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German Tax and Legal News

Discussion draft on amendments to domestic participation exemption for portfolio investments

A discussion draft that would reform Germany's Investment Tax Act, published by the Ministry of Finance in July 2015, proposes—in addition to fundamental changes to the taxation of income received by German investors through investment funds—amendments to the participation exemption rules that would abolish the 95% tax exemption for capital gains derived by corporate shareholders from portfolio investments and such gains would become fully taxable.

Background
Under the current participation exemption rules, capital gains realized from sales of shareholdings by German corporate shareholders effectively are 95% exempt from tax, with no minimum shareholding requirement (although exceptions apply for shareholdings held by banks on their trading books, life or health insurance companies and certain financial holdings for short-term investments). The remaining 5% of the capital gains is deemed to represent nondeductible business expenses under Germany's domestic rules, and is added back to taxable income.

The 95% tax exemption previously applied to dividends received by German corporate shareholders, with no minimum shareholding requirement. However, Germany eliminated the 95% exemption for dividends derived from less-than-10% shareholdings in subsidiaries as from 1 March 2013 (refer to GTLN).

Although a proposed elimination of the participation exemption for capital gains derived from portfolio investments was not enacted in 2013, the federal government and government coalition parties have agreed to eliminate the exemption, as part of a fundamental reform of the Investment Tax Act.

Proposed new rules
The discussion draft proposes abolishing the participation exemption for capital gains where a German corporate shareholder's holds directly less than 10% of the share capital of the company whose shares are being sold. The shareholding percentage would be determined at the beginning of the relevant calendar year in which the sale occurs. Any subsequent acquisitions during the calendar year would not be counted toward the 10% threshold for the taxation of capital gains.

As an exception to the general rules for capital gains and dividends from portfolio investments, a "forward purchase" of a shareholding of at least 10%, with a delivery date for the shares within a calendar year, would count toward the dividends received in the calendar year if the shareholding is held for the remainder of the calendar year. As a consequence of the full taxation of the gross dividends there would be no separate addback of the 5% of relevant portfolio capital gains that otherwise would be deemed to represent nondeductible business expenses.

Any losses in connection with portfolio shareholdings, e.g. from disposals or writedowns to market value, could be offset only against capital gains from portfolio shareholdings. Any remaining balance of losses from portfolio shareholdings could be carried forward and offset against future profits from portfolio shareholdings, with no time limitations. The loss carryforward would be subject to the general change-in-ownership rules and, therefore, could be forfeited upon a relevant shareholder change.

Reduced tax rate for venture capital investments
The discussion draft also proposes that capital gains from certain venture capital (e.g. start-up) investments would benefit from a reduced tax on capital gains during the period 2018-2027.

The tax on eligible capital gains would be reduced to 30% of the acquisition costs of the shares sold, but would be limited to the amount of corporate tax paid on the capital gains derived from the shares.

To benefit from the reduced tax rate, the shares would have to meet the following requirements: (1) be newly issued shares bearing voting rights; (2) not be listed on a stock exchange; and (3) have been held for at least three years. The company would have to be eligible to receive state aid to promote risk finance investments under applicable EU regulations, but the acquisition of the shares themselves could not have been subsidized.

Proposed application

The official legislative procedure to adopt the proposals has not yet commenced. However, the discussion draft was sent to industry associations for comments, which were due in early September. Although the timing for the next steps is not yet clear, it is expected that an official governmental draft may be issued soon, and the legislative process still could be finalized by the end of 2015.

If adopted, the new rules would apply as from 1 January 2018, i.e. on any relevant capital gains realized after 31 December 2017.
