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Amending the German Investment Tax Act in the wake of the EU's Alternative Investment Fund Managers Directive

On 4 December 2012, the German Federal Ministry of Finance submitted a draft bill for legislation amending the German Investment Tax Act to reflect the draft act transposing the EU's Alternative Investment Fund Managers Directive into German law. As with the current draft of the new German Capital Investment Act (*Kapitalanlagegesetzbuch*), the above draft bill is intended to ensure that the Investment Tax Act will regulate the taxation of all types of funds covered by the draft Capital Investment Act, along with their investors.

Overview

- Comprehensive tax regime for all funds (UCITS and AIFs) under a new Investment Tax Act
- Grandfathering for funds currently covered by the Investment Tax Act
- Unfavourable flat-rate tax may apply to investors in those AIFs structured as specialised funds, investment stock corporations or comparable foreign legal forms which invest in areas such as private equity, infrastructure, renewables and possibly also real estate
- Tax provisions for the new German open-ended investment LP

One beneficial aspect of the draft bill is that any funds covered by the Investment Tax Act under existing legal provisions and having been launched before 22 July 2013 will be grandfathered.

For any other funds, i.e. funds which are not covered by the current Investment Tax Act and for funds launched after 21 July 2013, a new classification with new tax regimes shall apply according to the draft bill. One of three tax regimes shall apply to such funds: Alongside the tax regime that applies under the current Investment Tax Act (so-called limited transparency principle) and a tax regime for so-called investment partnerships, a third regime for so-called investment corporations has been created. Investors of such investment corporations would be subject to a disadvantageous flat-rate taxation. In our view, such flat-rate tax regime, which can result in the taxation of fictitious profits, is unconstitutional.

1. Introduction: New Investment Tax Act regime

Subject to the grandfathering provisions (see Section 2 below), the new draft bill creates two main categories of funds: **investment funds** and **investment enterprises**.

Investment funds (*Investmentfonds*) include any undertakings for collective investment in transferable securities (**UCITS**) and any alternative investment funds (**AIFs**), which meet **specific criteria** set out in the amended Investment Tax Act.

- The new category **investment enterprises** (*Investitionsgesellschaften*) covers AIFs which do **not** meet one or more of such tax criteria.

As to the tax consequences and the applicable tax regime, the following applies:

- **Investment funds** – i.e. UCITS and "qualifying" AIFs – systematically replace the category of domestic and foreign investment funds as defined in the current law. The **restricted transparency principle** applicable to investments funds and their investors states, in simple terms, that earnings at the fund level are be determined (so-called fund tax reporting) and allocated to the investors at the end of the year or when profit distributions are made, with their specific tax attributes being retained. While the Investment Tax Act currently still uses the concept of domestic and foreign investment funds as defined for regulatory purposes, the new draft bill sets out a list of tax criteria which are independent from the draft Capital Investment Act and which are more restrictive in certain areas. More information is given under Section 3.1.
- The new **investment enterprises** – i.e. non-qualifying AIFs – and their investors are subject to a different tax regime, depending on their legal form:
  - **Investment *corporations*** (*Kapital-Investitionsgesellschaften*; as to the exact definition cf. below) pay trade tax and corporate income tax on their income, i.e. the "general" rules apply in this regard. However, investors holding shares in such investment corporations shall be subject to a new flat-rate tax according to the draft bill. The calculation of taxable income shall correspond to the "penalty taxation", which applies under the current regime in case a fund does not comply with the fund tax reporting obligations. However, crucially, it shall not be possible under the draft bill to prevent such flat-rate taxation by complying with reporting obligations or in any other way. This flat-rate taxation may result in the taxation of fictitious income and this could make this type of vehicles unattractive to the majority of investors. In our view, this flat-rate tax regime needs to be reconsidered in the course of the legislative process. Section 3.2.1 provides more information on this concept and the tax consequences.
  - Investment enterprises organised as partnerships are referred to as **investment *partnerships*** (*Personen-Investitionsgesellschaften*). The provisions applicable to "standard" partnerships also apply to investment partnerships and their investors (including standard and separate declarations). Section 3.2.2 sets out more details on this definition and its consequences.

2. Grandfathering clause for investment funds falling under the current Investment Tax Act

Grandfathering rules shall apply to funds which are regarded as domestic or foreign **investment funds** under existing legal provisions, i.e. under the Investment Tax Act, and these will continue to be governed by the **restricted transparency principle** if they have been or will be **launched prior to 22 July 2013**.

This grandfathering provision relates exclusively to the **launch date** of the fund. This means that it will also apply to any investor acquiring units ***after*** **21 July 2013** in a fund that was launched prior to 22 July 2013. The time investments are made is irrelevant under the new draft bill. The grandfathering provision does not include any **time limits**. In the case of umbrella funds, the launch date of the relevant sub-fund shall be decisive. The (minimum) requirements for "launching" a fund will evolve from future discussions among the interested parties.

If the grandfathering clause applies to a specific fund, the tax regime applicable to it and its investors will not change, even if the fund no longer qualifies as an investment fund (as it does not meet the tax criteria set out in the draft bill). The fund and its investors will still be taxed in accordance with the restricted transparency principle. Certain aspects of this principle are due to be amended (see below).

Funds not covered by the existing Investment Tax Act are not covered by the grandfathering clause. This means that investors in these funds may be subject to flat-rate taxation in the future (see Section 3.2 below).

3. New classifications

3.1 Investment funds

The new "**investment funds**" category includes

- all UCITS and
- any AIFs satisfying the following **tax criteria**:
  - subject to investment supervision;
  - providing for a right of redemption (at least once a year);
  - objective: investment/ management on behalf of investors, but no active management/influence,
  - level of risk diversification: at least four assets conferring different risks;
  - no more than 20% of the total value of the AIF is invested in unlisted participations, no more than 5% of the total value in the same issuer and less than 10% of all shares issued are acquired by the AIF; **special provisions for real estate funds**: no more than 49% of the total value of the AIF is invested in real estate companies (no limits are placed on the level of investments in such companies and their shares);
  - loans: short-term loans only up to 30% of the total value of the AIF; **special provisions for real estate funds**: no more than 10% short-term loans, otherwise leverage of up to 30% of the current property values;
  - investment restricted to certain eligible assets (securities, money market instruments, derivatives, bank deposits, property, rights equivalent to property and comparable rights under the laws of other countries, real estate companies as defined in Section 1 para 19 no. 22 of the draft Capital Investment Act, units in German investment funds, EU investment funds and foreign investment funds, precious metals, non-securitised loan claims and participations where the market value of these can be determined);
  - terms of investment/ articles of association include the above requirements.

The fact that these requirements are set out independently in the Investment Tax Act means that the scope of the restricted transparency principle is no longer linked to the supervisory law. The list is **more restrictive compared to the current scope**, particularly compared to the current definition of foreign investments funds.

The main differences are as follows:

- In future, both **investment supervision *and* a right of redemption** will be required. Under the current definition, it is sufficient for a foreign fund to be either subject to supervision or to make provision for a right of redemption.
- The tax criteria demand for the first time that **holdings in individual investment enterprises** be limited (no more than 5% of the total value to be invested in shares in any one company and less than 10% of all shares issued). The current legal provisions do not specify any corresponding restrictions for specialised funds.
- Contrary to the current definition of foreign investment funds, the tax criteria limit **short-term loans** to 30% of total fund assets.
- The changes for **real estate funds** are particularly marked. The list places a **limit on indirect real estate investments** (via property companies) to **49%** of the fund's holdings and limits **leverage** for investment purposes to **30%** of the current property values and short-term loans to 10% of the total fund assets. The current definition does not impose any requirements in this regard (although restrictions may arise under the German Insurance Supervision Act).

Under the draft bill, in particular the following funds *inter alia* and their investors would no longer be taxed in line with the restricted transparency principle if they are not covered by the applicable grandfathering provisions:

- **closed** and semi-open-ended funds;
- funds investing **via investment vehicles** (which are not investment funds themselves);
- **hedge funds** taking out loans other than on a short-term basis;
- **real estate funds** with leverage of more than 30% of their total value or with more than 49% of its investments made indirectly (via property or holding companies).

The proposals set out in the new draft bill, which effectively limit the scope of the restricted transparency principle, are **not convincing** in our view. A specific administrative practice has developed around the current definition of funds and the **legal certainty** provided by this would be abandoned without any apparent need. It is difficult to see the fiscal reasoning behind the proposed restrictions. **Real estate funds investing internationally** and/or their investors would be among those parties no longer taxed in accordance with the restricted transparency principle as a result of the 49% threshold. The 30% leverage threshold for real estate funds falls short of the flexibility under the regulatory rules (open-ended specialised AIFs with fixed terms of investment may incur leverage of up to 50% under the draft Capital Investment Act).

The new draft bill does **not** propose any **amendments** to the following provisions, despite the fact that objections were raised that they infringe the EU's basic freedoms: It remains the case that **only domestic investment funds will be exempt from German corporate income tax and trade tax,** which means that **other EU investment funds** are still treated less favourably. In addition, German investors receiving German dividends via **EU investment funds** will continue to be subject to a higher tax burden in many cases than if they invested via a domestic investment fund.

Certain details of the taxation regime applicable to investment funds and their investors will be amended. These changes, which are not detailed in this newsletter, relate to the allocation of costs, the source of distributions and their priority and steps to combat certain bond stripping models.

3.2 Investment enterprises

The new category of **investment enterprises** includes "non-qualifying" AIFs, which are those AIFs **not** meeting one or more of the **tax criteria** for qualifying as an investment fund set out in Section 3.1 above. This new category generally includes **private equity funds, infrastructure funds, funds investing in renewable energy (solar, wind etc.)** and **real estate funds** which do not qualify as investment funds. Based on the draft bill, these investment enterprises would be regarded as investment corporations or investment partnerships (see Section 3.2.1 and 3.2.2).

3.2.1 Investment corporations

Any AIF which does not meet the tax criteria for investment funds and is organised as a German **investment stock corporation** (*Investmentaktiengesellschaft*), as a German **contractual-type fund** (*Sondervermögen*) or has a **comparable foreign legal form** (such as a Luxembourg SICAV S.A. or Luxembourg FCP) are classified as investment corporations. No grandfathering provisions apply in this regard. Investors in such investment corporations are likely to face **significant disadvantages** (see below) and will need to keep a close eye on whether the draft bill will actually be adopted in this regard.

Investment corporations would be subject to taxation at the **fund level**:

- German contractual-type funds (*Sondervermögen*) are regarded as corporations or legal persons (in accordance with the current fiction). However, German contractual-type funds and investment stock corporations not meeting the tax criteria for investment funds are **not exempt from corporate income or trade tax**.
- Foreign AIFs with comparable legal forms will be classified as "non-transparent" corporations under the new draft bill (and not as transparent). This will mean that foreign contractual-type funds like Luxembourg FCPs will be subject to German corporation tax on German source income (i.e. such income will not be directly attributed to their investors) and any permanent establishment in Germany will be required to pay German trade tax, just like a Luxembourg SICAV S.A.

The most important changes affect **German investors** in investment corporations:

- They shall be subject to **flat-rate taxation** based on the penalty taxation for non-transparent funds, but without it being possible to influence this requirement by complying with certain reporting or other obligations. Domestic investors are required under the new bill to pay tax each year on all **distributions** and on **70% of the increase** of the last annual redemption price (or market / stock market price) compared to last year's redemption price, **but at least on 6% of the final redemption price** (based on the fiscal year if known). In the event that an investment corporation does not have any positive returns, or makes a loss, German investors are still required to pay tax on 6% of the redemption price. This effectively represents a tax on capital in those years where insufficient profits are generated.
- Any such fictitious income which has been taxed in the past can be deducted from the capital gains when the fund units are **sold or redeemed**. There is, however, uncertainty as to whether and when any resulting losses incurred on the disposal or redemption would effectively compensate for the tax due on fictitious income. A compensation may well not be possible

because of various limitations to carry-back or offset losses.

- It depends on the tax position of the investment corporation whether or not income from such vehicles is tax-exempt in case of commercial investors (i.e. 40% exemption from income tax or an effective 95% exemption from corporation tax and possibly also from trade tax). The aforementioned exemptions shall only apply if the foreign investment corporation pays at least 15% tax in the country where it is domiciled. This means that German business investors of **Luxembourg SICAVs and FCPs** have to pay tax on the earnings **at the full rate**.
- The **withholding tax rate** of 26.375% (including solidarity surcharge) is applicable to **private investors**, regardless of the tax rate applicable to the investment corporation.

The proposals in the new bill for the harsh taxation of investors of investment corporations can only be understood from a fiscal point of view. The draft bill's explanatory statement indicates that the tax legislator deems the current CFC-rules, whereby certain passive and low-taxed income from foreign companies is subject to taxation in Germany, to be increasingly **ineffective**, particularly due to the ECJ's ruling in the Cadbury-Schweppes case.

This does, however, not **justify** the **flat-rate tax** in our view:

- Flat-rate taxation cannot be regarded as an appropriate standardised form of taxation in this regard. We believe that it infringes the **principle of the ability to pay** and is therefore **unconstitutional**.
- Private equity funds, infrastructure funds, funds investing in renewable energy (wind, solar etc.) and real estate funds not regarded as investment funds often invest indirectly via **portfolio companies, project companies or property companies** which are subject to taxation in the country where the investment is made. This means that many of the specified investments are already taxed in such country. Therefore, the investment vehicles affected by the flat-rate taxation cannot be qualified as "aggressive" or as tax-saving schemes. It is also the case that many of these vehicles distribute their earnings, i.e. do not "shield" their income from German tax. This should also be taken into account in any assessment under constitutional law.
- Under the new bill, no **grandfathering provisions** apply to investors in investment corporations. In order to avoid being subject to flat-rate taxation, investors would have to sell these investments at short notice or, if possible and enforceable, push for the liquidation of the investment corporation and its investments. The flat-rate taxation would particularly affect life and health insurers since, absent any distributions, they are not in a position to build tax-deductible reserves for their policy holders to offset fictitious income. Fire sales and any liquidation before the end of the investment period would involve considerable losses.
- In terms of **new fund projects**, fund initiators will probably need to fall back on funds in the **form of partnerships**. This may be desirable in terms of tax and fiscal policy, but the German investment LP (*Investmentkommanditgesellschaft*) has just been introduced and does not therefore offer the **legal certainty** and **standardisation** which is valued in the case of contractual-type funds (*Sondervermögen*) and so important to institutional investors. The issue of **how to treat distributions from such partnerships in the p&l account**, which is another key issue for institutional investors, has also yet to be fully clarified.

3.2.2 Investment partnerships

Any AIFs not meeting the tax criteria for investment funds and structured as **investment LPs** or in a **comparable foreign legal form** shall be regarded as investment partnerships.

Investment partnerships may be subject to **trade tax** at the fund level in accordance with the general conditions. No trade tax exemption applies to foreign investment partnerships, unlike for investment funds structured as German investment LPs.

The provisions applicable to "ordinary" partnerships are also applicable to investors in investment partnerships, i.e. the income of investment partnership is attributed to, and taxed in the hands of, its investors.

3.3 Open-ended investment LP

The draft Capital Investment Act introduces a new structure for open-ended investment funds in Germany – the **open-ended investment LP** (*offene Investment-KG*). The aim is to create a transparent and attractive investment vehicle for **pension asset pooling** for international companies.

Based on the draft Capital Investment Act, open-ended investment LPs must **diversify their investments** and have a **reasonably flexible investment horizon**. They are open to **professional** and **semi-professional investors**.

The **tax regime** for open-ended investment LPs **depends** on whether they qualify as investment funds in accordance with the list of tax criteria set out in Section 3.1. Some of these **tax criteria** will be met by any open-ended investment partnership because of its regulatory framework (under the draft Capital Investment Act), in particular supervision, annual right of redemption, risk diversification and typically also "passive" investment activities. Additional requirements have to be met, however, in order for them to qualify as investment funds, including limits on investments in unlisted companies, leverage and eligible assets.

The following applies to open-ended investment LPs **qualifying as investment funds**:

- Such open-ended investment LPs are **exempt** from **trade tax**. This means that no tax on income applies at the level of such open-ended investment LPs.
- Investors are taxed in accordance with the **restricted transparency principle** (not the transparent tax regime applicable to "ordinary" partners) and the principles described in Section 3.1 therefore apply accordingly.
- For the purposes of **double taxation agreements**, the German legislator deems that open-ended investment LPs should be regarded as transparent in accordance with the provisions applicable to "ordinary" partnerships. This is intended to allow investors to rely on treaty benefit vis-à-vis the foreign tax authorities. The issue of whether this is opposed by the taxation of investors under the restricted transparency principle (see previous bullet point) should be assessed on the basis of the foreign tax law provisions and be clarified in advance in cases of doubt.
- With regard to **non-German group companies** investing in an open-ended investment LP as part of a pension asset pooling strategy, their participation shall be deemed not to create a permanent establishment in Germany in order not to attract German tax on their income (only to the extent that this would also be the case for non-German investors in any investment funds).

The provisions outlined in Section 3.2.2 above apply to any open-ended investment LP which does **not qualify as an investment fund**, i.e. the "general" principles applicable to any "ordinary" partnership apply to them and their investors.

The new draft bill to amend the German Investment Tax Act is silent on the treatment of foreign AIFs which are comparable to an open-ended investment LP (within the meaning of the of the draft Capital Investment Act). In the absence of any such provision, the trade tax exemption and the taxation of German investors in accordance with the restricted transparency principle would not apply in this case. This may not be compatible with the EU's basic freedoms.

Notes

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