Update on the German investment tax reform – clarification on investment fund taxation in the context of securities lending transactions

31 May 2018

In brief

The German Investment Tax Act 2018 (InvTA 2018 (InvStG 2018)) entered into effect on 1 January 2018. Almost half a year later, some rules are still unclear and even more complex than before.

Among clarifications with regard to the partial deductibility of expenses (Art. 21 InvTA 2018), the German Federal Ministry of Finance (BMF) has clarified in a recent circular dated 15 May 2018 that (foreign) investment funds in the meaning of the InvTA 2018 are subject to tax filing obligations in Germany if they entered into certain securities lending transactions or repurchase agreements (repos) with regard to German sourced assets/income.

The new circular leaves no room for interpretation that investment funds will be obliged to file a corporate tax return in Germany, in case no or insufficient withholding tax has been levied on income received in the context of certain stock lending transactions.

We have observed that several market participants have significantly decreased, or fully stopped securities lending transactions in German assets since January 2018 due to the uncertainty of who his ultimately liable to withhold the taxes and what type of income is taxable.

In detail

Since 1 January 2018 investment funds are subject to German corporate tax with their German domestic sourced income, e.g. dividends from German equity and compensation payments in the context of securities lending transactions in the meaning of Art. 6 Section 3 Sentence 1 No. 2 InvTA 2018.

According to the BMF, the purpose of that rule is to prevent tax avoidance practices regarding domestic dividend income. Thus, income from securities lending is potentially in scope of corporate tax and (foreign) investment funds might be obliged to file a corporate tax return in Germany if certain criteria are fulfilled.

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Tax deduction and potential tax filing obligations for investment funds

Going forward, qualifying income from securities lending transactions (e.g. any consideration in return for the transfer of German assets, compensation payments etc.) will be taxed at source. The Federal Ministry of Finance made a clear statement concerning the attribution of the obligation who has to transfer taxes to the responsible tax administration in Germany. According to the BMF, principally the debtor of such payments is obliged to pay the taxes to the responsible tax office. In practice, only domestic German debtors (including a domestic branch of a foreign bank) will be obliged to withhold and transfer the taxes to the tax administration. Foreign debtors cannot be forced to withhold and pay taxes in the same way. In that scenario the investment funds as creditor might be obliged to declare that income and to pay taxes in Germany by filing a corporate tax return.

Since the main purpose of this regulation is to prevent tax avoidance on German sourced dividends, the taxable amount is limited to the gross dividend paid by the underlying German equity, which is the subject of the lending transaction.

On a less positive note, the Federal Ministry of Finance did not satisfy the request of the Association of Foreign Banks in Germany to implement a possibility to exempt equivalent (dividend-) compensation payments from corporate tax if the beneficial owner is able to prove that dividends received have already been subject to at least 15% WHT on settlement day.

As a result, income is potentially subject to double taxation if the dividend in the hand of the borrower is pre-charged with 15% WHT at source and, on top, the compensation payment in the hand of the creditor is taxable at 15% corporate tax, too.

According to Art. 4 InvTA 2018, the investment fund has to notify the responsible tax office in Germany (typically the Federal Central Tax Office (BZSt)) for foreign investment funds) if the fund received income in the meaning of Art. 6 Section 3 Sentence 1 No. 2, on which no or insufficient tax was withheld or if taxes were reimbursed by mistake.

Transfer of rights and obligations

The circular defines which "components" (i.e. compensation payments etc.) within the frame of securities lending transactions are taxable and who is ultimately liable to withhold the tax. Most securities lending transactions are handled via a central counterparty (i.e. Eurex Clearing AG) who, according to the BMF, is not obliged to withhold taxes if certain conditions are met.
In principal, the initial contracting parties remain liable to levy and declare the taxes. The central counterparty (or under certain conditions “agency lenders”) will not qualify as contracting party and accordingly not considered liable to withhold taxes.

Conclusion

In the course of the German investment tax reform, investment funds have become subject to corporate tax on qualifying domestic income and potential corporate tax filing obligations have to be assessed carefully going forward, even if investment funds are not distributed in Germany. Effective processes should be implemented in order to identify and determine the relevant income in scope of German corporate tax and to ensure that the correct withholding tax amount is levied and declared.

Especially income in the context of securities lending transaction should be monitored carefully. Accordingly, securities lending transactions with underlying German assets carry significant disadvantages from a corporate tax point of view. The risk of double taxation of related income might lead to a further decrease of securities lending transactions in the market.

As usual, the devil is in the detail. We would be happy to discuss this in more detail with you. We can support you to establish a robust monitoring process and/or assist you with the preparation of the tax return. Our tax experts are looking forward to discuss with you.

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