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New German Fund Taxation Rules

By Till Fock

After many years of discussions and various proposals that were later dismissed, the German legislature last month finally passed a law that substantially amends the principles of fund taxation in Germany. This Investment Tax Reform Act, the main body of which will come into force in 2018, will also have an impact on foreign funds (including UCITS and AIFs) that offer their interests to German investors.

The Current System

German investors in collective investment schemes, both domestic and foreign, are currently taxed on the basis of the distributions received and certain undistributed income and gains that are allocated to investors as so-called "deemed distributions" *(ausschüttungsgleiche Erträge)*. This semi-transparent treatment of funds for tax purposes requires a sort of shadow accounting in order to correctly calculate the amount of "deemed distributions" as well as certain other data relevant for the taxation of German investors. The numbers have to be certified by an auditing firm and — in the case of funds not limited to a restricted number of institutional investors — published in a government electronic database.

For many years, this system of fund taxation was viewed as overly complicated and as allowing sophisticated market participants to use collective investment schemes for the purpose of tax avoidance and optimization. The German legislature has therefore decided to abandon the concept of "deemed distributions" such that the tax liabilities at the investor level are calculated based on the fund's actual retained income and gains. Only so-called *Spezialfonds*, i.e., funds restricted to a limited number of usually institutional investors will remain subject to the traditional system of semi-transparency.

Taxation of Fund Investors as of 2018

The treatment of investors in all other types of funds, including closed-ended vehicles unless structured as limited partnerships, will change as of 2018.

In the future, they will be taxed on the basis of (i) all distributions received by the fund in the respective calendar year, plus (ii) the amount in which, if at all, a certain deemed minimum return of that calendar year has exceeded the distributions. The deemed minimum return is equal to the redemption price of the investor's interest in the fund at the beginning of the calendar year multiplied by 70% of the so-called "base interest rate" and will be capped at the increase in the redemption price of the interest in the respective year, if any. The "base interest rate" will be fixed by the Deutsche Bundesbank once a year on the basis of the long-term return of a portfolio of public bonds and be published by the Federal Ministry of Finance.

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In addition, investors will need to pay tax on capital gains from the disposal or redemption of their fund interest; however, the capital gains will be reduced by the undistributed amount already taxed, i.e., the amount which over the period of holding the deemed minimum return has exceeded the received distributions.

Based on the type of assets held, the income and gains from investing in the fund may be partially exempt. In the case of funds that invest at least 25% of their assets in equities, the exemption amounts to 15% for private individuals holding the fund interest as a private asset, 30% for all other private individuals, and 40% for corporate investors. If a fund holds at least 51% of its assets in equities, the exempted part of the income and gains will be doubled to 30%, 60%, and 80%, respectively. For funds that invest at least 51% in real estate, the exempted portion for all investors will be 60%, which will be increased to 80% in the case of a real estate fund if 51% of those assets are invested outside Germany. Therefore, income and gains from funds investing only in government bonds will not be exempted.

Unlike today, the new rules will also provide for a partial tax liability of the collective investment scheme itself, which, however, will only be of relevance to funds based in Germany.

Outlook

For foreign-fund management companies, the future taxation of its investors in Germany out-side of a *Spezialfonds* should be much less complex. In particular, there will be no further need to instruct an auditing firm to calculate and certify certain tax data for Germany. The only information necessary as of 2018 will be

(i) the qualification of the fund for purposes of a potential exemption (percentage of equity or real estate investments),

(ii) the redemption prices at the beginning and at the end of a calendar year,

(iii) the amount of distributions, and

(iv) the “base interest rate”.

It will be important, however, to determine in which category any existing funds of a manager with German investors will fall in the future. In particular, with respect to institutional funds, it might be advantageous to adjust the fund documentation in order to allow its investors access to the new fund taxation rules.

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