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December 2013

Tax Alert.

Act Adjusting German Fund Tax Rules to AIFMD entered into force

On 28 and 29 November 2013 respectively, the German lower and upper houses of parliament (*Bundestag* and *Bundesrat*) adopted the Act on the Adjustment of the German Investment Tax Act and Other Acts to the AIFM Implementation Act (*Gesetz zur Anpassung des Investmentsteuergesetzes und anderer Gesetze an das AIFM-Umsetzungsgesetz – '**AIFM-StAnpG**'*). The AIFM-StAnpG has entered into force upon publication in the Federal Tax Gazette on today's date, 23 December 2013 (see *Bundesgesetzblatt*).

After the proposal had failed to become law during the last legislative session, the draft bill submitted by the upper house in early November has now been fast-tracked through both houses. The long-awaited Act will particularly eliminate the taxation uncertainty that had been reigning since the introduction in July of the new German Capital Investment Code (*Kapitalanlagegesetzbuch* – '**GCIC**'), due to the lack of corresponding adjustments in investment taxation. In addition to significant amendments to the German Investment Tax Act (*Investmentsteuergesetz* – '**GITA**'), the Act contains further important tax changes. The main changes to investment taxation as well as details about the additional statutory changes will be discussed below.

Overview of the main new provisions of the GITA

After more than a year of legislative preliminaries including a multitude of draft amendments (see our Tax Alerts of December 2012 as well as January and June 2013 for details) and the failed simultaneous implementation with the GCIC on 22 July 2013, the legislator has passed an AIFM-StAnpG which substantially corresponds to the version adopted by the lower house on 16 May 2013 at 2nd/3rd readings as well as to the unofficial agreement reached by the conciliation committee (*Vermittlungsausschuss*) this summer.

The main provisions are summarised in the following.

Extension of the GITA's scope of application to AIFs

In implementing the GCIC under the AIFM Implementation Act, the legislator has significantly expanded supervisory rules. In addition to *undertakings for collective investment in transferable securities* ('**UCITS funds**'), now all do-

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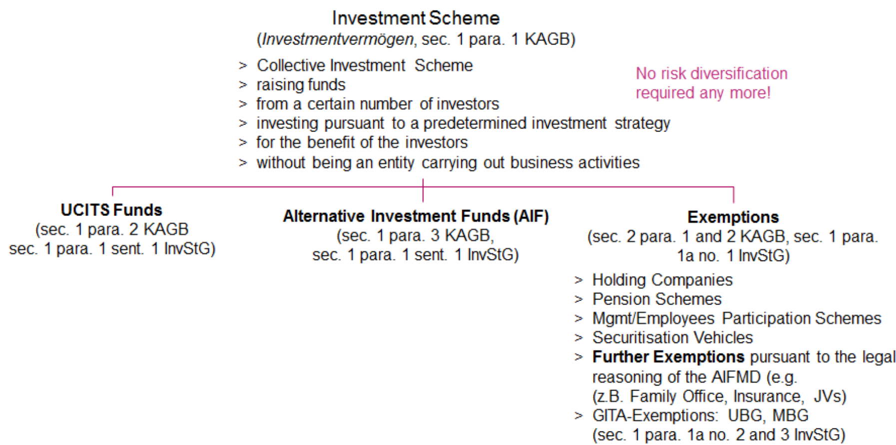
mestic and foreign alternative investment funds will also be included in the scope of the GCIC. Based on the reference to these supervisory rules in the new Sec. 1 para. 1 GITA, investment taxation law will now also be subject to the broad scope of application as well. As shown in the following diagram, investment in qualifying or risk-diversified assets will now no longer be a prerequisite for the application of the GCIC or the new GITA:



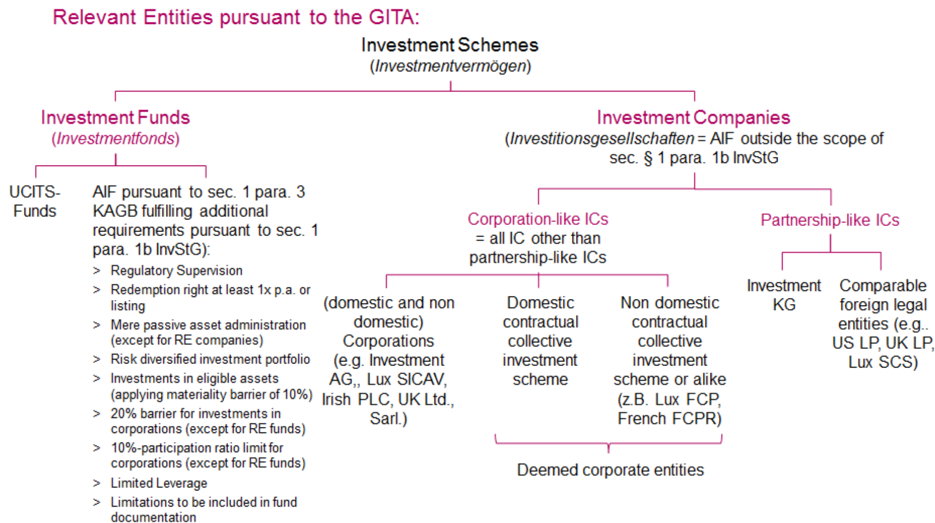
Dual approach – investment funds and investment companies

For tax purposes, in the future an additional distinction between tax-privileged investment funds (*Investmentfonds*) on the one hand and investment companies (*Investitionsgesellschaften*) on the other will have to be made.

Investment funds means UCITS funds and AIFs that fulfil the additional requirements of the new Sec. 1 para. 1b GITA. Only open-ended funds that are subject to supervision and respect a multitude of investment restrictions will continue to benefit from current investment tax rules. Although typical (closed-ended) alternative investment structures (private equity, infrastructure, etc.), will now also fall within the scope of the GITA, they will be excluded from the tax-privileging provisions for investment funds. This constitutes a significant tightening of the rules as compared to current law.

Investment companies means all AIFs which do not fulfil the additional prerequisites of the new Sec. 1 para. 1b GITA. Within the investment companies category, one must distinguish between *corporation-like* and *partnership-like* investment companies (*Kapital-Investitionsgesellschaften* and *Personen-Investitionsgesellschaften*) – depending on the investment vehicle's legal form. In these cases, particularly with regard to their different taxation schemes (see below), the comparison of legal forms can be of significant importance. Contractual investment schemes (*Sondervermögen*) which are not investment funds will now be explicitly deemed as corporation-like investment companies.

This new dual approach with regard to investment vehicles under the amended GITA is illustrated in the following diagram:



Taxation of investment vehicles under the amended GITA

The taxation rules for *investment funds* and their investors generally correspond to those applying to investment vehicles under the former GITA; i.e. distributions and so-called deemed distributed income will be taxed in the hands of the investor (transparency principle), in accordance with the qualification of the respective income item, under the investment-tax transparency principle at the level of the fund, subject to the fulfilment of the investment-tax reporting obligations of Sec. 5 GITA. However, it must be noted in this respect that the application of these rules will be significantly more difficult due to the aforementioned catalogue of requirements. In addition, the legislator has extended taxation of **dividends paid to minority shareholders** (*Dividenden aus Streubesitzbeteiligungen*) (Sec. 8b para. 4 of the German Corporate Income Tax Act (*Körperschaftssteuergesetz* – '**GCITA**')) to include shares held indirectly via funds as well, so that such dividend income will in future fundamentally be **fully taxable** (see also our Tax Alert of March 2013 in this respect).

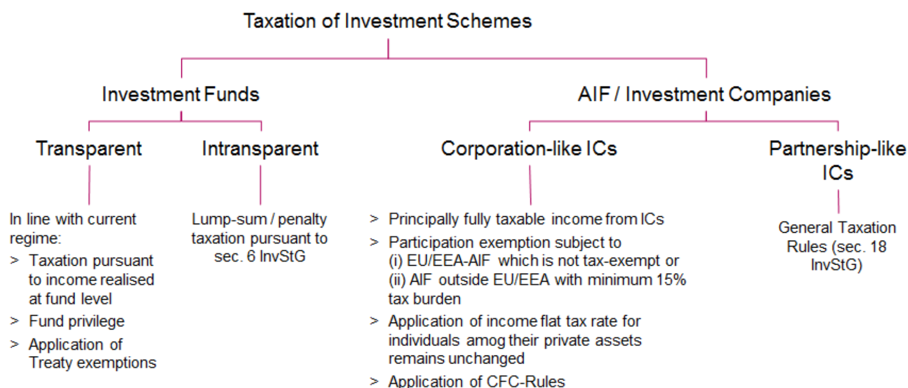
For *investment companies*, two types have to be distinguished:

Income from *partnership-like* investment companies will be subject to taxation at the investor level in accordance with general taxation rules. General trade-tax rules apply at the level of the investment company as well; i.epartnership-like investment companies carrying out a trade or business (or deemed to carry out such trade or business) with a domestic permanent establishment are subject to German trade tax.

With regard to the taxation of *corporation-like investment companies*, fortunately the mitigated proposal in the revised draft bill (see also our January 2013 Tax Alert) has been adopted. Accordingly, investment companies will remain opaque for purposes of the new GITA; i.e. only distributions will be taxed at the level of the investor, without an additional lump-sum tax that is independent of actual distributions. The 95% tax exemption of Sec. 8b GCITA or the 40% tax exemption pursuant to Sec. 3 no. 40 of the German Income Tax Act (*Einkommenssteuergesetz* – '**GINTA**') for dividends and capital gains will only be applicable, however, if the corporation-like investment company residing in an EU/EEA member state is subject to income taxation of corporations or, if it has its residence in another country, income taxation of at least 15%. Further, the German CFC-rules remain applicable with regard to these entities (Sec. 19 para. 4 GITA).

In addition to the taxation on investor level, one must note in this regard, that domestic contractual investment schemes, which up to now qualified as tax-exempt investment vehicles, will in future be subject to full corporate- and trade tax as corporation-like investment companies (to the extent that they maintain an economic activity as per Sec. 2 para. 2 of the German Trade Tax Act (*Gewerbesteuergesetz* – '**GTTA**')) if they no longer fulfil (after expiry of the transition period until 2016, see below) the additional prerequisites as investment funds pursuant to the new Sec. 1 para. 1b GITA (see also below under *Actions to be taken*).

The various taxation regimes are illustrated in the following diagram:



First application and transitional provisions

The new provisions of the GITA will generally take effect on the day after their publication in the Federal Law Gazette (new Sec. 22 para. 1 sentence 1 GITA); i.e. from 24 December 2013 onwards.

For funds which qualified as investment vehicles under the former GITA and which continue to fulfil the prerequisites under the amended GITA, a transitional period until 2016 has been granted; such funds will be grandfathered as (privileged) investment funds under Sec. 1 para. 1b sentence 2 of the amended GITA until the close of the fund business year that ends after 22 July 2016; i.e. until 31 December 2016 for business years matching the calendar year (*fund grandfathering*).

Furthermore, with regard to the restriction of participations in businesses under the new Sec. 1 para. 1b sentence 2 no. 6 GITA, a grandfathering rule has been provided for existing participations. Participations in businesses will accordingly remain non-detrimental, even if they are in the legal form of a partnership (*Personengesellschaft*), if they were acquired before the lower house adopted the bill (on 28 November 2013) and do not exceed the 20% limit for participations under the new Sec. 1 para. 1b sentence 2 no. 6 GITA overall (*business-participation grandfathering*).

With regard to the statutorily unclear transitional period between the introductions of the GCIC on 22 July 2013 and the amended GITA, the new Sec. 22 para. 1 sentence 2 GITA provides that the former GITA (which still refers to the German Investment Act (*Investmentgesetz*)) continues to apply until the amended GITA takes effect. Thus the solution already provided for in the German Federal Ministry of Finance’s (*Bundesministerium der Finanzen*) circular dated 18 July 2013 has now also been adopted as law. The question whether such a retroactive provision can remain valid, particularly where it causes negative tax effects, will presumably have to be clarified by the tax courts.

Other significant changes in investment taxation

In addition, the amended GITA contains the following significant new provisions:

> **Counteracting bond stripping**: A special income calculation method has now been added under the new Sec. 3 para. 1a GITA for structures which, through bond stripping, aim to accelerate the tax realisation of interest income. Accordingly, bond stripping will be deemed as a sale of the bond and an acquisition of both the principal-only element and the interest coupon, so that the original acquisition costs will be split on a pro-rata basis. The new rule will apply to all bonds stripped after the 2nd/3rd readings in the lower house (i.e. as of 29 November 2013) (new Sec. 22 para. 3 sentence 1 GITA).

> **Allocation of general expenses (*Werbungskosten*)**: The legislator has now adopted, under the new Sec. 3 para. 3 GITA, rules for the allocation of general, not directly allocable income-related expenses. According to the legislator’s explicit reasoning, this provision is to prevent certain assumed

sheltering structures in the allocation of income-related expenses. Regardless of whether the provision will in fact succeed as intended, it will in any case further increase the complexity of fund income calculations. The new rule will apply to fund business years beginning after 31 December 2013 (new Sec. 22 para. 3 sentence 2 GITA).

> **Order of distribution**: Furthermore, the new Sec. 3a GITA creates a rule – similar to the order of distribution applicable to corporations under Sec. 27 GCITA – under which the fund's capital will only be deemed used after all profits have been distributed. The former rule will be grandfathered for eight months, i.e. the first distributions to be deemed as profits will be those made eight months from the date the new GITA is promulgated (new Sec. 22 para. 4 GITA).

Action to be taken

As compared to the current law, the new rules, which do not grant the 95% participation exemption on **investments in corporation-like investment companies** if a prior tax burden is lacking or inadequate, constitute a significant negative development for German tax-paying investors. Indeed, particularly in cases of indirect investment in corporations, this will lead to a requalification from privileged participation income at the level of the investment company to fully taxable earnings for the investor. This will apply particularly to corporates (including CTA structures), property and accident insurances as well as to private investors holding their participations among their business assets (e.g. in limited partnerships carrying out (or deemed to carry out) a trade or business or asset-administrating corporations). In order to avoid this significant tax burden, investments should in future be structured using transparent vehicles (partnership-like investment companies).

Finally, one must take into account that under the tightened prerequisites for investment funds, **domestic contractual investment schemes may become subject to trade- and corporate income tax after expiry of the transitional period in 2016**. Indeed, such contractual schemes will only continue to benefit from the tax exemption for investment funds if the additional prerequisites of Sec. 1 para. 1b GITA are fulfilled (see above); if they no longer are, the contractual investment scheme will be deemed as a corporation-like investment company and therefore become fully subject to trade- and corporate income tax. Against this background, the transitional period should be used either to ensure that the prerequisites of the new Sec. 1 para. 1b GITA are fulfilled in order to benefit from the tax exemption, or to restructure the scheme; otherwise there is no guarantee that the corresponding earnings will continue to be treated efficiently without additional taxation at the level of the entity.

Further changes under the AIFM-StAnpG

Rules on acquired provisions for contingent losses (“*angeschaffte Drohverlustrückstellunge*”)

Under tax-accounting rules, certain (civil-law) liabilities cannot or cannot entirely be recognised in the tax balance sheet, thus creating hidden liabilities / built-in losses. The tax consequences of a transfer of such liabilities, both for the transferor as well as the transferee, had until now been disputed. According to the tax authorities, the hidden liabilities were neither to be realised by the transferor nor recorded by the transferee of the underlying liability. The Federal Tax Court (*Bundesfinanzhof – BFH*) had completely rejected this view in numerous decisions. The legislator has now provided statutory rules in the newly introduced Sec. 4f GINTA (treatment by the transferor) and in an addition to Sec. 5 GINTA as paragraph 7 (treatment by the transferee). These provisions generally cover the tax authorities’ position, but with some mitigated rules.

> **Tax treatment by the transferor (new Sec. 4f GINTA):** Unlike the original proposal, before the suggested compromise by the conciliation committee, the new Sec. 4f GINTA will not completely exclude the transferor’s claiming expenses from the transfer of the hidden liabilities. Instead, the law will now distinguish between three different situations:

- Case 1: the expenses resulting from the transfer of the liability cannot be deducted in whole immediately, but rather must be spread over 15 years (including the year of transfer). This case includes all liability transfers which do not fall under cases 2 or 3, especially all isolated liability transfers as well as those associated with the transfer of single assets (new Sec. 4f para. 1 sentences 1 and 2 GINTA).
- Case 2: the expenses resulting from the transfer of the liability may be claimed in whole immediately, i.e. in the year of transfer. This case includes the sale or cessation of an entire business or an entire partnership interest (*Mitunternehmeranteil*) as defined by Secs. 14, 16 paras. 1, 3 and 3a as well as 18 para. 3 GINTA, as well as the transfer of pension obligations when an employee changes employers. For small and medium-sized businesses as defined by Sec. 7g GINTA, this rule will apply regardless of the context in which the hidden liabilities are transferred (new Sec. 4f para. 1 sentence 3 GINTA).
- Case 3: the expenses resulting from the liability transfer may be set off against the income resulting from the simultaneous realisation of the hidden reserves, to the extent that the transfer of the liability occurs during the sale or cessation of a business division (*Teilbetrieb*) as defined by Secs. 14, 16 paras. 1, 3 and 3a as well as 18 para. 3 GINTA. The expenses are to be spread out as in case 1 only to the extent that the resulting balance is negative, i.e. if net expenses are incurred (new Sec. 4f para. 1 sentences 4 to 6 GINTA).

The new Sec. 4f para. 1 GINTA is the result of the political compromise negotiated by the conciliation committee. Its main purpose is to prevent potential

losses of tax revenue, by “penalising” those transfers of assets and isolated liabilities which were being intentionally used by transferors to accelerate, for tax purposes, the realisation of hidden liabilities.

It should be noted that, pursuant to the new Sec. 4f para. 2 GINTA, only the 15-year rule will be applicable to assumptions of debt (*Schuldbeitritt*) or performance (*Erfüllungsübernahme*) as defined by Secs. 421 and 329 of the German Civil Code (*Bürgerliches Gesetzbuch*), respectively. Given the explicit reference to only sentences 1 and 2 of paragraph 1, the provisions of cases 2 and 3 will not apply in this regard.

The new Sec. 4f GINTA will apply to all transfers of liabilities taking place in business years ending after 28 November 2013 (adoption by the lower house). This will also include transfers having taken place before that date, as long as they fall within the corresponding business year only (e.g. transfers in May 2013 where the business year matches the calendar year).

> **Tax treatment by the transferee (new Sec. 5 para. 7 GINTA):** According to the legislator’s reasoning, the rule of Sec. 5 para. 7 GINTA is intended to prevent the restrictions against creating reserves from coming to nought, in cases of transferred hidden liabilities, until the new Sec. 4f GINTA first applies. From this perspective, the application of the new Sec. 5 para. 7 GINTA would only have been necessary in the cases where the transferor could claim the expenses from the realisation of the hidden liabilities immediately. In fact, the amended Sec. 5 para. 7 does not correspond – as was the case in previous drafts – with the new Sec. 4f GINTA in this regard. On the contrary, the new rule provides that, regardless of the application of the new Sec. 4f GINTA and in all cases enumerated therein, the original restrictions against creating reserves which applied to the transferor, will equally apply anew to the tax balance sheet to be prepared at the end of the business year in which the transfer of the hidden liability occurs (sentence 1). This will apply both to transfers of liabilities as well as to assumptions of debt and performance (sentence 2), and also to the acquisition of a partnership interest (sentence 3). Sentence 4 contains a special rule for the recognition of transferred pension obligations.

At the same time, this also means that the transferee will be able to fully recognise the liabilities at the time of their transfer, in accordance with the corresponding Federal Tax Court case law. The acquisition per se therefore will continue to have no effect on profit or loss. The respective restriction against creating reserves will only apply to the first balance sheet thereafter.

Profit-reducing reserves will be allowed to be created in the amount of 14/15 to (proportionally) set-off the resulting profits (option), at least 1/15 of which will then have to be respectively released to profits over the next 14 business years (sentence 5).

If the hidden liabilities are realised within the 14-year release period, any reserves remaining at the time of realisation will have to be released to profits, thus setting off any expenses from the realisation of the hidden liabilities (sentence 6).

According to the amended Sec. 57 para. 14a GINTA, the new Sec. 5 para. 7 GINTA will first apply to business years ending after 28 November 2013. Since the restrictions will affect the recognition of the transferred liability on the tax balance sheet, they will apply to all hidden liabilities still remaining at the close of the first business year ending after 28 November 2013 – regardless of when the hidden liability was actually transferred. This is significant especially for the transfer of pension obligations, since in such cases the hidden liabilities usually are realised only later. If the transfer of the corresponding liability took place before 14 December 2011, however, the admissible reserve period is to be extended from 15 to 20 years.

> **Actions to be taken:** If liabilities are transferred in an asset deal, the transfer should be structured such that the expenses from the realisation of the hidden liabilities can be directly recognised. This would necessitate the transfer of a business or a business division (as defined by Sec. 16 GINTA). For the acquirer, the spreading of the income over 15 years should run mostly parallel to the creation of the actual liability, i.e. the tax expense. In economic terms, the recognition of business income ("*Erwerbsgewinn*") spread over time corresponds to an accordingly lower accretion of goodwill, i.e. the income is to be set-off by corresponding amortisations of higher goodwill. Otherwise, the additional tax burden should be taken into account accordingly when calculating the purchase price of the assets to be transferred.

Changes to the taxation of fiscal unities (*Organschaftsbesteuerung*)

The substitution of 1 January 2015 for 31 December 2014 in the new Sec. 34 para. 10b GCITA eliminates a legislative oversight in the recent mini-reform of fiscal unities. It has now been clarified that the adjustment of a profit and loss pooling agreement to the new statutory requirements may also still be undertaken in 2014 without thereby putting the fiscal unity at risk.

Restrictions to "Goldfinger" models

Finally, loss offsetting restrictions will be significantly tightened with regard to so-called Goldfinger models. In future, losses incurred in connection with the acquisition of assets (e.g. gold) by a commercial or commercially-tainted partnership, where no actual physical acquisition of the good takes place, will fundamentally be subject (i.e. without the additional prerequisites of Sec. 15b GINTA needing to be fulfilled) to the loss offsetting restrictions of Sec. 15b GINTA (see the amended Sec. 15b para. 3a GINTA). The new rule will apply to all acquisitions of such assets after 28 November 2013. According to the legislator's reasoning, the provision "clarifies" that, contrary to the divergent opinion in the tax court case law, corresponding losses may only be offset, in accordance with the principle of Sec. 15b GINTA, against profits from the corresponding tax deferral scheme. Sec. 32b GINTA has also been adjusted to the new rule.

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