessary, assisted in the identification and implementation of solutions (e.g. re-wording of the prospectus, revision of the investment/holding structures etc.). Our longstanding experience with German tax reporting allows us to combine our tax technical, our product and our market knowledge to the benefit of our clients. Furthermore, our Frankfurt team has preferential contacts to the German supervisory authority, which allows us to address areas of doubt and stay informed of any development.

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