German Fund Tax Legislation – Draft Changes

On 6 February 2007, the German Ministry of Finance issued draft changes to the German Investment Tax Act (Investmentsteuergesetz), the tax provisions for (mutual / hedge) funds domiciled in Germany or non-German funds marketed into Germany and their investors. In addition, the draft announces changes to direct investor taxation rules.

This World Tax Service Financial Services Info Letter highlights the main changes to German taxation rules proposed.

The reform is proposed by the German federal government. The Lower and the Upper House of German Parliament have yet to pass the bill, which will also be discussed with the industry. The draft bill in its present stage does have a few technical flaws. Thus, at present, it is too early to predict, which of the proposed tax rules will change during the course of the legislative process and which will be enacted at all.

The announced revision of the taxation rules for funds and the direct investment into financial instruments is part of a substantial German tax reform, which the present coalition of Christian Democrats and Social Democrats has been labouring with for some time. Thus, our prognosis is that the reform as such is likely to pass.

The changes to German fund tax law would generally apply to the fund business year that ends in 2009. The sale / redemption of fund units acquired by private investors after 31 Dec 2008 will be subject to new taxation rules.

The legislative process of the tax bill at hand is scheduled to end in July 2007.

The revision at hand complements recently proposed changes to the regulatory environment of funds domiciled or distributed in Germany.¹

¹ For a description the recently proposed changes to the German regulatory environment, please see the WTS FS Info Letter # 1 – 2007, dated 6 Feb 2007.
Summary

The main idea of the reform is to introduce a new capital gains taxation regime for the private investor, who holds financial instruments directly. The present system: full taxation of capital gains at the personal marginal income tax rate (15% - 45%), if realized within the one year holding period; tax free capital gain if realized outside of the one year holding period, would be replaced by a 25% flat tax rate regime, irrespective of any holding period. This change of the direct investor taxation regime triggers certain adaptations in German fund tax law.

The draft would bring changes of tax technical nature to the determination of the German tax buckets at the level of the tax-transparent fund. However, none of these changes would lead to a substantial complication or simplification of the present rules that a fund administrator needs to be aware of.

Under the draft, the need of the tax-transparent fund to publish a G-Tax certificate in the electronic Federal Gazette within 4 months after the business year-end of the fund would remain.

Under the draft, all capital gains generated by the fund and realized by the investor via a distribution of the fund or via the sale / redemption of the fund unit are taxed at the level of the investor. However, capital gains generated and accumulated by the fund would not accrue to the investor at the end of the fund business year.

Disregarding the common belief that Germany is a country of high taxation, the draft offers to HNWI the possibility to enhance the after tax return: the proposed flat tax rate of 25% on income from the investment of capital is substantially lower than the present maximum rate of 45%.

This WTS FS Info Letter # 2 - 2007 cannot describe all of the interesting tax changes in depth. Please give us a call, if you wish for further information.

\[^2\text{50\% of the gain is the tax basis in case of capital gains from equity.}\]
Details

The changes announced would effect the taxation of fund investors and the taxation of direct investors in financial instruments usually found in fund portfolios. Thus, the following description aims to compare the present and the envisaged rules as well as investments in financial products via a fund versus direct investment.

1. German Fund Tax Rules


The concept of the Zwischengewinn (Interim Profit) would remain, according to the wording of the present version of the draft. We, however, believe that the Interim Profit is likely to be abolished in the course of the legislative process: the envisaged exit taxation (25% flat tax irrespective of any holding period) makes the old Interim Profit obsolete.

The concept of the Aktiengewinn (Equity Profit) will survive the envisaged reform.

The concept of the Immobiliengewinn (Real Estate Profit) is likely to be introduced for private investors.

Regarding the Accumulated Deemed Distribution Income (ADDI), we believe that the legislator will not abolish this reporting item during the reform at hand.

Withholding taxes suffered by the fund would only be deductible at fund level in the future, at least for retail (mutual & hedge) funds. Under the present system, the fund can choose between deducting WHT as an expense at fund level or passing through the WHT for crediting / deducting at investor level.

Although this aspect is not yet mentioned in the present draft version, it seems likely that the rule on the non-deductibility of 10% of the indirect expenses will be abolished.
a) Institutional Investor

The draft does not mention any changes that would materially alter the taxation of the German institutional fund investor.

b) Private Investor

For private investors, all interest and dividend income generated by the fund would be taxed at a flat rate of 25% (or less), irrespective of whether the fund distributes or accumulates such income. At present, interest income and half of the dividend income is taxed at the personal marginal income tax rate of the investor (15% - 45%).

Under the draft, capital gains generated at tax-transparent fund level (including capital gains from derivatives) would be taxed at private investor level, when received via a fund distribution or via the sale / redemption of fund units, irrespective of any holding period, whether at investor or at fund level. The tax would be levied by the German paying agent of the investor as a withholding tax. The WHT rate would be 25%. The German investor would be able to choose between accepting the WHT as final or declaring the income in a tax return in order to lower the (final) income tax burden. The capital gains generated at fund level do not accrue to the German investor as a deemed distribution as long as the tax transparent fund accumulates the capital gains. Under the draft, the tax free benefit remains for capital gains from real estate realized at fund level after a 10 year holding period. This is a privilege for real estate assets that does not fit into the new system because all other capital gains are taxable.

With regard to the taxation of capital gains, the draft rules on German fund tax law can be characterized as a U-Turn because, at present, the most striking benefit of German fund tax law for private investors of the tax-transparent fund is that (almost) all capital gains generated at fund level are tax free, irrespective of whether the German private investor receives such gains via a distribution of the fund or via the sale / redemption of fund units.

The new rules would be applicable to fund earnings generated during a business year of the fund that ends in 2009. For earnings generated by the fund in prior business years, a grandfathering rule would apply.
2. German Direct Investor Tax Rules

The draft announces interesting changes to the taxation of direct investors invested in financial instruments usually found in fund portfolios.

a) Institutional Investor

The flat tax rate of the Corporate Tax Act would decrease from 25% to 15%.

The new law would enact specific anti-avoidance provisions to counter tax driven financial products such as structured security lending transactions. This rule would already be implemented for the year 2007, i.e. without any grandfathering.

b) Private Investor

Under the current German capital gain tax regime for private investors the private investor will not be taxed on most capital gains (including those from the sale / redemption of fund units) if realized after the one year holding period. Under the draft, the one year holding period benefit will be abolished and all capital gains will be taxable. The tax free benefit would remain only for capital gains on real estate realized after a 10 year holding period.

Capital gains from futures, options and swaps would – for the first time - be covered by a comprehensive tax rule and would be taxable at the flat rate of 25%, irrespective of the holding period. At present, a private investor is taxed on capital gains from derivatives directly held only if the derivative position is realized within the one year holding period.

The draft introduces new ring fencing rules for losses: losses from the investment of capital can no longer be offset from other types of income.
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Sincerely yours,

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