Private Finance Newsletter

Investment tax reform law adopted

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The half-life of German law is not only falling in the field of inheritance tax; the investment tax law has also experienced several changes in recent years. After the last amendment via the AIFM Directive Implementation Act from 24 December 2013, there was again a rumbling in the responsible committees, resulting in first discussion drafts of a substantial reform of the investment tax law in July 2015. After adopting the current draft bill in the second and third reading by the German Federal Parliament, the Federal Council of Germany also issued its consent to the new investment tax reform law on 8 July 2016.

A. Changes

While the law previously differentiated between public and special investment funds, as well as between partnership investment companies and capital investment companies, in future the law will only differentiate between investment funds and special investment funds. Partnerships will be excluded from the scope of the law.

I. Investment funds

The Investment Taxation Reform Act (InvStRefG) foresees a fundamental systematic change in taxation of investment funds. In future, investment funds will no longer be largely considered transparent structures, but as special purpose funds (German investment funds) or assets/legal estates (foreign funds) will instead be subject to corporate income tax of 15% plus an additional 5.5% solidarity surcharge. The corporate tax liability applies uniformly for both domestic and international investment funds, but only to:

- **Income from domestic holdings:** Mainly dividends received from domestic corporations, but not gains from the sale of these participating interests. These shall remain tax-free in order to ensure Germany's tax competitiveness.
- **Income from domestic real estate:** This includes both recurring income as well as capital gains from the sale of domestic real estate. In contrast to private real estate transactions, a holding period of more than ten years will not result in tax exemption, so that there is unlimited tax liability for capital gains from real estate.
- **Other domestic income:** Mainly includes trade or business income.

Interest, gains from the disposal of securities and gains from futures, as well as foreign dividends and foreign real estate income, will remain tax-free at the level of the fund.

As before, the individual **investor** is still taxed on fund dividends and capital gains from the sale of fund shares. Furthermore, the current deemed distribution income will be replaced by the so-called advance flat rate. In order to avoid or reduce double taxation of the same income at the fund level as well as at the investor level, the investment income will be partially exempted at the investor level. The size of this partial exemption depends on both the fund category (stock, mixed, real estate or other funds) and the type of investor (private individual, entrepreneur or corporation). The exemption ranges from 15% (e.g. mixed funds held as private assets) to 80% (real estate funds with foreign real estate). No exemption will be granted for investments in other funds.

Initial calculations show that the combination of the advance flat rate and the partial exemption need not leave the investor worse off. The new investment tax reform law may be a **positive surprise** for some investors.

II. Special-investment funds

The current taxation regime for special investment funds will remain in place. Therefore, the funds will continue to be considered transparent for tax purposes and the income will only be taxed at the level of the investor. However, this will no longer happen automatically. The special investment fund will need to explicitly make use of the so-called transparency option, otherwise special investment funds will be treated as investment funds for tax purposes.

A major change for special investment funds relates to legally-permitted investors. Going forward, it will not be permitted for individuals to acquire shares of a special investment fund **via asset management partnerships** According to the InvStRefG, individuals will only be permitted as investors if the shares are held within the individual's business assets. A grandfathering is intended for existing indirect participating interest on asset management partnerships. This applies to the acquisition of shareholdings after 24 February 2016 until 2020 and to acquisitions before 24 February 2016 until 2030.

B. Effective Date

The InvStRefG takes effect from 1 January 2018. In order to complete the change in the system, the Act creates a fictive sale of all fund shares obtained before 1 January 2018 on 31 December 2017 and their subsequent repurchase on 1 January 2018. Any capital gains resulting from this fictive sale will be taxed when the shares are actually sold.

The transitional rules will be particularly incisive for the following fund classes:

- Shares in Luxembourg special funds (so-called "**millionaire funds**") purchased before 10 November 2007;
- Shares in **money market funds** purchased before 19 September 2008; and
- Shares in **investment funds** purchased before 1 January 2009.

The grandfathering (tax-free sale of the fund shares) that was previously applied to these shares will be limited to value gains up to 31 December 2017. Changes in value after 1 January 2018 will be taxed in cases where the capital gains from the sale exceed EUR 100,000.

The Act also fictively creates a stub fiscal year to 31 December 2017 at the level of the fund for funds without a calendar fiscal year.

C. Action Points

I. Fictive sale

Given the fictive sale of all fund shares on 31 December 2017, it should be considered whether an actual sale prior to this date would be advantageous (especially where capital losses are expected in the remaining time).

II. Partial tax exemption

The above-mentioned partial tax exemption for the investor requires the corresponding classification of the relevant funds as stock funds, mixed funds or real estate funds according to the investment guidelines. A review and, where necessary, adjustment of the investment guidelines should therefore be performed before 1 January 2018.

III. Investment strategy

Given that the corporate income tax liability at the level of the fund is only limited in certain cases, it may be worth reconsidering the strategy of the fund from a tax perspective. This also applies for the varying partial tax exemption levels per fund asset class. Exceeding or undershooting certain asset levels can have significant tax consequences for the investor.

IV. Disclosure obligation

Foreign investment funds with domestic dividend income or domestic real estate income should ensure that they will be able to meet their disclosure obligations in Germany from 1 January 2018.

D. Outlook

The corporate income tax liability of capital gains from the sale of free float shares was again averted. However, the matter does not appear to be closed: the Financial Committee of the Federal Council explicitly noted in its recommendation that uniform principles for the taxation of dividends and sale profits are both appropriate and necessary.

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