New investment opportunities for Foreign Tax-Exempt Investors in Germany

28 DEC 2017
By: Martin Heinsius

The German legislator recently enacted a far-reaching reform of the German Investment Fund Tax Act, which governs the taxation of investment funds and its investors, which will take effect on 1 January 2018. The reform aims at removing inconsistencies in the taxation of non-resident and resident investors in German investment funds, and the freedom of movement of capital under the EU Treaty.

In general, under the present investment fund taxation rules, the German investment fund is tax exempt and at investor level, the income of the fund is subject to taxation on a pro rata basis as if the investor had invested in the investment funds assets directly himself. The investment fund, respectively its management company or the investment fund’s custodian, has to withhold withholding taxes from distributions and deemed distributions for the account of the investor. German resident investors are entitled to a full credit refund of such withholding taxes while non-resident investors are not so entitled, and have to rely on tax credits for German withholding taxes in their own country of residence.

In essence, under the new rules, investment funds will become subject to corporate income tax on their German-sourced income at a rate of 15 percent. German-sourced income in this context means real estate income including capital gains, dividends received from corporations tax-resident in Germany, as well as yields from lending transactions relating to shares in corporations that are tax-resident in Germany. German-sourced taxable income does not include capital gains made on the sale of shares in such corporations. In addition German-sourced income includes interest paid on debt secured by land charges or similar instruments on real property located in Germany, or on ships registered in a German register as well as interest paid on participation rights which qualify as debt for German tax purposes. In order to (partially) compensate the investor for the taxation of the fund’s taxable income, partial exemptions of between 30 and 80 percent apply at investor level, depending on the classes of assets in which the investment fund invests and whether the units are held as an asset of a trade or business.

Spezialfonds (ie those investment funds investing only in certain eligible assets, including real estate, which have no more than 100 (only corporate) investors and where the units can be redeemed at least once per year) may opt for tax transparency. In essence, this moves the taxation of the investment fund’s taxable income to investor level.

To ensure that such taxable income at the investor level is effectively taxed at a level comparable to other investments, the investment fund, that is, its management company or the custodian, is again obliged to withhold withholding taxes from all distributions to the investor. However, such withholding taxes are not charged on distributions to non-resident investors. German resident investors holding units in the distributing investment fund are entitled to a full credit or refund of the withholding taxes on the fund’s distributions.

To accommodate tax-exempt investors under the new rules, the legislator has provided two different tax
exemptions. The first of these applies to tax-exempt charities and provides for a full exemption of the investment fund’s taxable income to the extent to which the tax-exempt charity invests in the investment fund.

This exemption also applies to non-resident charities, provided that they are comparable to its German counterparts (ie would be eligible for tax-exempt status under German tax law had they been tax resident in Germany). The second exemption applies to tax-exempt resident corporations and their comparable non-resident counterparts. The most important entities which fall under this category are general pension funds (Pensionskassen) and pensions funds for the members of certain professions (berufsständische Versorgungswerke). The law is framed to limit this tax exemption to real estate income, however, a draft circular letter from the German Inland Revenue Office broadens this tax exemption to the same scope as for tax-exempt charities, that is, it covers the entire taxable (ie German-sourced) income of the investment fund. Based on precedent from the European Court of Justice, the question whether or not a non-resident pension fund (or other tax-exempt corporate investor) is comparable to its German counterpart is to be answered from a functional perspective. Accordingly, most pension funds from other EU member states, as well as pension funds for the members of certain professions, should be comparable to their respective German counterparts. In addition the non-resident investor who is eligible for the tax exemption needs to be resident in a country that provides administrative and tax collection support equal to, or at least comparable to, the Mutual Assistance Directive and the Tax Recovery Directive. These states are all EU member states and certain others such as, for example, Canada. The tax exemption covers the pro rata share of the investment fund’s taxable income which is allocable to the investor on a per unit basis. If one assumes that only these kinds of pension funds or charities invest in the investment fund, its entire taxable income would be covered by the tax exemption.

The investment fund has to apply for such tax exemption in its corporate income tax return. When filing its return, the investment fund would have to provide evidence on the comparability of its tax-exempt non-resident investor with its German counterparts as well as on its tax residency.

In summary then, these new rules also allow non-resident, tax-exempt investors, such as charities and pension funds, to use an investment fund as a vehicle for a tax-exempt investment in German real estate and other assets which would otherwise produce German-sourced taxable income at investment fund level. This is provided the investor can furnish evidence to show it is comparable, from a functional perspective, to one of its counterparts under German law and is resident in an EU member state or a state which provides not only administrative but also tax collection support to the German tax authorities. There will be no withholding on distributions of the investment fund to these investors. Thus the new rules put non-resident, tax-exempt investors in real estate investment funds on an equal footing with resident tax-exempt investors.

Read the full issue of the Real Estate Gazette

AUTHORS

Martin Heinsius
Of Counsel
Frankfurt | T: +49 69 27133 0
[Email protected]