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German Investment Tax Act

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Effective 1 January 2004, the German Investment Tax Act ("ITA") regulates the taxation of investors subject to German taxation where such investors hold units in non-German and German mutual funds. This Memorandum gives a short and simplified summary of the new tax regime and must, therefore, not be relied upon without obtaining advice from a qualified adviser.

1 Fundamental principles of taxation for investors in a fund

From the tax perspective of a German investor, three different tax regimes for investments in (non-German or German) funds need to be distinguished:

- Transparent (white) funds: most beneficial tax treatment for investors
- Semi-transparent (grey) funds: acceptable tax treatment for investors
- Non-transparent (black) funds: tax penalty for investors

Which regime applies to a fund depends on the degree of its co-operation with the German tax authorities.

Assuming full co-operation of the fund and, therefore, focussing on the transparent (white) fund tax status, the current investment tax regime pursues the principle of limited tax transparency. In general, the fund is tax transparent, i.e., an investor holding assets through a fund is generally taxed the same way as an investor holding the assets directly. However, the transparency is limited and there are a number of exceptions, most of which, however, are favourable for the investor. The most important exceptions are:

- For private individual investors, speculative gains from securities and derivatives realised by the fund are tax exempt, whether distributed or retained. In a direct investment scenario, a tax exemption only applies if the security or the derivative has been held for more than one year prior to the disposal.
- Corporate investors are taxed on speculative gains from securities and derivatives only upon distribution. Profit retention at fund level, therefore, achieves a postponement of taxation.
- As an unfavourable exception, where the fund generates losses, such losses must be carried forward at fund level and cannot be offset against positive income at investor level.

The above exceptions from the transparency principle make investments through funds very attractive for German investors. For investors in funds with semi-transparent (grey) or non-transparent (black) tax status, no benefits are available.

Significantly, the tax discrimination against investors in foreign funds has been almost entirely abolished; the remaining discrimination is immaterial. The tax treatment of investors in domestic and non-German funds depends solely on whether or not the fund complies with its tax reporting and publishing requirements. The tax reporting requirements are, however, extensive and, depending on the fund's investment strategy, may be quite difficult to fulfil. The regulatory position of the fund with a view to its registration with the German regulator, BaFin, is no longer relevant when determining the tax position of the investors.

2 Scope of application of the ITA

The scope of the ITA is identical to the scope of the German Investment Act which regulates regulatory and marketing issues. This means that, whenever a foreign entity is subject to the provisions of the Investment Act, its German investors will be subject to the tax regime provided by the ITA and vice versa.

The Investment Act defines a fund as an entity governed by the laws of a foreign jurisdiction and holding a risk-diversified portfolio of assets (from a list with a limited range of assets encompassing, in particular, securities and derivatives).

From a practical approach, it is often left to the BaFin to decide whether or not a foreign entity falls within the scope of the Investment Act. The decisions of the BaFin, although not legally binding, are therefore usually authoritative for the tax authorities. Consequently, where units in a foreign entity are to be publicly distributed in Germany and there is doubt as to whether or not the ITA is applicable, a ruling of BaFin should be sought.

3 Taxation of investors in transparent (white) funds

If the fund fully complies with the tax reporting and publishing requirements it is assigned transparent (white) tax status which is beneficial for German investors. The reporting and publishing requirements, however, are a hurdle to overcome, since for some types of funds they are quite extensive and difficult to fulfil. Difficulties may arise for funds with a large number of assets or asset movements.

3.1 Taxation of investors under the transparent (white) tax regime

Where a fund has transparent (white) fund status, the taxation is different for private and corporate investors. They are taxed as follows:

3.1.1 Private individual investors

(i) Taxation upon investment

The purchase of fund units is a tax neutral event.

(ii) Taxation during the investment

The taxation of the German investors depends on (x) the source of income generated by the fund and (y) whether or not the fund distributes its income. If the fund has generated income from several sources, it is at the sole discretion of the fund which basket of income it uses for a distribution, if any. The fund may also repay principal, which is usually tax neutral.

(a) Capital gains from the sale of securities and income from derivatives

Where the fund generates capital gains from the sale of equity or debt securities (unless in nature interest or comparable income) or income from derivatives (e.g. forwards and futures), such profit is tax exempt in the hands of private investors. For this reason, profit retention or distribution of the fund is irrelevant from the investor's perspective.

(b) Dividends

Dividends generated by the fund, whether retained or distributed, are subject to the so called half income method under which the tax base of each investor is halved. The individual progressive tax rate (up to approx. 50% for high net worth individuals) is then applied to the reduced tax base. As a result, the overall tax burden is also halved.

Where the fund retains its dividend income, the private investor is only taxed in the above manner at the end of the fund's business year.

(c) Interest and other income

Interest and other sources of income generated by the fund, whether distributed or not, are taxed in the hands of the private investors at their individual progressive tax rate.

Where the fund retains interest or other income, the private investor is only taxed in the above manner at the end of the fund's business year.

(d) Rental income and capital gains from the sale of real estate

Rental income generated by the fund, whether distributed or not, is taxed in the hands of the private investors at their progressive tax rate unless, in the case of non-German real estate, a double taxation agreement exempts such income from German taxation.

The same applies to capital gains from the sale of real estate. However, as a favourable exemption, where the fund holds real estate for more than ten years after the acquisition, the capital gain arising from the sale of such real estate will be tax exempt in the hands of the private investors, whether distributed or not.

(iii) Taxation upon sale

Where private investors redeem or dispose of their units within one year of acquisition, the capital gain from the sale is taxable at investor's individual progressive tax rate. Any redemption or disposal after such point of time, however, is entirely tax exempt. This tax exemption is under political discussion in Germany.

3.1.2 Corporate investors

Corporations holding units in a transparent (white) fund are taxed as follows:

(i) Taxation upon investment

The purchase of fund units is a tax neutral event. The units are capitalised in the balance sheet at their acquisition cost.

(ii) Taxation during the investment

Again, as stated above in 3.1.1(ii), the taxation depends on the source of income and the distribution policy of the fund, but the consequences are somewhat different:

- (a) Capital gains from the sale of securities and income from derivatives

A capital gain from the sale of equity securities is 95% tax exempt for corporate investors, whether distributed or retained.

Capital gains from debt securities (unless in nature interest or comparable income) and income from derivatives are only taxed upon distribution at regular rates. Profit retention, therefore, achieves a postponement of taxation.

- (b) Dividends

Dividends generated by the fund, whether retained or distributed, are 95% exempt from corporate income tax but may (depending on the size of the indirect shareholding of the investor in the distributing corporation) be subjected to trade tax (the latter at the applicable municipal tax rate currently varying between 10 and 20%).

Where the fund retains dividend income, the corporate investor is only taxed in the above manner at the end of the business year of the fund.

- (c) Interest and other income

Interest and other sources of income generated by the fund are taxed at regular rates, whether distributed or not.

Where the fund retains interest or other income, the corporate investor is only taxed in the above manner at the end of the business year of the fund.

- (d) Rental income and capital gains from the sale of real estate

Rental income generated by the fund, whether distributed or not, is taxed in the hands of the corporate investors at regular rates unless, in the case of non-German real estate, a DTA exempts such income from German taxation.

The same applies to capital gains from the sale of real estate. However, as a favourable exemption, where the fund holds real estate for more than ten years after the acquisition, the capital gain arising from the sale of such real estate will only be taxed upon distribution. Profit retention at fund level, therefore, achieves a postponement of taxation.

- (iii) Taxation upon sale

Where a corporate investor redeems or disposes of its units, the capital gain is taxable at regular rates, except for that portion of the gain attributable to tax-exempt income generated and not distributed by the fund. In particular, this holds true for capital gains from and the unrealised appreciation of shares and for dividends (so-called share-related profit) as well as for non-German source income exempted under a DTA which is usually relevant for income and gains related to real estate.

3.2 Tax reporting and publishing requirements for transparent (white) fund status

To achieve the transparent (white) tax regime treatment described in 3.1 above, the following information must be provided to investors in German (x) for each distribution or (y) where the fund retains income, within a four-month period after the end of the business year at the latest. The list is extensive and, for some funds, will be difficult to fulfil.

3.2.1 Information to be published upon distribution:

- (i) Amount of the distribution (to at least 4 decimal places), encompassing distribution of income as well as repayment of principal
- (ii) Amount of distributed income (to at least 4 decimal places)
- (iii) The following amounts included in the distribution:
 - (a) Deemed distributions of prior years (i.e. income generated but not distributed by the fund in prior years and subjected to tax at investor level in prior years)
 - (b) Capital gains from shares and derivatives (forwards, futures and the like) which are tax exempt for individual private investors
 - (c) Dividend and similar income subject to the half-income method for individual investors
 - (d) Dividend and similar income exempt from corporate income tax for institutional (incorporated) investors
 - (e) Capital gains from the sale of shares subject to the half-income method for individual investors
 - (f) Capital gains from the sale of shares exempt from corporate income tax for institutional (incorporated) investors
 - (g) Gains from the disposal of rights to subscribe stock dividends, unless qualifying as investment income
 - (h) Gains from the disposal of real estate after a 10-year speculation period for private individual investors
 - (i) Foreign source income exempted from German taxation on the basis of a DTA
 - (j) Foreign source income not exempted from German taxation, for which the fund has not opted for a deduction of creditable foreign taxes
 - (k) Foreign source income not exempted from German taxation, for which a fictitious foreign tax credit is granted on the basis of a tax treaty (tax sparing)
- (iv) The portion of the distribution for which a credit or refund of German withholding tax is available, i.e.
 - (a) Investment income (e.g. interest and other debt income), except equity income

- (b) Dividends from domestic corporations
- (v) The amount of German withholding tax actually creditable or refundable relating to the distributions mentioned in (a) and (b) above
- (vi) The amount of the foreign tax credit related to foreign source income not exempted from German taxation, which is
 - (a) creditable against German income taxes
 - (b) deductible from the German income, unless the fund has opted for their deduction
 - (c) granted as a fictitious tax credit on the basis of a tax treaty (tax sparing)
- (vii) The amount of depreciation, capped as provided in the Income Tax Act
- (viii) Only where the fund holds shares in German corporations: the amount of corporate income tax reduction at the level of a distributing German corporation corresponding with the corporate income tax increase at the level of the corporate investor.

3.2.2 Publication requirements for retained income

Where the fund retains income, the above information must be published 4 months after the end of the business year at the latest.

3.2.3 Tax accounting principles

All of the above figures must be calculated on the basis of a cash-oriented accounting scheme. In essence, the influx principle prevails.

However, interest, rental income from real estate and expenses are to be accounted for on an accruals basis.

The depreciation of buildings and other assets constitutes deductible expenses which can be offset against the fund's income. The depreciation amount may fall short of the maximum depreciation permissible under German tax laws but must not exceed such limit.

As regards expenses not directly attributable to specific income sources, the ITA provides for a rule pursuant to which a certain amount of such expenses is not tax deductible. Strictly adhering to the wording of the law, this provision only applies to German domiciled funds. It is an open issue whether or not the tax authorities will apply a similar regime to foreign funds.

The rule, where applied to a non-German fund, affects funds with income from non-German real estate and/or shares.

- (i) Non-German source income exempted under a DTA

Last year average NAV of the non-German assets of the fund
 : Last year average NAV of the total assets of the fund
 = Percentage
 * Expenses related to income exempted under a DTA
 = Amount of non-tax deductible expenses

(ii) Further non-tax deductible amount

Expenses related to income exempted under a DTA

./. Amount of non-tax deductible expenses calculated under 3.2.3(i) above

= Interim sum

* 10%

= Further amount of non-tax deductible expenses

(iii) Share-related expenses

Expenses related to income exempted under a DTA

./. Amounts calculated under 3.2.3(i) and 3.2.3(ii) above

= Interim sum

The quotient of the last year average NAV of shares held by the fund divided by the last year average NAV of the total assets of the fund is then applied to the Interim sum. Half of the figure so calculated is non-tax deductible for private investors. 5% of such figures is non-tax deductible for corporate income tax purposes.

Non-German funds following e.g. US-GAAP will most likely need to consult their fund administrators or advisers if they wish to re-adjust their income statement in order to comply with the tax reporting requirements.

3.2.4 Media for publication

The fund has to publish the above information in the Electronic Federal Gazette together with the annual report.

The fund must also publish a certificate issued by a tax advisor, an auditor, a lawyer or a comparable professional certifying that the provided information complies with German tax principles.

3.2.5 Aggregated deemed distributions

A foreign fund is obliged to publish the aggregated value of the deemed distributions, if any, beginning 31 December 1993 not yet subjected to withholding tax. The publication must be made together with the redemption price.

3.2.6 Proof

Upon a request of the Federal Tax Authority a foreign fund has to prove the correctness of the information published with a view to distributions or deemed distributions within a three-month period .

4 Taxation of investors in semi-transparent (grey) and non-transparent (black) funds

Given that the reporting and publishing requirements are potentially difficult for some funds to satisfy, it is important to remember that there are two other tax regimes that may apply to investors in funds that do not comply with the reporting requirements fully or at all.

4.1 Semi-transparent (grey) funds

4.1.1 Tax reporting and publishing requirements

Where the fund complies with the tax reporting and publishing requirements set out in 3.2, with the exception of 3.2.1(iii) and 3.2.1(vi), investors are subject to the semi-transparent (grey) tax regime.

4.1.2 Taxation

The investor is taxed on all income realised by the fund, whether distributed or not at the applicable individual tax rate or the corporate and applicable trade tax rate, as the case may be. No tax exemptions are available. Where the fund retains its income, the investor is only taxed at the end of the business year of the fund.

A capital gain realised by private individual investors from a redemption or disposal of the fund unit more than one year after its acquisition, is tax exempt. For corporate investors, the gain is fully taxable.

4.2 Non-transparent (black) funds

4.2.1 Violation of reporting requirements

Where a fund does not comply with tax reporting requirements to an extent qualifying as a transparent (white) or at least semi-transparent (grey) fund, the fund is assigned non-transparent (black) tax status.

This is a major risk for funds which are not expected by their sponsors to fall within the scope of the investment legislation, e.g. private equity and real estate funds. However, it should be mentioned that even the inability to satisfy the tax reporting requirements is not an obstacle to marketing risk diversified foreign funds into Germany, since the industry has developed structures to overcome this issue.

4.2.2 Penalty taxation

German investors in non-transparent (black) funds are taxed at regular rates on all distributions of the fund plus the higher of (i) 70% of the increase of the net asset value in the calendar year and (ii) 6% of the net asset value of the fund at the end of the calendar year.

Upon exit, the taxation of the capital gain is identical to the semi-transparent (grey) tax regime, i.e., there is no penalty taxation upon exit. This means that, where an investor becomes aware of the non-transparent (black) tax status of its fund, it can avoid penalty taxation by disposing of the units prior to the end of the calendar year.

5 Taxation of investors in funds-of-funds

With regard to a fund-of-funds, the above mentioned taxation rules are applied twice. Technically, the fund-of-funds is deemed a private individual investor in the target fund.

To achieve transparent (white) tax status, each of the fund-of-funds and the target funds must itself comply with the tax reporting and publishing requirements.

However, if a single target fund fails to comply, this does not “infect” the other target funds or the fund-of-funds. Only the income stream from the non-compliant target fund is affected. This limits the risk for investors in funds-of-funds.

6 Taxation of investors in institutional funds

An institutional fund is defined as a (domestic or foreign) fund having no more than 30 investors, none of which are private individuals.

The tax regime for investors in an institutional fund is almost identical to the investment in a public fund. However, the penalty taxation for non-transparent (black) funds does not apply to investors in institutional funds. In a worst case scenario, an institutional fund can only be assigned semi-transparent (grey) tax status. This is a major improvement for German investors who may have inadvertently acquired units in funds falling within the black fund regime.

7 Structured products

Repackaging and structured products are usually not covered by the ITA (exceptions are possible), but follow the general tax treatment applicable to bonds.

Individuals holding a structured product as a private asset for more than one year from the acquisition are exempt from tax on the capital gain generated by its disposal or redemption, unless the product is interest bearing or guaranteed in total or in part. A disposal or redemption prior to such point of time is taxable at the individual progressive tax rate.

Corporate investors are fully taxable upon disposal or redemption of structured products.

Comparing the tax regime for structured products to the tax regime for direct investments

- private individual investors might prefer structured products achieving an entire tax exemption which, in the case of a direct investment, is only achieved where the fund generates gains solely from securities and derivatives and where such fund is assigned transparent (white) tax status
- corporate investors should prefer a fund investment achieving tax exemption for capital gains from shares and dividends, if any, generated by the fund, whereas profit from structured products is always fully taxable. Obviously, this only holds true where the fund is not assigned non-transparent (black) tax status.

The conclusion, therefore, is that a tax-enhanced distribution channel for corporate investors is a fund investment, whereas private individual investors are likely to favour a suitable structured product.

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