Capital Markets Insight

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Germany 2018 - Revisiting attraction of fund types

On 1 January 2018, after years of discussion, a new Investment Tax Law ("InvStG") will become effective, providing for a fund taxation concept that implies a radical cultural change. The German legislator now favors opaque over transparent taxation as the grand solution for the future.

For international mutual and hedge funds, UCITS and AIFs, their promoters, distributors, administrators and - last but not least - all fund investors, the article at hand offers a business evaluation of the interesting content of the upcoming reform of German fund tax law.

The 2018 law differentiates between two substantially distinct fund investor tax regimes:

- A traditional tax transparent system for so-called 2018 Special Funds, which much resembles the concept of a partnership income recognition regime.

- A new 2018 Opaque Fund concept for the investors of all other funds such as UCITS, AIFs, hedge funds, single investor funds, except for fund vehicles in the legal form of a partnership.

The 2018 law extends to 31 Dec 2017 the grandfathering for those funds, especially hedge funds, which were privileged funds up to 24 Dec 2013 but do not meet the prerequisites of the current privileged tax regime.

For specific German sourced income, the 2018 reform introduces a limited tax liability in Germany, applicable to both fund types named, whether German or non-German.

The reform will come into effect as of 1 Jan 2018, irrespective of the fund business year-end.

BUSINESS EVALUATION

In general, the reform is good news for the international fund industry. The soft trade barrier of the peculiar German tax compliance is de facto lifted. Fund tax law is liberated from old-fashioned tax-driven investment restrictions and is no longer conflicting with fund regulation; tax law constraints based upon asset allocation or investment strategies are abolished. Furthermore, international funds will be granted a comparable competitive playing field with their German counterparts as the tax compliance complexity and its inherent cost for UCITS and AIFs would be reduced to almost zero. In fact, Germany foresees not only a competitive tax regime for funds aiming for German investors but will facilitate the needs of international investors, too.

The changes to the overall environment of the industry, i.e. a combination of the reduction of tax-driven investment restrictions and the evident need for the reallocation of fund investments held by HNWI, should provide for interesting business opportunities.

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Steffen has published widely on German tax law and the Financial Services industry, especially focussing on the fund industry. He is the co-author of one of the two leading commentaries on German fund tax law.
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German health insurers, fund-linked life insurance products and corporate pension plans will benefit first from the ability to invest into all funds (including hedge funds) globally without tax law driven restrictions and second from the privilege of a pure cash-flow based tax concept applied on investor level.

Furthermore, the very significant group of tax exempt German investors (e.g. endowments, churches, privileged pension schemes), which favored German domiciled funds for tax reasons in the past, are now entitled to an equal after tax return if their non-German fund fulfills certain tax compliance requirements with regard to its German sourced income streams.

However, the 2018 Special Fund will still suffer from tax-driven investment restrictions. Therefore, the 2018 Opaque Fund regime might provide for some inroads into the 1,500 billion Euro German domiciled Spezialfonds industry, opening up new possibilities for asset managers. Especially German institutional investors will re-evaluate their current investment structures, a shift of investments is lurking due to the need for optimized investment solutions. German HNWI investors will face the need to re-organize their pre-2018 Spezialfonds investments. After 1 January 2018, the 2018 Special Fund type will no longer be acceptable for many of these investors, especially due to a significant tax increase penalizing any future 2018 Special Fund investment in comparison with the 2018 Opaque Fund regime or the direct holding of assets by HNWIs.

The 2018 Opaque Fund tax regime is applicable to most funds, including UCITS, AIFs and even to one-investor fund vehicles.

In the view of these changes, international funds might strengthen their German marketing strategy.

TECHNICAL DETAILS

The 2018 Opaque Fund tax regime is applicable to most funds, including UCITS, AIFs and even to one-investor fund vehicles. This new concept does not contain any restrictions in respect of fund assets or the investment strategies employed. It causes little, if any, tax compliance cost and is, in most cases, very tax efficient in so far as the annual lump-sum investor tax base foreseen should be significantly lower than the annual economic gain generated by the fund. Successful funds and their investors will benefit most, notably in a low inflation environment. Fund investors should no longer be exposed to the cumbersome CFC/PFIC ("Aussensteuergesetz") taxation and reporting.

For 2018 Opaque Funds, the reform will end the current tax compliance requirements which are complex and can be costly, i.e. the ongoing NAV related Interim Profit and the (40% / 95%) tax free Equity Gain reporting, the annual business year end reporting within 4 months after the end of the business year and the eGazette certification are abolished.

The new opaque tax concept introduces a blended cash-flow based tax methodology with an annual lump-sum tax base on fund investor level, moderately referencing 70% of the official annual yield for German government bonds (for 2016: 70% of 1,1% of the fund's NAV). The tax base is capped to the annual NAV increase of the fund. Upon redemption, the investor can offset his holding period related annual lump-sum deemed distributions from the capital gain (loss) realized. However, numerous investor types, like German health insurers, fund-linked life insurance products and corporate pension plans are exempt from this lump-sum deemed distribution concept; they will be taxed only upon the redemption of their fund units.

Investors of equity funds and real estate funds benefit from a special tax exemption, granted to mitigate taxation suffered on fund level and tax treaty override disadvantages of the opaque tax regime. For example, in the case of a 2018 Opaque Fund that qualifies as an equity fund (at least 51% of the NAV invested into equity assets), all income and capital gains generated from the fund are 80% tax exempt for the corporate fund investor (30% for the private, 60% for the individual business investor).

However, the opaque tax regime might impact negatively accumulating closed ended funds as the investor would incur tax annually disregarding any fund distribution; this may be the case for some infrastructure funds and private equity structures in the legal form of a corporation.

The 2018 Special Fund, on the other hand, will be restrained by limitations, i.e. such funds are limited with regard to the assets they can hold and the strategies they can employ. Whether the 2018 Special Fund is more or less tax beneficial for its German investors than the new opaque fund type has to be analyzed on a case by case basis. For example, 2018 Special Funds can only invest into UCITS and AIFs, which must comply with the same restrictions on assets and strategies as the top fund, plus 2018 Special Funds.

For 2018 Special Funds, in principle, the traditional tax transparency concept would remain: (1) The annual business year end and the ongoing NAV-related Equity Gain reporting with their inherent tax compliance requirements would be required; (2) The accumulation privilege of such fund is expanded because the capital gains from all bonds types would be included. The accumulation privilege would also cover capital gains from target fund units. The new law will put an end to the current tax-beneficial re-characterization of interest or dividend income into capital gain of derivatives.

In order to cultivate a level playing field between German and foreign funds (UCITS and AIFs), the legislator introduces a limited tax liability on fund level in accordance with the general rules, for specific German sourced income (e.g. German dividends, income from German real estate or German business income), whether 2018 Opaque or 2018 Special Fund. A discrimination of funds compared to the direct investment, in case of certain privileged tax free (German or non-German) investors, can be avoided via specific tax compliance procedures on fund level.

Finally, the following details should be noted: Funds in the legal form of a partnership will be taxed upon the principles of partnership taxation; the 2018 Opaque and 2018 Special Fund regimes are not applicable. As a general rule, private investors will lose the tax-free grandfathering of so-called old fund units acquired before 1 Jan 2009.

SUMMARY - FUND AND INVESTOR TYPES

With regard to the German investors of funds as of 1 January 2018, as a first overview, please also note that:

- The 2018 Opaque Fund, if UCITS compliant or AIF qualifying for public distribution (UCITS-alike real estate), is eligible for all German fund regulatory investor types (= private, semi-professional, professional investors), disregarding whether the investor is a natural or a non-natural person.
- The 2018 Opaque Fund, if AIF, is eligible for the German fund regulatory investor types of semi-professional and professional investors, disregarding whether the investor is a natural or a non-natural person.
- The 2018 Special Fund will always be an AIF from a regulatory perspective. Thus, only the German fund regulatory investor types of semi-professional and professional investors are eligible.

However, unlike in the case of the tax type 2018 Opaque Fund (see above), for tax law reasons, the private investors - even if they should qualify as German fund regulatory investor types of semi-professional or professional investor - cannot join the fund for tax reasons, unless they hold the fund units as part of their business assets, e.g. via a German entrepreneurial business partnership (esp.: German Mittelstand).

SUMMARY - 2018 GERMAN FUND TAX EFFICIENCY MATRIX

The following table presents, based on economic fund categories, a first high-level analysis of the tax efficiency of the upcoming German fund tax types for certain groups of German investors. The table gives a first indication, it is not comprehensive. Taking into account the circumstances of the single fund and its investor will usually require a more detailed view.

Also note the general fund qualification restrictions that (1) ETFs are not suitable to qualify as 2018 Special Funds, (2) that hedge funds are typically not suitable to qualify as 2018 Special Funds and (3) that Private Equity funds are typically not suitable to qualify as 2018 Special Funds.

	Economic fund type			
Tax type of German investor	**Bond Fund (incl. bond index tracker)**	**Equity Fund (incl. equity index tracker*)**	**Balanced Fund 25 - 50% equities**	**Balanced Fund ≥ 51% equities**
Private investor	2018 Opaque Fund only	2018 Opaque Fund only	2018 Opaque Fund only	2018 Opaque Fund only
Tax exempt investor (e.g. charitable endowment, church, non-profit organization)	2018 Special Fund or 2018 Opaque Fund	2018 Special Fund or 2018 Opaque Fund	2018 Special Fund or 2018 Opaque Fund	2018 Special Fund or 2018 Opaque Fund
Occupational pension scheme (Versorgungswerk)	2018 Special Fund or 2018 Opaque Fund	2018 Opaque Fund	2018 Opaque Fund	2018 Opaque Fund
Standard institutional investor (Sec. 8b KStG entitled, incl. CTAs of such investors)	2018 Opaque Fund	2018 Special Fund	2018 Special Fund	2018 Special Fund (individual analysis necessary)
Business investor (non-corporate)	2018 Opaque Fund	2018 Opaque Fund	Individual analysis necessary	2018 Opaque Fund
Bank (trading book only) Health insurer	2018 Opaque Fund	2018 Opaque Fund	2018 Opaque Fund (individual analysis necessary)	2018 Opaque Fund

FOOTNOTE

* Only valid for physically replicating index tracker funds.
Further, the table is based on the assumption that the 2018 Special Fund exercises its transparency options.

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