Newsletter January 2012

Federal-state working group submits proposal on "New Investment Taxation Model"

On 15 December 2011, a working group consisting of representatives from the fiscal authorities of the German federal government and the states of Hesse and North Rhine-Westphalia submitted proposals for a "New Investment Taxation Model". The proposals call for a fundamental restructuring of investment taxation law. Every type of fund and investor group – retail investors, wealthy private investors and institutional investors – would be affected by these changes.

This newsletter offers an overview and initial assessment of these proposals.

Recent discussions between the working group and fund and other financial associations suggest that major elements of the proposals will be overhauled. The working group aims at publishing its final recommendations at the end of February 2012.

Key issues

- Finance Minister conference asked for proposal to reduce complexity and to bring investment tax law in line with EU rules.
- Working group recommend that the current "principle of limited transparency" be replaced by two alternative systems.
- Following recent discussions with fund and other financial associations the proposals will be overhauled. Final recommendations are expected at the end of February 2012.

Reason behind reform efforts

The reform efforts were prompted by what the Conference of Finance Ministers viewed to be the exceeding complexity of current investment taxation law.

Another reason for the need for reform has to do with European law: Current investment taxation law discriminates against foreign funds, since in contrast to domestic funds, they are not exempt from German taxation of German rents, gains from the sale of real estate, and dividends. This also prompted the reform efforts.

According to the proposals put forward by the working group, investment taxation law is to be fundamentally reformed in concept, including abandoning the principle of limited transparency. Two systems of investment taxation are to take its place: a transparent and a non-transparent system. The applicable system will primarily depend on the legal form of the fund.

- The so-called non-transparent system is to be applicable to foreign and domestic vehicles that take the form of contractual-type funds (*Sondervermögen*) and investment companies (*Investmentaktiengesellschaften*), i.e. to practically all existing retail funds (*Publikumsfonds*) and institutional funds (*Spezialfonds*). Although the non-transparent system would not be restricted to a specific investor group, in many cases it would not be attractive to institutional investors from a tax standpoint. For more, see the section "Non-Transparent System".

- The so-called transparent system is to be reserved for institutional investors and would only apply to foreign and domestic funds that, like partnerships, are considered to be transparent (comparing the features of the fund to partnerships). For more, see the section "Transparent System".

Non-Transparent System

Overview

The non-transparent system is to be open only to foreign and domestic vehicles in the form of contractual-type funds and investment companies. The scope of applicability is to be determined independently by tax law, but in all other respects it would generally conform to current law. One exception is relevant for foreign funds: they are to be covered only if they are subject to regulation *and* grant a right of redemption (under current law, it is sufficient to meet just *one* of these requirements). This means, in particular, that regulated closed-ended foreign funds would no longer fall within the scope of investment taxation.

Under the non-transparent system, funds and their investors would be taxed as follows:

At the fund level:

As has been the case to date, funds of a contractual nature (investment funds) and a corporate nature (investment companies) would continue to be treated as a taxable entity. But in contrast to past practice, income of domestic funds would no longer be exempt from corporate income tax (*Körperschaftsteuer*); instead, German-source rents, gains from the sale of German real estate, and dividends paid by German corporations would be subject to corporate income tax (15.825%, including the solidarity surcharge) at the fund level. The comprehensive exemption from trade tax (*Gewerbesteuer*) would remain in place. This means that foreign funds, which are to continue to be subject to the taxation of property earnings and dividends from German sources, would no longer be treated less favourably.

At the investor level:

"Cash flow principle": German investors would generally be required to pay tax on all fund distributions and on gains from the redemption or sale of fund units, irrespective of which types of earnings (at fund level) "feed" these distributions and gains. This would eliminate both the distinction as to fund entry level – by type of earnings, amount of interest income within the meaning of the interest barrier rules (*Zinsschranke*), or between earnings and return of capital – as well as the (pro-rata) exemption for gains on redemptions or sales under the rules covering gains on stock and real estate (*Aktien-/ Immobiliengewinn*). The definite tax on dividends and real-estate earnings at fund level would be taken into account for certain types of funds through a flat-rate partial exemption (for details, see below).

Taxable flat amount: Also to be eliminated along with the "principle of limited transparency" is the taxation of so-called deemed distributions (*ausschüttungsgleiche Erträge*), i.e. certain earnings retained by the fund. Since many funds retain their earnings, the report stipulates that investors pay a tax each year on a flat amount (as adjusted for acquisitions during the year), in order to offset for the loss of tax revenues. This taxable flat amount is to be calculated by multiplying the long-term interest rate attainable for public bonds (base interest rate, for 2012 declined to 2.44%) by the unit value, with a 20% deduction for administrative expenses.

A deduction of withholding tax with respect to the taxable flat amount – which for private investors would have the benefit that they would not have to include such taxable item in their tax return – would essentially not be possible without liquidity. In order to reduce the number of cases where private investors have to file a tax return declaring the taxable flat amount, the report calls for an allowance of EUR 300 per private investor per year. If the allowance is exceeded, it is conceivable, according to the report, that the fund may decide to distribute its earnings or that the investor may instruct his or her custodian to debit the amount attributable to the taxable flat amount from his or her account or to sell fund units in order to generate the cash required for the custodian to pay the withholding tax.

In the case of equities funds (assumed in case of at least a 51% share of equities), the report provides that 20% of all taxable earnings (distributions, gains from redemptions or sales, and the taxable flat amount) are to be tax-free, in order to account for the withholding tax for foreign and domestic dividends. In the case of real estate investment funds (assumed in the case of at least 75% in real estate assets), 40% of all taxable earnings are to be tax-free. The

UR 300 allowance would be reduced accordingly on a percentage basis.

The remaining taxable earnings would – as is currently the case – be taxed for private investors at the flat tax rate for investment income (*Abgeltungsteuer*). For business investors, these earnings would be subject to income or corporate income tax, as well as trade tax (in each case, plus solidarity surcharge and, if applicable, church tax).

Transparent System

Overview

The transparent system is intended to be applicable only to those funds that for tax purposes are considered to be transparent (comparing the features of the fund to partnerships). The report noted that under current German investment law, there is no fund vehicle that would meet these conditions, i.e. which would fall within the transparent regime. However, the working group expects that an entity with a legal form "fitting" into the transparent system will be introduced with the open-ended investment limited partnership (*open-ended investment-LP*) (in addition to the closed-ended investment-LP created in the course of implementing the AIFM Directive, which would not, however, be subject to investment taxation).

In addition, the scope of application is to correspond to that for today's institutional funds, with two important exceptions:

- Only those funds that are subject to regulation *and* grant a right of redemption would be covered (until now: one or the other).
- The maximum number of investors is to remain unchanged at 100 institutional investors. However, in the future, only corporations (subject to corporate income tax) would count as institutional investors. By excluding partnerships, the indirect participation of natural persons, in particular, shall be excluded.

Foreign funds are to fall under the transparent system under the same conditions.

With respect to institutional funds, the report calls for two ways for switching to the transparent system:

- Tax-neutral transformation into the new legal form of the open-ended investment-LP, or
- Option to be taxed under the transparent system for a transitional period of five years.

Under the transparent system, funds and their investors would be taxed as follows:

At the fund level: In accordance with its legal form, the open-ended investment-LP is not deemed a taxable entity for the purposes of income and corporate income tax. The open-ended InvKG is by law to earn business income but would be exempt from trade tax. Its income, which is ascertained on an accruals basis (not taking into account business assets held by the investors and used by the open-ended investment-LP), would be determined in a uniform and separate manner, as with "normal" partnerships. The same is to apply for foreign transparent funds and non-transparent funds that make the election.

At the investor level, the rules that have applied to date for investments in partnerships would also apply to investments in open-ended investment-LPs. In order to preserve in part the so-called fund privilege (tax-free reinvestment of certain earnings), the working group is considering the introduction of a "reinvestment reserve" for gains on the sale of stock (unless already exempt under the Corporate Income Tax Act). The report provided no details about this.

Notes

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