Plans to reform the German Investment Tax Act
Overview and impact

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It is almost a legal tradition that the income earned by German taxpayers through an investment fund is taxed in accordance with the so-called principle of tax transparency. For some time, however, a number of ministries of finance have been pursuing a plan to reform the German Investment Tax Act to such an extent that the principle of tax transparency could be eliminated.

Should this initiative pass the legislative process, the new taxation regime would most probably have a significant impact on the business of asset managers when selling fund units to German investors.

Starting point: principle of tax transparency

Under the current taxation system, German investors in an investment fund are taxed in line with the principle of tax transparency. Essentially, this means that profits as well as income generated by an investment fund are only taxable in the hands of the investor; the investment fund as such should not be subject to tax. The purpose of the principle is to make sure that the tax burden is more or less identical, regardless of whether an investment is made directly in the assets or indirectly through an investment fund. In other words, the interposition of an investment fund should neither lead to a higher nor a lower tax burden for the investor.

The principle of tax transparency requires the investment fund to publish certain tax bases in line with German tax laws; these are then used in order to arrive at the correct tax assessment of the investor. If the investment fund fails to provide these tax bases, the investor is taxed on a lump-sum basis. This, however, fails to take into account the actual financial position of the investment fund, which can lead to taxation even if the investment fund suffered a loss in value. Consequently, the so-called opaque investment funds are not usually marketable in Germany.

Political environment

The plan to reform the taxation of income from investment funds was reflected in the coalition agreement between the Christian Democratic Union and the Social Democratic Party of Germany in 2013. Under the terms of the agreement, the parties joined forces and stipulated that the federal government would discuss the fundamental reform of the taxation of income from investment funds once again hoping to change the future tax treatment of capital gains from portfolio holdings in an open and unbiased way.

The general perception in the market is that the work on the new act has been completed. The remaining questions at the moment seem to centre on if and when the draft bill is going to be introduced into the formal legislative procedure.

The intention, therefore, is to drop the principle of tax transparency for such mutual investment funds, i.e. to eliminate any type of investor tax reporting and to replace it with a simple taxation system that can easily be managed

Objectives of the reform

There are a number of arguments brought forward by supporters as to why a fundamental reform is considered indispensable. One explanation is that risks resulting from a potential violation of European Union law need to be precluded. In its 'Santander' judgment of 10 May 2012, the European Court of Justice (ECJ) found with respect to the French investment fund taxation system that it is not compatible with European Union law for withholding tax to be levied on dividend payments by domestic companies to non-resident investment vehicles while no tax is deducted when dividends are received by domestic vehicles. This is despite the fact that the legal situation in Germany is quite different given that, unlike the former French system, German investment funds are required to deduct withholding tax in the case of the distribution and accumulation of domestic dividends.

This holds particularly true in light of the recent ECJ case law 'van Caster und van Caster' dated 9 October 2014. In this judgement, the ECJ dealt with the question of whether or not it is in line with the law for investors in a non-German investment fund to be taxed on a lump-sum basis if the investment fund does not calculate and publish the tax bases in order to gain transparent status. Even though the underlying provision applies to both German and non-German investment funds, the ECJ decided that it is an unjustified restriction on the free movement of capital if the investor does not get the chance to prove the true tax bases himself.

The tax authorities are expecting an increase in the number of cases where taxpayers file applications aimed at consideration of self-assessed tax bases and that the work required on the part of the authorities will increase significantly. The concern is that, unlike today, there will potentially be a need to have specifically trained tax officers in each and every revenue office. It is said that the estimated expenses triggered by this development would most probably be out of proportion in relation to the expected amount of tax income.

Another point is that the fiscal authorities view the investment taxation area as being very prone to abuse because of its complexity and high asset volume. Even though known misuses have been eliminated by the AIFM Tax Adjustment Act, investment taxation requires reform in order to prevent or at least impede future abuse.

Furthermore, it is argued that the principle of tax transparency leads to a considerable administrative burden in practice. For example, each investment fund needs to calculate and publish up to 29 tax numbers upon each distribution and accumulation. Loss carry-forwards have to be separated into 12 categories.

Finally, the supporters of the envisaged reform criticise the fact that a review of the tax bases for all investors can only be carried out retroactively. Should errors be identified, a retroactive correction at the level of the investors is practically impossible due to the anonymous mass procedure. Investors in an investment fund are usually unknown and the investor composition changes frequently between the time when the error occurred and the time when it was detected. Instead of a retroactive correction, which would be appropriate from a substantive point of view, the current taxation system manages these cases by correcting the figures in the fiscal year in which the inaccuracy was discovered. As a result, investors who were not investing at the relevant point in time are hit by a correction, these investors can in turn claim a rescission of that error correction in their personal tax assessments. In the final analysis, the outcome is that a higher tax claim on the part of the tax authorities cannot be enforced.

Main content of the envisaged tax system

While the fiscal authorities are of the opinion that compliance even with complex rules can be safeguarded in the case of special investment funds, i.e. investment funds where the number of investors is limited to 100 and where investors must not be natural persons, it is said that the opposite is true with respect to mutual investment funds. The intention, therefore, is to drop the principle of tax transparency for such mutual investment funds, i.e. to eliminate any type of investor tax reporting and to replace it with a simple taxation system that can easily be managed. For special investment funds, the current taxation rules would, however, be retained and only minor changes would be made in order to eliminate any potential risks with regards to European Union (EU) law and reduce any scope for action.

Investment fund level

The major change would be that German dividends as well as rental income and capital gains from German real estate would be subject to a 15% corporate tax at the level of a German investment fund. All other income (e.g. interest income, capital gains from the sale of shares and other securities) would still be tax-free. As a result, German and non-German investment funds would be treated equally in order to avoid distortion of competition.

An exemption from corporate tax would be possible to the extent that funds can prove that tax-exempt investors have invested (e.g. charitable investors such as churches and foundations). The same would apply if investors held investment fund units as part of their official retirement arrangements. The relevant circumstances shall be evidenced by a voluntary certification procedure upon the acquisition and redemption of investment fund units. Total exemption from corporate tax would be possible if the terms and conditions of the investment fund dictate that only tax-exempt investors are entitled to participate.

Investor level

At the level of the investor, essentially any distribution would be entirely taxable regardless of the composition. In other words, even a repayment of capital would be subject to taxation. As an exception, investors would enjoy a tax exemption of 20% in the case of equity investment funds and 40% if they are invested in real estate investment funds. If the investment fund is primarily invested in non-German real estate, the tax exemption would go up to 60%. The partial exemption is considered necessary in order to compensate for the tax burden at the investment fund level.

In the case of a reinvestment fund or if the investment fund only distributes a very small amount of its income, the German investor would be taxed on the basis of a pre-lump sum. The amount of this pre-lump sum would be determined by the value of the investment fund unit at the beginning of the year, multiplied by the variable base interest rate pursuant to the German Valuation Act. The base interest rate is an average interest rate on government bonds determined by the German Central Bank once a year as per the first trading day of the year. In order to account for administrative costs at investment fund level, a discount of 20% on the base interest rate would be made.

The charging of the pre-lump sum would be capped by the actual increase in value of the investment fund unit. If there has been no increase in value during the calendar year, no pre-lump sum would be applied as tax base. The pre-lump sum would be deducted upon the sale of the investment fund unit, thereby reducing tax.

Transitional rules

The plan provides for the new rules to commence on 1 January 2018. Investment funds having a fiscal year differing from the calendar year would have to form a short fiscal year as per 31 December 2017 to ensure a uniform transition for all investment funds and their investors.

Investment units acquired before 2009 are, however, grandfathered under the old rules, i.e. a capital gain stemming from the sale of the investment fund units would be tax-free. This protection is limited in such a way that only disposals before 1 January 2020 are tax-exempt. Thereafter, any appreciation or depreciation originating from 2018 and onwards would be taxable.

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Business impact

The envisaged comprehensive reform of the German Investment Tax Act would constitute a complete change of investor taxation. Notwithstanding the arguments put forward by the fiscal authorities, the reform would have far-reaching consequences for the asset management industry. Many market participants, including asset managers, associations and investors, have considerable concerns about the plans and believe the 'investment fund' product could be damaged. One of their arguments is that tax reporting for German investors has been well established since 2003, when the system came into force, while the envisaged taxation system would ignore any investor-specific circumstances. Indeed, the tax aspects of investment products have become more and more important over the past years and it remains to be seen how investors and particularly business investors would react if the plans became reality. One scenario is that business investors would shift their investments into special investment funds and another is that the insurance business would significantly benefit from the reform.

In any case it is vital to keep a very close eye on further developments and to anticipate the consequences of the potential reform for the retail business. The impact can be quite different depending on the set-up of an investment fund and the composition of its investors. It will be advisable to consult a tax advisor in due course.

To the **point**:

- The German fiscal authorities are determined to reform the German Investment Tax Act to such an extent that the principle of tax transparency would be eliminated
- The arguments favouring a reform pertain to the fear of violating the European Union law, the conviction that the investment taxation area is extraordinarily prone to abuse, the considerable administrative burden as well as the fact that incorrect tax bases cannot be corrected retroactively
- The perception in the market at the moment is that a bill has already been drafted but the formal legislative procedure has not yet commenced
- For special investment funds, i.e. investment funds where the number of investors is limited to 100 and where investors must not be natural persons, the consequences of the reform would be moderate
- For mutual investment funds, the principle of tax transparency would, however, be dropped and investors would therefore no longer be taxed on the basis of their individual situation and the income of the investment fund but instead on the basis of generic assumptions
- German investment funds to the extent that they earn German dividends, German rental income and capital gains from German real estate would be subject to corporate tax. In addition, investors would be taxed on distributions and a pre-lump sum whereby certain tax exemptions would be depending on the type of investment fund
- Should the envisaged reform become a reality, the new taxation regime would most probably have a significant impact on the business of asset managers when selling fund units to German investors