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German Tax and Legal News

Reform of the German Investment Tax Act: Federal Ministry of Finance publishes 1st draft of the circular

The German Investment Tax Reform Act published in the Federal Law Gazette on July 26, 2016 raises a great number of practical questions – notwithstanding the objective to simplify the taxation of investment income which has been emphasised during the entire legislative procedure. The draft circular released by the Federal Ministry of Finance aims to clarify some of these questions.

I. Background

The German Investment Tax Reform Act dated July 19, 2016 introduces inter alia a new German Investment Tax Act (“GITA 2018”) with two completely different taxation systems: one taxation system for investment funds and another for special investment funds (for a description of the core elements of the GITA 2018 please refer to section no. III. below).

The new rules which will come into effect on January 1, 2018 and will cause significant implementation effort along with practical interpretation queries. The draft circular was therefore awaited with considerable expectations. In the light of this, it is regrettable that the circular falls short of these expectations in two different ways:

- The circular only deals with some provisions of the GITA 2018 which in certain cases are only of minor importance from a practical point of view. On the other hand, significant aspects particular with respect to special investment funds are not addressed. Insofar, we can only hope that further clarifications will follow soon. Circulars released by the Federal Ministry of Finance are an important element in order to implement the requirements resulting from the GITA 2018 as efficient as possible and on time.
- Comparable to the circular regarding the current German Investment Tax Act (“GITA 2004”), the circular in many cases only repeats the wording of the law as well as of the official reasoning of the law and provides somehow unsurprising conclusions.

In detail, the circular deals with the following topics:

- Scope of application
- Legal definitions
- Legal representative of an investment fund
- Competent tax authorities, power to issue statutory instruments
- Tax audit
- Transfer of assets into an investment fund
- Taxation of investment funds
- Deduction of German withholding tax towards investment funds
- Tax exemption due to tax privileged investors
- Proof of the requirements for the tax exemption
- Tax-exempt investment funds or share classes
- Obligation to pay out refunds to tax privileged investors
- Trade tax
- Partial tax exemption
- Application and transitional provisions

II. Selected aspects of the circular

In the following, we summarise the most relevant contents of the circular for you.

1. Scope of application

With respect to the scope of application, the circular unsurprisingly states that if an investment vehicle would qualify as an investment fund, the publications and statements of the German regulator (BaFin) can be referred to with however unbinding effect. From a practical point of view, this should only be relevant in the case of an abuse of law.

In addition, the content of the circular mostly corresponds to the perceptions that are

already in place under existing investment regulatory law.

2. Legal definitions

In relation to the legal definitions, there are some interesting statements in particular with respect to the qualification as an equity-, mixed- or real estate fund, the definition of the term "distribution" and the questions which documents would qualify as statutes (Anlagebedingungen) of the investment fund.

Qualification as an equity or mixed fund

- From a tax technical point of view, the circular appropriately concludes that a synthetic replication of the performance of equity participations via financial derivatives (completely or partly) does not suffice to qualify as an equity- or mixed fund. Since the income derived by these types of financial instruments does not lead to a tax burden at the level of the investment fund, a partial tax exemption of the investors would be inappropriate. On the other hand, it is harmless if the investment fund hedges the risks resulting from equity participations.
- The investment fund would have to fulfil the investment strategy and limits as described in the statutes, whereby only a long term violation will result in a loss of the status as equity- or mixed fund. A short term violation of the relevant quotas due to market developments or an incorrect qualification of assets as equity participation is however uncritical. This also holds true in the case of a passive violation of the quotas, provided that the investment fund takes possible and reasonable action to restore the necessary limits immediately after it has realised the violation.
- Only for non-German investment funds it suffices for the qualification as an equity- or mixed fund if the statutes allow a predominant investment in equity participations.
- For the determination of the value of the investment fund to be apportioned to equity participations, quite surprisingly the assets should be relevant according to the Federal Ministry of Finance. Only for UCITS where the borrowing is limited to 10% of the value and for comparable investment funds the net asset value can be used. Finally, for investment income received by the investor by June 30, 2019, it will be accepted for all other types of investment funds if the statutes refer to the net asset value. In this case, it is however necessary that the fund continually observes the relevant limit calculated on the basis of the assets and reassures this towards the investors, in a way that the public can get the information or towards a financial data provider such as WM Datenservice.

Qualification as a real estate fund

- The circular points out that the period of 4 years to comply with the relevant investment limits under investment regulatory law will also be granted under the GITA 2018. The investment fund needs to commence acquiring its first real estate properties or real estate companies within twelve month following its launch.
- The rules outlined above with respect to the short term and passive violation of the relevant limits as well as for the calculation of the equity participation ratio apply to real estate funds and the real estate property ratio mutatis mutandis.

3. Definition of the term „distribution“

As already stipulated by the GITA 2004, the term „distribution“ not only comprises the amounts actually paid out or credited to the investor, but also the German withholding taxes plus solidarity surcharge thereon as well as non-German withholding taxes levied upon the distribution.

4. Statutes of the fund

In particular for non-German investment funds, it should be helpful that also contractual agreements such as side letters are recognized as statutes of the fund. The sales prospectus, the annual report or similar documents are not acknowledged as statutes of the fund since they do not govern the contractual relationship between the investment fund and its investors. Only if the statutes rule that the investment policy is laid down in the sales prospectus, the latter document can also qualify as statute.

5. Tax audit

The competent tax authority is entitled to carry out tax audits. The circular points out that the tax audit can cover all issues that are relevant for the taxation of the investment fund and the investors. Inter alia, this encompasses the audit of the following:

- calculation of the income of the (special-)investment fund,
- criteria for the qualification as equity-, mixed- or real estate fund,

- compliance with the criteria to qualify as a special investment fund,
- tax figures calculated by the special investment fund for its investors (offsetting and reconciliation, double tax treaty gain, equity gain and partial tax exemption gain),
- deduction of German withholding taxes on fund level as well as on investor level in the case of a special investment fund.

The competent tax authorities may take action by ways of a desk- or a field audit. Field audits can only be carried out in Germany, a tax audit in other jurisdictions is only allowed within the scope of the EU-Directive as regards administrative cooperation in the field of taxation.

Compared to the current law, the GITA 2018 brings a significant extension of the authority to perform a tax audit. Thus, the verification as well as the documentation of compliance with the multifaceted requirements become much more important.

6. Taxation of investment funds

In terms of income that is subject to the partial corporate income tax at investment fund level, the circular states that the different sub-funds of an umbrella construction are to be treated separately resulting in the fact that an offsetting of losses would not be possible in contrast to the share classes of an investment fund.

In addition, the following statements can be found in the circular which are important from a practical point of view:

- The preparation and filing of a corporate income tax return is not required if the investment fund only generates income which is subject to German withholding tax.
- In the case an investment fund receives income from German real estate and other income not being subject to German withholding tax, the investment fund is obliged to file a corporate income tax return. The income has to be calculated for the respective calendar year. Investment funds with a fiscal year deviating from the calendar year may determine their income on the basis of their fiscal year.
- The calculation of the taxable income subject to corporate income tax has to be processed in principle by subtracting the expenses from the income with no balance sheet being necessary. The law modifies this principle insofar as only expenses that are economically connected with the income subject to corporate income tax can be deducted (in particular taxable depreciation following the depreciation rates for non-business assets). As far as expenses are linked to different types of income, they have to be attributed on a pro rata basis.
- The changes in value of real estate occurring by January 1, 2018 (tax exempt in the case of a total holding period of more than 10 years) have to be determined on the basis of the market value. This value can in turn be based on a valuation report which has been prepared in a time frame around December 31, 2017. In the case there should be no legal obligation to determine market values, the change in value occurred during the entire holding period can be apportioned on a linear basis. Taxable depreciation amounts already considered until December 31, 2017 have to be deducted.

7. Deduction of German withholding tax towards investment funds

In relation to the deduction of German withholding tax on income received by an investment fund, the circular states the following:

- The status certificate must be handed over in physical form to the institution which is obliged to deduct German withholding tax. It does however suffice if the status of being an investment fund can be retrieved from a data base operated by an acknowledged financial data provider (e.g. WM Datenservice) provided that the data provider confirms the authentication of the status certificate which has been made available to him.
- Upon receipt of the status certificate, the financial institution which is obligated to deduct German withholding tax towards the investment fund, must examine the authenticity of the status certificate. This holds also true if it has been uploaded into a database of a financial data provider. The financial institution can rely on the authenticity if the status certificate shows the tax office that has issued the certificate and if it contains an electronic signature of that tax office.
- All investment funds can apply for a status certificate except for share classes.

8. Trade tax

With respect to possible trade tax at investment fund level, the following important statements are included in the circular:

- For the determination of the business purpose not only the subjective purpose is relevant but also the business objective actually carried out.
- Even if the investment fund has actually only one investor or if the number of investors is limited to one investor in the statutes, the investment fund does not breach the criteria of a joint asset management on behalf of several investors.
- For the determination of a minimum limit (amount of the income from business activity less than 5% of the overall income) and with respect to the term „overall income“, the worldwide income of the investment fund has to be considered which reflects the gross amount, i.e. expenses do not have to be considered.
- A business activity of an investment fund has to be considered separately from the other activities and do not infect the asset management activities that remain exempt from trade tax.
- For the determination of an active entrepreneurial activity, the general rules that are relevant for the distinction of asset management from business activity are not applicable. Instead, a special criteria is relevant taking into account the specific background of a joint asset management.
- The participation in a business or deemed business partnership does not lead to an active entrepreneurial activity in case only advisory or control functions or other administrative rights that are carried out. In case the representatives of the investment fund influence the entrepreneurial decisions of the partnership, the income derived from the partnership is however subject to trade tax.
- The participation in a deemed business partnership does not represent a separate economic business.
- A criteria for trade tax liability is a German permanent establishment with the consequence that an active entrepreneurial activity of assets abroad is basically uncritical as far as the relevant entrepreneurial decisions are not made in Germany.
- The profit deriving from the economic business is calculated by subtracting the expenses from the income that qualifies as income subject to trade tax.

9. Partial tax exemption

In case the statutes of the investment fund do not contain the necessary information in order to apply the partial tax exemption rates already when German withholding tax is deducted, the investor can prove in the course of his personal tax assessment that the investment fund has actually exceeded the relevant thresholds throughout the entire fiscal year. According to the circular, this option is – based on the wording of the law – limited to the tax assessment. In other words, it cannot be applied towards the institution which is obligated to deduct German withhold tax.

The proof can be delivered via asset portfolios and / or a written confirmation of the investment fund whereby semi-annual or annual reports do not suffice given that they only reflect an effective date.

10. Application and transitional provisions

The circular contains comprehensive statements regarding application and transitional provisions with some repetitions of the wording of the law and the official reasoning. The following aspects are relevant from a practical point of view:

- It is confirmed that all distributions as of January 1, 2018 are subject to the GITA 2018.
- The prolongation of the deadline for the publication of the annual tax reporting figures from 4 to 12 months is also applicable to investment funds with a fiscal year congruent to the calendar year.
- For special investment funds, unrealised capital gains from privileged bonds (no DDI-bonds) which are realised as of 2018 are not part of the deemed distributed income.
- For the calculation of their deemed distributed income as of December 31, 2017, fund of funds can rely on the average deemed distributed income during the last 3 years received from of a sub-fund in the case the sub-fund should not have published its tax information by July 31, 2018 for the last fiscal year ending in 2017. A retrospective adjustment is not required if the sum of the actual deemed distributed income derived from sub-funds does not exceed the accumulated average value from sub-funds by more than 20%. This pragmatic approach is not applicable for special investment funds.
- Loss carry forwards can no longer be used according to the Federal Ministry of Finance.
- The new equity gain to be calculated as of January 1, 2018 under the GITA 2018 starts with zero. In the case of an actual disposal of fund units, two different equity gains have to be considered by the investor: (i) from the period beginning with the acquisition until December 31, 2017 and (ii) for the period beginning on January 1,

2018 until the date of the actual disposal.

III. Core elements of the GITA 2018

On July 26, 2016, the German Investment Tax Reform Act was published in the German Federal Law Gazette. As a result, the new German Investment Tax Act ("GITA 2018") will come into effect on January 1, 2018 with significant changes to the taxation of income received through an (special) investment fund.

For investment funds, the principle of tax transparency will be replaced by an opaque taxation system and consequently a German tax reporting towards the investors (annual tax reporting for distribution and/or deemed distribution as well as daily tax reporting) will not be necessary any longer. Only for special investment funds, the tax transparency regime continues to apply with however wide-ranging modifications.

Due to the new taxation rules and particularly taking into account that investment funds on the one hand and special investment funds on the other hand will be subject to completely different taxation principles, German institutional investors will re-evaluate their positions in investment funds. While institutional investors currently rank among the top investors in investment funds, there will be a shift towards special investment funds in the future. As a consequence, asset managers will have to verify their range of products and to decide from a strategic point of view to establish special investment funds targeting the German market.

1. Scope of application

The scope of application of the GITA 2018 has been substantially extended, i.e. any investment scheme regardless of whether it is a UCITS or an AIF in the sense of the AIFMD as well as its German investors will be subject to the new taxation rules. Notably, the GITA 2018 goes even beyond of the investment regulatory law and covers so-called fictitious investment funds which are investment schemes lacking certain criteria under the AIFMD (e.g. investment schemes having only one investors).

Certain exceptions of the AIFMD apply for GITA 2018 purposes mutatis mutandis, for example certain securitisation vehicles. Furthermore, investment schemes in the legal form of a partnership do not qualify as investment funds under the GITA 2018 unless they are UCITS or pension scheme investment funds. In this context, separate properties (Sondervermoegen) and comparable non-German legal forms are not considered as partnerships.

In order to qualify as a special investment fund, the following requirements must be fulfilled cumulative:

- qualification as an investment fund,
- number of possible investors limited to 100,
- exemption from German trade tax,
- compliance with certain investment criteria,
- documentation of the above in the sales documents.

2. Investment funds

The core element of the GITA 2018 is the abolition of the tax transparency regime for investment funds and the introduction of an opaque taxation system with two levels of taxation: (i) taxation at investment fund level and (ii) taxation at the level of the investor. Depending on the income received by the investment fund, a German as well as a non-German investment fund is partially subject to German corporate tax. The catalogue of in-scope income, i.e. of income subject to German corporate tax has been defined based on international taxation principles. As a result, particularly German sourced dividend and rental income as well as capital gains from the sale of German property are subject to German corporate tax.

In order to benefit from a reduced withholding tax rate of 15% instead of 25%, the German or non-German investment fund needs to apply for a so-called status certificate at the competent fiscal authority and to file it with the last German entity paying out the income to the investment fund. In the case of income not subject to German withholding tax, the German or non-German investment fund is obligated to prepare and to file a corporate income tax return on an annual basis.

A (partial or complete) exemption of the investment fund from German corporate tax is only possible if certain types of investors are invested and if certain requirements are fulfilled.

At the level of the investor, (i) any distribution made by the investment fund regardless of the actual composition (e.g. also a return of capital), (ii) a pre-determined tax base

(Vorabpauschale) and (iii) the capital gain from the sale of the investment fund units is taxable. A partial tax exemption is possible if the investment fund qualifies as equity, mixed or real estate fund which is the case if the respective investment fund meets certain requirements. In most of the cases, changes to the sales documents will be necessary.

3. Special Investment Funds

In general, a special investment fund and its investors are taxed in the same way as an investment fund and its investors. Unlike the investment fund, the special investment fund can however opt for tax transparency. In this case, the current taxation system (i.e. principle of tax transparency) will continue to apply with however substantial modifications particularly concerning the determination of the income attributed to the German investors.

The investor will be taxed on distributed and/or deemed distributed income as well as on capital gains from the sale of the special investment fund units. However, under the new German Investment Tax Act it is no longer permitted to operate income equalisation for tax purposes. Instead, the taxable income must be attributed to the investor on a pro-rata temporis basis. This means that the special investment fund needs to track (i) which investor (ii) was invested (iii) to which extend (iv) during a certain period of time and (v) which amount and (vi) which type of income has been generated during this time. Furthermore, any income and capital gains which are not part of the deemed distributed income are deemed to be distributed to the investor with the expiration of the fifteenth fiscal year following the collection.

The calculation and publication of the German daily tax reporting figures (equity gain and double tax treaty gain) is still required. In addition, a new daily tax reporting figure for the partial tax exemption on income deriving from underlying investment funds is introduced (partial tax exemption gain).

In a nutshell, the degree of complexity regarding the determination of the income for special investment funds will increase significantly. The implementation of a new computational logic in IT systems is therefore indispensable.

4. Service Offering

Deloitte has observed the developments right from the beginning and is best placed to provide excellent support in order for market players to be compliant with the new requirements and thus to secure and to expand the market share in Germany.

We are more than happy to answer any questions and to discuss further steps on how to prepare yourself for the upcoming reform.

[All articles related the topic investment taxation](#) (in German)

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