New tax regulations for investment funds

France, Germany, Ireland, Luxembourg,
Netherlands, United Kingdom

This article mainly focuses on the amendments to regulations and fiscal consequences for the taxation of investment fund units held by investors in the respective jurisdictions. The amendments to the existing taxation rules for investment funds comprise of regulations which are aimed at fine-tuning the tax assessment provisions as well as correcting clerical errors in previous tax legislation and preparing amendments for future tax assessment periods.

France

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The second half of 2012 has seen a significant number of tax changes, though some of these have yet to be finalised as we go to print. We will have to wait until the final vote of the revised finance bill for 2012 and the 2013 budget to have the complete picture of what the new French tax landscape will look like. However, based on the changes that have already been introduced and the draft proposals under discussion, it is fair to say that there are tougher times ahead for the asset management industry in France.

Many of the tax updates for France focus on personal tax and are still being debated and modified as we go to print. Accordingly, these changes will be discussed and analysed in the next issue of Perform*ance*. Below, we set out a summary of the main changes made to the French tax landscape in the second half of 2012.

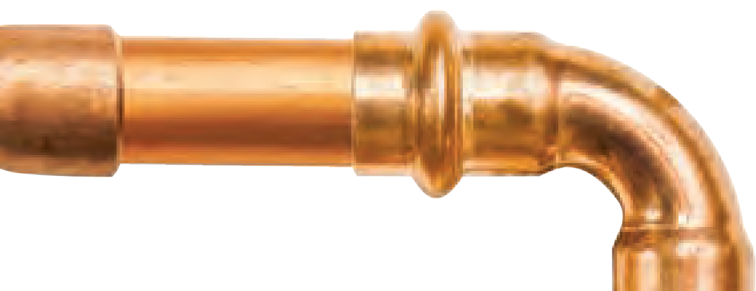
Financial Transaction Tax (FTT)

In 2011, Europe embarked on a race to implement a Financial Transaction Tax. As an agreement between the majority of EU member states was proving time-consuming and difficult to achieve, France decided to go ahead with the implementation of a local FTT while the European negotiations were ongoing.

The French FTT introduced on 1 August 2012 covers three types of transactions:

1. Acquisition of listed shares issued by French companies with a market capitalisation over €1 billion
2. CDS trading on EU sovereign debt
3. High frequency trading

The FTT rate on CDS and high frequency trading is 0.01%. These two areas have not been the priority concern of the industry, as they are limited to transactions entered into by French residents. However, the FTT on acquisitions of French listed shares has a much broader application and the rate is far higher, at 0.2%.



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Although the FTT is similar to the UK Stamp Duty Reserve Tax (SDRT), the mechanisms of taxation and collecting the tax are more complex. It is worth noting at this stage, that unlike with the EU proposal, the French tax applies solely to shares and equity instruments and does not include debt instruments or derivatives—unless they give rights to shares in a listed company covered by the FTT regulations.
Whereas brokers are primarily concerned by this tax, it does also have an impact on custodians, asset managers and investors. Custodians are at the centre of the investment cycle and would be affected due to their role in the reporting process; in addition, they may be an 'accountable party' in OTC transactions.

It is particularly important for custodians to understand which trades are liable for the FTT and which are not, and to identify the transactions for which they could be the accountable party (e.g. OTC transactions executed without a broker). Furthermore, even if a custodian is not the accountable party, it will play a key role in the reporting and payment of the tax. The responsibility and obligations of custodians will differ depending on the transaction.

Although asset managers may not have to deal with the more cumbersome filing obligations, they will be affected by other aspects of the tax. In particular, they may want to make sure that any exemptions available are correctly applied. Lastly, investors will ultimately bear the cost of the FTT and therefore have an interest in ensuring that their asset managers are applying the rules appropriately.

Changes regarding dividends

- **Withholding tax reclaims and withholding tax exemption on dividends**

  One piece of good news for asset managers in France is that dividends paid by French companies to collective investment funds are exempt from withholding tax. This was established by the decision issued by the CJEU on the Santander case in May 2012[1].

  Asset managers will therefore have the opportunity to reclaim withholding tax paid in France and across Europe. Statutes of limitation may vary between member states; however, several years of withholding tax payments can still be reclaimed in some 13 countries across Europe for both European and non-European funds.

  The Santander case specifically ruled that there should be no discrimination between EU funds and non-EU funds. As a result, French withholding tax can be reclaimed on dividends paid from 1 January 2009. Reclaims should be submitted to the French tax authorities before the official deadline of 31 December 2014. It is however recommended that reclaims are filed as soon as possible.

  Further to the Santander case, French legislation was amended to comply with European law by extending exemption to dividends paid to non-French investment funds. As from 17 August 2012, dividends paid to collective investment schemes should not be subject to withholding tax. A letter containing further clarification of the reclaim process has recently been sent to certain investment funds and their French advisors (and should soon be reflected in guidelines issued by the French tax administration). In this letter, the tax authorities provide somewhat vague guidance on the comparability criteria and a very thorough description of the formal evidence to be produced in order to support the claims. However, there is no information on the application of the exemption going forward. In any event, on the basis of the law, any withholding paid by an investment fund (UCITS or equivalent) after 17 August should be refunded.

- **3% surtax on distribution**

  The response to the withholding tax exemption on dividends paid to investment funds was the introduction of a 3% surtax on distributing companies subject to corporate income tax. This surtax applies to dividends and deemed dividends (for tax purposes) paid from 17 August 2012.

  This is not a withholding tax, and is therefore not discriminatory for EU purposes. It is borne by the company making the distribution, and may affect the yield on investment in French companies.

1 *See Performance issue 9*

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Germany

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Following the postponement of a major reform to Germany's Investment Tax Law, the Finance Committee of the upper house of parliament has proposed changes to the Annual Tax Law. The Finance Committee made recommendations for various amendments during consultations on the draft of the 2013 Annual Tax Act during June and July 2012.

At the time of writing (beginning December 2012), none of the proposed amendments to the Investment Tax Law have made it into the 2013 draft Annual Tax Act. Given that this is a provisional stage of the legislative procedure, it remains unclear whether the legislator will pursue all of the Finance Committee's recommendations. Some of the comments are merely in the form of a 'request for review' as to whether changes to existing legislation should be made. Nonetheless, the requested amendments are highly likely to come into force during the 2013 tax assessment period.

Proposed changes to the Investment Tax Law

Cost allocation

There is a request pending in relation to the allocation of 'general costs' for the purposes of German investment taxation. These are generally not directly attributable to a particular source of investment fund income. Under current rules, it is possible to allocate general costs predominantly to ordinary taxable ordinary income (e.g. dividends, interests) and thus reduce the investor's taxable deemed distributed income derived from fund investments.

According to the new rules, general costs would be allocated to taxable ordinary income as well as to capital gains. If the ordinary income and the sum of capital gains and losses are both negative, there is a fixed ratio of 50% for the allocation between ordinary income and capital gains. This means that the option to categorise 10% of the indirect costs as non-deductible expenses would be abolished. However, there will be no changes to the allocation of direct costs, i.e. costs that are directly attributable to a particular income source.

Mandatory source order to use fund income for distributions

The requested amendments include a mandatory order to use fund income for distributions to investors subject to taxation in Germany. Any distribution would be deemed to have been sourced from (1) all ordinary income and capital gains for the current or previous financial year if a distribution is made within four months from the financial year-end; (2) deemed distributed income
(i.e. ordinary income that has already been taxed) from previous financial years; (3) realised capital gains for previous financial years prior to 2004 (under KAGG or AuslInvG); or (4) substance.

The rule would be aimed primarily at restricting the ability of foreign investment funds to distribute substance, i.e. effectively repaying investor capital, even though the fund accumulates realised capital gains. A decree issued by the Ministry of Finance previously contained a related ruling.

Anti-abuse rules applicable to bond-stripping structures

There is a request pending to prevent certain structures involving the change in ownership rules of bond coupons, known as 'bond-stripping structures'. Until now, these structures have been used to generate taxable income from the disposal of stripped interest coupons at the fund level, which can be used as deemed distributed income to be offset against other losses of the investor and therefore avoid forfeiture of the investor's tax losses under the special regulations of the Corporate Income Tax Law. Future losses from the disposal of the fund units could be offset against other taxable income.

Tax exemption of dividends and capital gains

A possible change within the Corporate Income Tax Law regarding the tax exemption of dividends and capital gains for corporations will have implications for the Investment Tax Law as well. In the future, the 95% tax exemption for dividends and capital gains will only be applicable to shareholdings greater than 10%. This will also apply to fund investments. Thus the daily tax figure in relation to the equity gain for corporate investors might need to be adjusted.

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Ireland

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Irish regulated funds in the form of corporate funds, unit trusts or an investment limited partnership are treated as tax opaque or tax 'look at' structures. These regulated funds do not pay tax in Ireland on their income and gains where the fund units are all held by non-Irish residents. For that reason, Irish regulated funds are commonly referred to as 'gross roll-up funds' because of this tax efficiency. The Irish Common Contractual Fund (CCF), which has been used for a number of years for asset pooling (including pension pooling) is the one Irish regulated fund structure that is recognised as tax transparent in both Ireland and in numerous jurisdictions around the world.

Many of the tax changes involving funds in the last few Irish Finance Acts have focused on ensuring that Ireland was ready for European legislation such as UCITS IV and the Alternative Investment Fund Managers Directive (AIFMD).

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The main changes made to Irish tax legislation in 2012 are set out below.

Mergers: a clarification was introduced in Irish tax legislation such that in the case of a merger between an Irish fund and a 'good offshore fund[1], Irish investors are not deemed to have made a disposal of their units as a result of the merger. Instead, the new holding of shares or units in the merged entity is effectively treated as 'stepping into the shoes' of the old holding. In this way, it makes mergers under the UCITS framework tax neutral from the point of view of an Irish investor. Investors are taxed in Ireland when they dispose of those merged units, but with the cost for the purpose of calculating any gain being that of the 'old' units. For non-Irish investors, it was always the case that such investors were not taxed in Ireland on a merger scenario involving an Irish regulated fund. This is on the basis that such non-Irish investors have no tax liability in Ireland on any gains made on the disposal of their units/shares in Irish funds.

Reorganisations/amalgamations: Irish tax legislation was also amended to confirm that switching from one sub-fund to another sub-fund of the same umbrella is not a disposal for Irish tax purposes for an Irish investor in a good offshore fund. Legislation has been in place for several years which states that a switch between sub-funds of the same Irish umbrella is not a disposal for Irish tax purposes.

Master feeder structures: where assets are transferred from a good offshore fund to an Irish master, and in return the units in the Irish master fund are issued directly to the good offshore fund, the transfer of the assets can benefit from various reorganisation exemptions. While such stamp duty and direct tax exemptions already applied to situations where the units were issued directly to the investors in the fund, they have now been expanded to include cases in which the units are issued to the good offshore fund. The effect of the above changes on Irish tax legislation was to further enhance the Irish tax framework, so that fund groups can restructure and reorganise their fund offerings in a tax-efficient way from both an investor and a fund perspective.

One change signalled this year—which is still a work in progress—concerns a new corporate structure for the funds industry which will meet the US 'check-the-box' tax requirements. The Minister for Finance has approved in principle the regulatory proposals for this new structure, and part of this initiative will also see the introduction of accompanying tax legislation. The intention of the Irish funds industry is that this new corporate structure will be in place before AIFMD comes into effect in July 2013. To date, much of the preparation and groundwork for the tax changes needed for the implementation of AIFMD has already been completed in the last few Finance Acts.
The annual Irish Finance Bill is expected in the first quarter of 2013, so it will be interesting to see what further changes or enhancements are made to tax legislation for funds at that time.

1 A fund regulated to an equivalent level of an Irish fund and tax resident in the EU or in a country with which Ireland has a double taxation treaty

Luxembourg

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In Luxembourg the transposition process for AIFMD started last summer.

The government, having consulted with various working groups and industry bodies, drafted a law and submitted it to the Luxembourg parliament on 24 August 2012. The parliament must review, discuss and—if necessary—modify this draft before it can be approved. Adoption of this law would strengthen Luxembourg's position as a fund centre, as achieved under UCITS, and help position it as a location of choice for alternative fund managers. The draft law includes the following fiscal measures:

- **Overhaul of the partnerships law, including creation of the 'special limited partnership'**
  The draft law proposes notable changes to the Law of 10 August 1915 on commercial companies, including:
  - A modernisation of the legal regime applicable to the common limited partnership (Société en Commandite Simple or SCS) based on practices developed over time and on the Anglo-Saxon partnership model, emphasising the broad principle of freedom of contract
  - The creation of a new vehicle—the special limited partnership (Société en Commandite Spéciale or SCSp)—which is in most aspects similar to the SCS regime but differs from the latter in its absence of legal personality. In addition to unregulated funds, it would also be possible for SIFs and SICARs to be set up in this new legal form
  - Amendment of the law on the partnerships limited by shares (Société en Commandite par Actions or SCA)

From a tax standpoint, a key measure of the draft law consists of an amendment of the income tax law and municipal business tax law to limit the application of the '*Geprägetheorie*' tax principle for SCS and SCSp to cases where at least one of the general partners is a Luxembourg capital company owning a minimum of 5% of the partnership interests in the SCS/SCSp. This measure would achieve full tax transparency, including for municipal business tax (unlike the current regime) for any new SCS/SCSp with the general partner below the 5% threshold (which is typically the case for an alternative investment fund) while preserving the possibility of benefiting from the *Geprägerechtsprechung* in some specific cases.

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- **Introduction of a new tax regime for carried interest**
  A key point of the draft law is the introduction of a temporary regime for the employees of AIF managers and of management companies of an AIF ('employees'). The income that employees derive from their right to share in the profits of the AIF will be taxed at a reduced rate (a maximum of 10.90%) under certain conditions. The regime will apply to employees who (i) transfer their residence to Luxembourg during the year the law enters into force or during one of the five following years, and who (ii) have neither been tax resident in Luxembourg nor subject to taxation on their professional income in Luxembourg during the five-year period preceding the year the law enters into force. Eligible employees will be able to benefit from this regime for 11 years from the year in which they take on the position in Luxembourg that entitles them to the carried interest.

Moreover, the capital gains that the employees may derive from the sale/redemption of their shares/units of the AIF will be taxable according to the usual tax regime applicable to capital gains (i.e. exemption if the shareholding did not exceed 10% at any point during the five-year period prior to the sale, and the holding period exceeds six months). In addition to the advantages granted by its tax regime to highly-skilled workers (the two regimes have conditions in common), Luxembourg—which is a long-standing location for investment funds—will become a location of choice for fund managers as well. Whereas the tax regime for highly-skilled workers may already lead, on average, to yearly savings of personal income tax ranging from €40,000 to €50,000 for an executive whose compensation package is properly structured, this executive would also save around 30% tax on carried interest through the temporary regime.

- **Cross-border management of AIF**
  In a similar way to the arrangements for UCITS and as per the provisions of the AIFMD, the draft law provides that an authorised AIFM established in Luxembourg is allowed to manage AIFs established in other EU member states. From a tax viewpoint, these cross-border management services should not create any management and control issues, since the draft law specifically exempts from tax cludes the subjection to Luxembourg tax of these AIFs established outside Luxembourg but with their central administration or management in Luxembourg.

Netherlands

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Finnish investment funds entitled to full refund of Dutch withholding tax?

The Court of Appeal in Den Bosch has decided that a Finnish investment fund was entitled to a refund of the Dutch withholding tax deducted on portfolio dividends. The investment fund is exempt from taxation on profits in Finland. As a result, the Dutch withholding tax could not be credited. A request for a refund was denied by the Dutch tax authorities. However, the Court of Appeal considered that the situation of the Finnish investment fund was comparable to the domestic situation of exempt corporations which are entitled to a refund of Dutch withholding tax on dividends. The court therefore reached the decision that the denial of a refund infringed the free movement of capital. The case is currently pending before the Hoge Raad, which is the highest tax court in the Netherlands.

Dutch and U.S. tax authorities reach agreement on FGRs

The Dutch and U.S. tax authorities have entered into an agreement with regard to the tax treatment of Dutch FGRs (fund for joint account or besloten fonds voor gemene rekening). The authorities have agreed that the FGR is not the beneficiary of the income. Instead, the income is (proportionately) considered to be that of the participants in the FGR. This is good news for beneficiaries who are entitled to a reduced tax rate or exemption from withholding tax under a tax treaty or national tax law in the United States.

The Netherlands has previously reached similar agreements with Canada, Denmark, Norway and the UK, whereas—without entering into an agreement—a similar understanding has been reached with Austria, Belgium, South Africa and Taiwan. Moreover, the most recent Dutch tax treaties, such as those with Ethiopia (2012), Germany (2012), Japan and Switzerland, contain a specific clause about the treatment of tax transparent entities (e.g. FGRs).

The implementation of the AIFM Directive is entering its final phase. It is currently pending before the Dutch Senate

Full refund of Dutch withholding tax on distributions by FBIs

The Dutch FBI (fiscal investment institution or *fiscale beleggingsinstelling*) is widely favoured for investments in equity and real estate, whereas it is also used for funds that make use of a high dividend policy. In addition, FBIs are entitled to a payment reduction for any Dutch dividend withholding tax and foreign withholding taxes on dividend and interest. Any distributions by a FBI are subject to dividend withholding tax. The 2013 Budget Law includes a proposal for withholding tax to be fully refundable in at least EEA situations if the beneficiary of the dividend is exempt from taxation on profits and would also be exempt from tax if a resident of the Netherlands.

FATCA: Netherlands negotiates an intergovernmental agreement with the U.S.

At the time of writing, the Netherlands was in negotiations with the United States on an intergovernmental agreement that would provide for a government-to-government approach regarding the exchange of information under the U.S. Foreign Account Tax Compliance Act. An advantage of the 'government-to-government approach' is the lower administrative cost for financial institutions in the Netherlands. Financial institutions would not have to enter into individual agreements with the IRS. Instead, the exchange of information would take place via the Dutch tax authorities in accordance with new national legislation.

The Netherlands is among the first countries to implement the AIFM Directive

The implementation of the AIFM Directive is entering its final phase. It is currently pending before the Dutch Senate. The proposed legislation stipulates that an alternative investment fund is—for tax purposes—considered to be a resident of the country in which it is authorised. This provision would make it possible for Dutch management companies to take full advantage of the 'management company passport', which ensures that the licence granted by the management company's residence state is valid in the entire European Union. The proposed legislation avoids any discussion about the residence of alternative investment funds managed from a different member state to that in which the management company is established (the home state). Last year, a similar rule for UCITS was added to Dutch legislation.

United Kingdom

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UK tax transparent fund

The UK is in the process of introducing a tax transparent authorised contractual fund, designed to provide the UK investment management industry with a competitive alternative to European tax transparent funds such as the Luxembourg FCP or Irish CCF. There will be two possible legal forms of the UK authorised contractual vehicle: a co-ownership scheme (which will be transparent only for the purposes of income) and an authorised limited partnership (which will be transparent both for income and capital gains).

There are a number of expected uses of the UK authorised contractual fund:

- **Fund rationalisation**—one use of the fund would be to pool the assets held by multiple funds to achieve greater efficiencies and economies of scale in portfolio management

- **UCITS IV master funds**—UCITS IV permits cross-border master-feeder structures, which enable fund managers to offer a single portfolio of investments to different types of investors in multiple jurisdictions through different feeder funds. In order for the investors to be in the same tax position as they would have been if their feeder fund had held the underlying master fund's investments directly, the master fund needs to be tax transparent

- **Pooling for investors with favourable tax treaty benefits**—the fund will be attractive to investors who wish to obtain the benefits of a pooled fund but to retain their tax profile, such as favourable double taxation treaty benefits

- **Solvency II solution for life company reinsurance arrangements**—the fund may also offer an appropriate alternative to life company reinsurance arrangements to reduce/eliminate capital adequacy requirements under Solvency II (the fundamental review of the capital adequacy regime for the European insurance industry)

The UK authorised contractual fund is primarily designed to be UCITS-compliant, but it can also be established as a Non-UCITS Retail Scheme (NURS) or Qualified Investor Scheme (QIS). Indeed, given the nature of the expected uses of the fund detailed above, we might well see more UK contractual funds authorised as NURS and QIS.

The UK tax authorities consulted last year on the draft regulations to bring the vehicles into existence, and on the associated capital gains tax, stamp duty and VAT regulations required for their effective functioning. The final regulations should be laid this month and will come into force on 1 April 2013. As a result, fund providers should now begin assessing whether the UK authorised contractual funds might be an attractive option.

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