On 8 July 2016, the German Investment Tax Reform Act passed the Federal Council of Germany. As a consequence, the act will basically take effect on 1 January 2018 with a wide-ranging impact on the taxation of income realised through an investment fund. The reform implies a significant challenge for Asset Managers but also present new opportunities to gain additional market shares. Now is the right time to focus on the reform and to take action in order to make the most of the new legal environment.
Basic content of the reform
The reform fundamentally changes the taxation of investment income by introducing two separate taxation systems for investment funds on the one hand and special investment funds on the other hand. While an opaque taxation system will apply to investment funds where both the fund and its investors are subject to tax, the principle of tax transparency can be continued for special investment funds with however fundamental modifications.

Scope of application
The reformed German Investment Tax Act (“GITA 2018”) is applicable to investment funds which are defined as investment asset pools within the meaning of the German Capital Investment Code. In addition, so-called “fictitious investment funds” are in scope of the GITA 2018 even though they do not qualify as investment asset pools. In practice, the most relevant case from a practical point of view will be so-called single investor funds, i.e. investment vehicles which limit the number of possible investors to one single investor but are in line with the remaining requirements for an investment asset pool. Furthermore, a company which must not unfold an active entrepreneurial activity under the laws of its home country and which is not subject to tax or exempted from tax will be deemed an investment fund.

The GITA 2018 is not applicable in the following cases:
- If the certain exceptions of the German Capital Investment Code are applicable (e.g. securitisation special purpose vehicles and holding companies)
- If the investment asset pool is established in the legal form of a partnership, provided that it does not qualify as UCITS; investment funds of a contractual type (Sondervermögen) are however not considered to be partnerships.

It will be important to cope with the new requirements of a special investment fund already before 1 January 2018 given that a change from an investment fund to a special investment fund is excluded after that date.
In the case of participation companies pursuant to the German Participation Companies Act and REITs which are subject to the German Real Estate Investment Trust Act

In order to qualify as a special investment fund, an investment fund must comply with certain additional requirements which are comparable to the criteria to be fulfilled by all types of investment funds under the law currently in force. In other words, those requirements relate to regulation, redemption rights, eligible assets and investment limits. In addition, the number of investors must not exceed 100 whereby private individuals are basically prohibited. Unlike under the current rules, individual investors may however invest even directly into a special investment fund if they hold the fund units as part of their business assets. On the other hand, a look-through approach in relation to partnerships as investors will take place resulting in the fact that private individuals can basically no longer invest indirectly into a special investment fund.

It will be important to cope with the new requirements of a special investment fund already before 1 January 2018 given that a change from an investment fund to a special investment fund is excluded after that date.

**Investment funds**

One of the key points of the GITA 2018 is that investment funds will be subject to German corporate tax to the extent they receive German sourced dividend and rental income as well as capital gains from German real estate. These items are fully taxable at a rate of 15% including solidarity surcharge in the case of income subject to German withholding tax. In the case of income where no deduction took place, i.e. where the investment fund needs to file a corporate tax return with the German fiscal authorities, the tax rate amounts to 15% plus solidarity surcharge thereon. All other income (e.g. interest income, capital gains from the sale of stocks and other securities) is tax-free.

An application for exemption from corporate tax is possible to the extent that certain eligible investors are invested in the investment and management of the assets for the joint account of the investors and if an active entrepreneurial management of the assets to a substantial extent is excluded.

In addition to the investment fund, also the investor is subject to tax based on a very generalising system. Under the GITA 2018, the following items will trigger a taxation:

- Distributions regardless of their composition (e.g. even a repayment of capital will be taxable)
- Pre-determined tax bases
- Capital gains realized upon the disposal of investment fund units

The objective of the pre-determined tax base is to make sure that at least the risk-free market yield is taxed in the hands of the investors. It is therefore due if the distributions remain under the so-called base proceed. The base proceed in turn has to be determined by multiplying the first redemption price set in the calendar year with 70% of the base interest rate (long-term yield on public bonds published by the German Central Bank). The base proceed is capped by the actual increase in value of the investment fund unit plus any distributions. The pre-determined tax base is then deemed to be received by the investor on the first business day of the following calendar year.
Any investment income (distributions, pre-determined tax bases and capital gains from the disposal of investment fund units) can generally be subject to a partial exemption provided that the respective investment fund qualifies as equity fund, mixed fund or real estate fund:

- **equity funds** are investment funds that invest continuously at least 51% of their value in equity participations according to their constitutive documents. The partial exemption amounts to 30% for private individuals. For individuals holding the investment fund units as part of their business assets, the partial exemption increases to 60%. For corporate investors, 80% of the investment proceeds are tax-free.

- **mixed funds** are investment funds that invest continuously at least 25% of their value in equity participations according to their constitutive documents. In this case, half of the partial exemption rates applicable to equity funds is available.

- **real estate funds** are investment funds that invest continuously at least 51% of their value in real estate and real estate companies according to their constitutive documents. The partial exemption rate amounts to 60%. If the relevant investments are made in non-German real estate and non-German real estate companies, the partial exemption rate increases to 80%.

Special investment funds

On principle, special investment funds are subject to German corporate tax to the same extent like investment funds. They can however opt for tax transparency, i.e. the tax system known under the prevailing law can be continued depending on the choice of the special investment fund. In other words, the tax liability is dropped and the income of the special investment fund is deemed to be received directly by the investors. It should though be noted that significant amendments have been made to the principle of tax transparency.
As under the current GITA, investors are taxed on distributed income, deemed distributed income and on capital gains from the disposal of special investment fund units. The modifications mentioned above primarily concern the determination of the income at the level of the special investment fund and the attribution to the investor:

- The income needs to be grouped depending on the tax effects at the level of the respective investor;
- with regard to distributed income, a new distribution order is to be taken into account;
- the equalisation methodology will not be accepted for tax purposes any longer; instead, an attribution of income and expenses to the investor on a pro rata temporis basis takes place:
  - in the case of a distribution of income which has been generated during a time period where the investor was not invested in the special investment fund, a repayment of capital is simulated
  - in the case of a reinvestment, only income and expenses actually generated during the holding period of the investor are attributed to that investor; in addition, the income is deemed to be received by the investor at the end of the fiscal year of the special investment fund regardless of a prior sale of the special investment fund units
- The extent of the deemed distributed income has been newly defined, i.e. inter alia it does not include capital gains from the sale of bonds whereby a distinction between DDI-bonds and plain vanilla bonds is not necessary any longer; an exception only applies in the case of swap contracts to the extent that the swapped payment flows are determined by dividend or interest income;
- Any income which is not part of the deemed distributed income is deemed to be distributed with the expiration of the fifteenth fiscal year of the special investment funds following the collection.
Transitional rules
The GITA 2018 will basically enter into force on 1 January 2018 regardless of the fiscal year of the investment fund and of the acquisition date of the investment fund units. Investment funds with a fiscal year differing from the calendar year have to form a short fiscal year as per 31 December 2017 for tax purposes.

Investment fund units acquired before 2009 are currently grandfathered in such a way that capital gains are not taxable. This protection will end on 1 January 2018, i.e. any changes in value taking place from that date onwards will become taxable to the extent they exceed a tax exempt amount of €100,000.

Impact for Asset Managers
The GITA 2018 will completely change the way of how investment income is taxed and particularly Asset Managers should undertake immediate action in order to prevent outflow of funds. Particularly business investors are balancing pros and cons at the moment regarding the question whether they should shift their investments from investment funds to special investment funds.

As far as investment funds are concerned, the main points are that Asset Managers need to make sure that the fund is taxed correctly in Germany which may include the filing of corporate tax returns. Equally, it may be necessary to re-structure investment funds in order to avoid any tax disadvantages for the fund as well as for its German investors. This includes amendments to the constitutive documents as well as an appropriate flow of information and communication. Finally, an adequate management of withholding taxes is vital to remain competitive and processes need to be implemented for the purpose of benefitting from a partial or even full exemption from German corporate tax in the case of eligible investors.

In relation to special investment funds, the challenges go even beyond. In particular, Asset Manager should engage themselves with the question whether or not it is necessary to launch special investment funds specifically for the German market in order to retain their German business investors. The usual business where an investment fund is structured in such a way that the units can be distributed on a cross-border basis will not work any longer due to the specific requirements of the GITA 2018. In the case a special investment fund has been founded, the new provisions dealing with the determination of the income means an enormous challenge for Asset Managers.

This particularly holds true with respect to the attribution of income and expenses on a pro rata temporis basis as a result of the omission of the equalization method for German tax purposes. Broadly speaking, the new investor reporting will no longer follow a “one-size-fits-all-approach”. Instead, the reporting need to be individualised taking into account the specific position of each and every investor.

To the point
• On 8 July 2016, the German Investment Tax Reform Act passed the Federal Council of Germany. As a consequence, it will basically take effect on 1 January 2018 with a wide-ranging impact on the taxation of income realised through an investment fund.
• The reform implies a significant challenge for Asset Managers but also present new opportunities to gain additional market shares. Now is the time to concentrate on the reform and to take action in order to make the most of the new legal environment.
• For investment funds, the principle of tax transparency will be dropped resulting in the fact that both the fund and its investors will be subject to German tax.
• By way of contrast, special investment funds can opt for tax transparency meaning that the taxation known under the prevailing law can be continued; the legal modifications are however significant.
• Asset Managers need to make sure that the investment fund is taxed correctly in Germany which may include the filing of corporate tax returns. Furthermore, care has to be taken that investment funds are optimised from a German tax perspective, that withholding taxes are managed in the most efficient way and that processes are implemented in order to benefit from a potential exemption from German corporate tax.
• As far as special investment funds are concerned, Asset Manager should consider to establish special investment funds exclusively for the German market in order to retain German business investors. The complexity of the investor tax reporting will increase considerably, because it needs to be individualised taking into account the specific position of each and every investor.
The GITA 2018 will completely change the way of how investment income is taxed and particularly Asset Managers should undertake immediate action in order to prevent outflow of funds.