IN FOCUS –
Understanding German Fund and Investor Tax Regime Changes in 2018

A FAQ document on Opaque and Special Funds

June 2017

Overview

Effective January 1, 2018, Germany is introducing two new investment fund tax regimes which will impact investor level reporting. Broadly, funds will be classified as either:

Opaque funds or Spezialfonds (Special Funds)

Opaque, meaning not tax transparent, funds include Undertakings for Collective Investments in Transferable Securities (UCITS), Alternative Investment Funds (AIF), hedge funds and single investor funds. The new opaque fund regime includes two tiers of taxation:

1) Taxation at the fund level for the first time
2) A revised regime applicable to investors in those opaque funds

As a consequence of the new regime, the legacy investor reporting obligations will fall away for newly classified opaque funds. Specifically, reporting of Aktiengewinn (AKG 1 and 2 - equity gain), Zwischengewinn (IP - interim profit); and Immobiliengewinn (real estate gain) will no longer be required for opaque funds. The current daily and annual reporting requirements will no longer be required. A new 15% German corporate tax (for a total assessment of 15.825% considering the applicability of the 5.5% solidarity surcharge thereon) will be introduced.

Special Funds will need to meet defined regulatory and investment restrictions by January 1, 2018 to be classified as such. The 2018 tax regime applicable to Special Funds will either be a modified form of transparency should the fund opt for this, or, otherwise, will fall back into the tax regime for opaque funds (as noted above).

The new regimes will also be applicable to non-German resident funds seeking distribution to German resident investors, or receiving German sourced income. For non-German resident funds, paying 15% withholding tax (15% being the general double taxation avoidance treaty (DTAT) rate under Germany's treaties) on German sourced dividends effectively discharges the 15% corporation tax at fund level and there is no further tax to pay. In this regard there is no effective change for non-German resident funds as German withholding tax has always in practice been applied to German sourced dividends. However, there will be a newly introduced opportunity to avail of the 15% dividend withholding tax rate at source, rather than under the current system where reclaims are required.

The following is a summary reference comparing the 2018 requirements under each of these new regimes as is presently known. Brown Brothers Harriman remains committed to sharing information on the evolving German tax reforms for 2018 and will release further updates once clarification is received from the market on the open matters identified below. As such, the information below may change once finalized by the German authorities.

	OPAQUE FUNDS (e.g. authorized investment funds/mutual/retail funds)	**SPECIAL FUNDS**
Definition	• Investment funds not considered special funds; typically opaque/non-transparent funds	• Specific regulatory and investment conditions must be met
Fund level taxation	• All funds: German sourced income is taxable at 15% corporate tax (15.825% including the 5.5% solidarity surcharge). For nonresident funds this will be discharged by withholding tax • Provision of fund status certificate is desirable • Proof of investor tax exempt status where applicable is desirable	• Non-transparent regime is the same as for opaque funds • If the transparent regime is opted for, then 15% tax corporate tax does not apply
Investor level taxation	• Taxed upon distributions, redemptions and lump sum basis (where the lump sum basis applies) • Investors will need to determine their own tax base using fund-level information such as net asset value (NAV), distribution amounts, knowledge of fund qualification as equity fund, mixed fund, real estate fund and also market information such as the German base interest rate • Partial tax exemptions available based on the fund's investment portfolio composition	• Taxed upon distributions, redemptions and deemed distributed income • If transparent, income is deemed to be received directly by the investors ('partnership' style accounting)
Fund reporting	• No reporting on behalf of investors • Fund monitoring and probable publication of equity and real estate asset tests for the purpose of partial exemptions • Potential fund-level tax return for when receiving non-German dividend income	• Annual tax reporting to the German Tax Authority • Calculation of investor specific taxable income • Reporting of equity gain in modified form and partial exemption gain
Transitional	• 'Hard' close on December 31, 2017 • Potential for shortened period to December 31, 2017 for tax purposes only; associated annual reporting due by December 31, 2018 • Distributions made out of income arising prior to January 1, 2018 and paid out in 2018 are expected to be subject to 2018 rules. The fund should be aware of the tax consequences of making distributions under the 2017 regime and the 2018 regime • An investor's units in investment funds falling within the new 2018 regimes are deemed to be sold on December 31, 2017 and reacquired on January 1, 2018	

WHY ARE NEW REGIMES BEING INTRODUCED?

German investors in collective investment schemes, both German resident and non-resident, are currently taxed on a transparency basis, i.e. German investors are treated as if they hold the assets of investment funds directly hence any related income is attributed to the investors and taxed accordingly. To facilitate this, a fund distributing to German resident investors is required to publish a myriad of daily and annual tax reporting figures. A failure to provide this reporting results in punitive tax consequences for the German investors.

For a number of years this transparent regime was considered to be overly complicated, requiring numerous figures to be reported resulting in a burdensome and costly regime to comply with, and administer. As a result, new legislation was approved in July 2016 to abandon the concept of transparency and deemed distributions in their current forms; tax liabilities at the investor level will be calculated based on the fund's actual retained income and gains. Only Special funds will remain subject to the system of transparency in a modified form, where they opt to do so.

Furthermore, part of the purpose of the new opaque regime is to comply with European Union law on anti-discrimination so that German sourced income would be treated the same for German resident and non-resident funds. The tax position of non-German resident funds is largely unaffected as German withholding tax is currently applied to German sourced income.

Finally, it was felt that the investment fund tax regime was sufficiently weak thereby enabling fraudulent activity; as such there have been a number of tax avoidance provisions introduced as part of the reforms to combat such avoidance.

The current tax regime is applicable up to and including December 31, 2017. All impacted funds will need to assume a December 31, 2017 business year end, even if that entails a short period solely for tax purposes.

WHAT ARE THE NEW REGIMES IN 2018?

Beginning in 2018 there will be three categories of investment fund. All German resident funds and non-German resident funds distributing to German resident investors or receiving German sourced income will be classified under the following for German tax purposes:

- Opaque funds e.g. Mutual / retail funds / UCITS
- Special funds
- Investment schemes, namely partnerships, which will need to file a partnership tax return on behalf of their German investors. The scope of this paper excludes such schemes.

WHAT IS THE NEW REGIME FOR OPAQUE FUNDS?

Presently German resident funds are considered to be tax transparent at fund level. The new regime sees funds subject to a new corporate tax of 15% at fund level. The 15% tax, which will align German resident funds with the general withholding tax rate for non-German resident funds, will be applied to German sourced income including:

- Dividends
- German rental income
- Gains from the sale of real estate
- Income from securities lending
- Income from security repurchase agreements
- Income and capital gains attributable to a German permanent establishment of an enterprise

Any other income, such as interest and income from non-German sources, is excluded from tax in Germany. Capital gains are not taxable at the level of the investment fund to the extent they are not attributable to a permanent establishment in Germany.

The new corporate tax will either be collected by withholding tax, which in the case of German sourced dividends will be collected by the German paying agent, or by tax assessment in the case of rental income, capital gains on German real estates, or other income for which Germany has the right to tax. As mentioned above, for non-German resident funds, the 15% corporate tax is discharged by the 15% withholding tax, and there is then no further tax liability.

An opaque fund will need to file a tax return should it receive any German sourced income other than dividends. The tax return due date depends if a tax adviser is involved in the preparation and submission. Where no tax adviser is involved the submission deadline is May following the end of the year concerned; where a tax adviser is involved the submission deadline is December 31 of the following year.

There is no requirement to file a tax return for German sourced dividend income only as this would already have been subject to withholding tax. Ordinarily the withholding tax would be the German statutory 26.375%, however the fund can reduce the withholding tax to 15% at source if a certificate of its status as an investment fund within the 2018 regime is presented to the paying agent; the paying agent is required to satisfy themselves of authenticity. This should ideally be done in advance of the dividend payment, but it is possible to submit a reclaim subject to procedural requirements and an 18 month statute of limitation. It is believed that WM Daten (a recognized central access point for provision of referential data which has been mandated by the financial market to optimize tax reporting by domestic and foreign fund companies) is implementing a field indicating to paying agents whether a fund is in possession of a valid fund status certificate. It is not envisaged that share classes can apply for a fund status certificate; it is yet to be confirmed whether administratively, applications can be made at the umbrella level, or only the sub fund level.

Furthermore, the new regime introduces a new exemption mechanism in respect of opaque funds with underlying exempt investors. The exemption covers both German withholding tax on German dividends, German corporation tax and German sourced real estate income. The exemption at the sub fund level is granted to the extent that:

a) The German or non-German investors are tax exempt; and either

  i) Those investors have, at time of receipt of the relevant income by the fund, been invested for at least three months; or

  ii) The fund units are held by a specific German pension plan.

If the opaque fund accepts only tax exempt investors then an economic substance test needs to be met in order to prevent dividend stripping techniques; these are part of the anti-avoidance provisions mentioned above. These conditions need to be met where the opaque fund is looking to claim for a refund that would result in a lower than 15% net withholding tax. Where the following conditions are not met, 15% withholding tax may apply. The conditions are:

- Minimum Holding Period. This entails a continuous minimum holding period of 45 days within a 91 day window around the dividend pay date. Foreign investors have to be the beneficial owner within this Minimum Holding Period.
- Minimum Risk Element: The fund must be economically exposed to a minimum of 70 percent of the market value risk of the shares.

To facilitate this tax exemption, the exempt investors must obtain a certificate of tax exemption from the German Tax Authority, provide this to the fund who must then certify ai) or aii) above and the Minimum Holding Period and Minimum Risk Element conditions. If so, the fund will not incur withholding tax at source. The investor exemption certificate is valid for three years.

For non-resident funds, the impact of the anti-avoidance provisions is to portfolio holdings (less than 10%) where the beneficiary has uninterruptedly owned the German shares for at least a year at the time of distribution, and the tax rate is less than 15%. As these avoidance provisions are already effective, a new reclaim form for non-German resident funds was released in April 2017.

Fund Status Certificate Process Summary

FUND WITH SEGREGATED **TAXABLE** INVESTORS	FUND WITH SEGREGATED **EXEMPT** INVESTORS
Fund applies to the German Tax Authority for a fund status certificate and provides supporting documentation (process and documentation requirements still pending)	Fund applies to the German Tax Authority for a fund status certificate and provides supporting documentation (process and documentation requirements still pending)
Fund status certificate is passed to the local German paying agent who can pay German sourced dividends with 15 percent withholding tax at source; no reclaim is required. This settles the fund level tax	Tax exempt investors apply to the German Tax Authority for an exemption certificate (process and documentation requirements still pending) and once obtained passes this to the fund
If the fund status certificate is submitted late, overpaid withholding tax can be reclaimed within 18 months	The fund passes its fund status certificate and investor exemption certificate to the paying agent along with confirmation of the anti-avoidance provisions
	Once these conditions are met, the paying agent can pay German sourced dividends to the fund who in turn can pay the dividend to the investors without withholding tax.

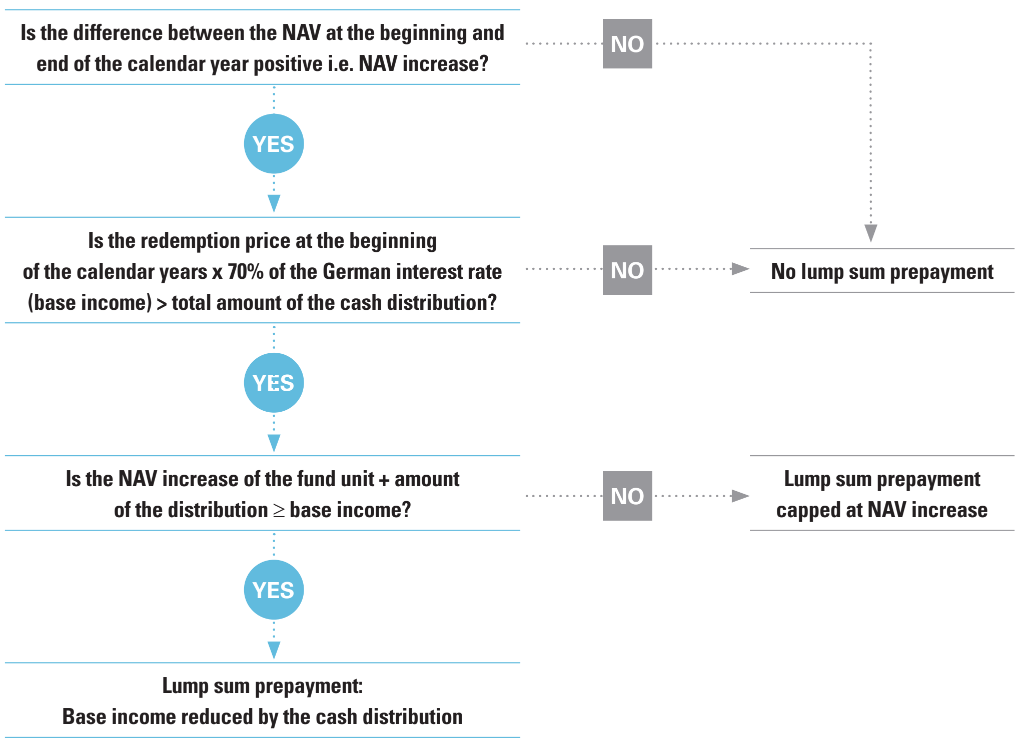
WHAT IS THE NEW REGIME FOR INVESTORS IN OPAQUE FUNDS?

Beginning January 1, 2018, opaque fund investors will be taxed on:

1. All distributions received by the fund in the respective calendar year, plus
2. A yearly lump sum prepayment (where applicable), regardless if the fund is distributing or accumulating; plus
3. Capital gains from the disposal or redemption of their fund interest.

The yearly lump sum pre-payment is of importance for accumulating investment funds as it serves the purpose of avoiding an indefinite tax deferral; for distributing funds it represents the annual minimum tax base. The lump sum is 70% of the base interest rate set by the Bundesbank, multiplied by the NAV at the beginning of the calendar year. Actual distributions reduce the lump-sum amount which is limited to the actual NAV increase during the calendar year. The lump sum amount will be applied if the value of the investment fund has increased and the fund retained its earnings, or if the amount of the distributions falls below the advance lump sum amount.

Investor level permutations:



To account for prior tax impositions on the investors' proceeds through German corporate tax at the fund level and the fund level withholding tax which an investor cannot offset, partial exemptions are offered to investors to prevent double taxation. Partial exemptions are available and applicable to income from opaque funds which mainly invest in shares or real estate on an ongoing basis. The partial exemption does not only apply to distributions but also to disposal or redemption proceeds as well as to the lump-sum amount.

German investors will receive a tax exemption / discount on income and capital gains generated out of their fund's investments; this is applicable to investments in both German resident and non German resident funds. The discount will only be granted where the fund publishes a certain minimum quota for their investments. The partial exemptions operate as follows:

MIXED / EQUITY FUNDS		REAL ESTATE FUNDS	
More than 25% invested in equities	**More than 51% invested in equities**	**Invest at least 51% of their assets in German real estate and real estate companies**	**Invest at least 51% of their assets in non-German real estate and real estate companies**
• 15% exemption for private individuals holding the fund interest as a private asset • 30% for all other private individuals • 40% for corporate investors	• 30% exemption for private individuals holding the fund interest as a private asset • 60% for all other private individuals • 80% for corporate investors	• The exempted portion for all investors will be 60%	• The exempted portion for all investors will be 80% savings income outside their resident state

A German Tax Authority Circular for consultation was released in March and outlined proposals covering matters such as where the thresholds are breached on a temporary basis, monitoring provisions, calculation of the total assets and publication. It is not expected that these proposals will be finalized until later in 2017.

WHAT IS THE NEW REGIME FOR SPECIAL FUNDS?

Special Funds are funds limited exclusively to institutional investors such as insurance companies, pension funds, foundations, church associations or comparable organizations, allowing for a more lenient regulatory framework compared to mutual funds. Special funds are limited to 100 investors and do not accept retail investors. They enable professional investors to invest in funds specially tailored to their needs and enables regulated investors to obtain exposure to asset classes otherwise not eligible to them. They have some comparison with Luxembourg's Special Investment Fund (SIF) and Ireland's Qualifying Investor Fund (QIF).

Special fund status under the current regime doesn't automatically mean the fund will qualify as a Special fund under the 2018 regime. To qualify under the 2018 regime, specific regulatory and investment conditions need to be met as outlined below. It should also be noted that an investment fund cannot opt for treatment as a Special fund even if it fulfils the requirements, if its investors were already taxed under the new opaque tax regime described above. Thus, investment funds considered as Special funds must opt for Special fund transparency before January 1, 2018. The declaration for transparency is irrevocable. The new regimes foresee only a possible switch from Special fund status to opaque status, and not vice versa.

The conditions to qualify as a Special beginning January 1, 2018 are:

1. The fund or its manager must be subject to investment supervision in its country of domicile by a body comparable to the German investment supervision;
2. Fund investors are entitled to redeem their units at least once a year;
3. The purpose of the fund is limited to the investment and administration of its assets for the joint account of the investors; an active entrepreneurial management of the assets is excluded.
4. The fund pursues the principle of risk diversification which is usually fulfilled if the fund invests into at least three different assets with different investment risk;
5. The fund invests at least 90% of its NAV into eligible assets; eligible securities are considered to include securities, money market instruments, derivatives, and real estate;
6. The fund must not invest more than 20% of its NAV into unlisted equities;
7. The fund must not hold more than 10% of the capital of a target corporation;
8. The fund's borrowing is limited to short-term borrowing, considered to be less than one year, and also no more than 30% by NAV value;
9. The number of investors (directly or indirectly via partnership) is limited to no more than 100 non-natural persons;
10. The fund has been granted an exceptional right of termination if the number of investors exceeds 100, or if there are non eligible investors invested;
11. The above conditions are stated in the fund's investment guidelines. (Confirmation is pending as to which documents constitute a fund's investment guidelines).

Should the Special fund no longer continue to meet at least one of the conditions, from a tax perspective the fund is considered to be liquidated and reestablished under the opaque fund tax regime. The resultant capital gain from the fictitious liquidation will be realized upon the German investors but only crystalizes when the investors actually redeem their units.

As mentioned, a Special fund can continue with the existing transparent tax regime should they opt to do so, otherwise the regulations for opaque funds will be applied. With the option to continue transparency, the 15% tax liability is not imposed and the income of the Special fund is deemed to be received directly by the investors. In this narrow regard the 2018 remains conceptually similar to the current regime.

However, Special funds will have to calculate taxable income on an investor by investor basis applying principles relevant to the investor's tax profile i.e. tax exempt or taxable. This is a significant change from the current regime where calculations are performed at the level of the fund units rather than per investor. As such the 2018 Special fund regime requires each investor to be treated akin to a unique share class for German tax purposes and an allocation is made for income, expenses and capital gains.

Accounting under the new Special fund regime will be akin to partnership accounting in the sense that income of the Special fund is deemed to be received directly by the investors. For example, presently tax figures are calculated on a per share basis, per share class. Under the 2018 transparent regime the fund accounting will need to attribute to each single investor what has been generated as income and expense during the holding period of that investor. There are new cost allocation rules in this regard which are yet to be clarified. Overall therefore a transparent Special fund will need to track which investor was invested to what extent during a certain period of time, and for which amount as well as which type of income has been generated during this time.

If the investor redeems during the course of the year they will need to be provided with capital gains and daily information such as equity gain and any double taxation component. The investor may also receive deemed distributed dividend income at the year end in respect of their share of a dividend which is announced after they have exited the fund. Further guidance is expected on this.

For a continuing / non-redeeming investor the income statement will need to be submitted as above within 4 months of the year end. The German Tax Authority has yet to release the prescribed form but it is expected to be conceptually similar to a K1 form used for Unites States tax purposes.

WHAT ARE THE 2018 SPECIAL FUND REPORTING REQUIREMENTS?

Daily reporting

Special investment funds will be obliged to determine and to publish daily tax figures, including:

- Equity gain
- A new daily tax reporting figure for the partial tax exemption on income deriving from underlying investment funds is introduced (partial tax exemption gain).

Hence, the daily reporting of equity gain and real estate gain will continue. However, the equity gain will be modified in that it will not include dividend income. It is yet to be confirmed where this will be reported.

Unlike the current daily tax reporting information which is either reported as an amount per share or as a percentage, future daily tax figures must be shown as total amounts. Income or expense equalization will not be allowed under the new regime.

Annual reporting

Special funds will be required to provide the German Tax Authority with annual tax reporting within 4 months of the year end. Whilst not defined, the information as part of the annual tax reporting is likely to include:

- Financial statements for the respective fiscal year of the fund, including the trial balance
- Income distribution statement
- Prospectus of the fund

- List of shareholders (including those who have exited the fund)
- Evidence of how income was allocated to the shareholders of the fund

The Special fund is responsible under law to submit the annual tax reporting and, unlike the current regime; the information does not need to be certified by an auditor.

A further German Tax Authority Circular is expected during 2017 with regards to Special funds.

WHAT IS THE NEW REGIME FOR INVESTORS IN SPECIAL FUNDS?

Investors in Special funds which have opted for transparency are taxable upon the following:

- Any distributions from the funds;
- Any deemed distributed income; and
- Any capital gains from the disposal of units in the fund.

Investors in Special funds which have opted for transparency will be able to credit against their tax liability against any non German withholding tax. This is based on either German domestic law, or provisions under Germany's DTATs.

TRANSITIONAL RULES

The current regime will come to a hard close on December 31, 2017 and the new regime commences on January 1, 2018 regardless of a fund's year end. Accordingly, all investment funds will need to have a period that ends on December 31, 2017. This means that for funds that currently have a non December period end, a new shortened period must be created to determine tax figures with the corresponding annual tax report to be submitted by December 31, 2018. For such funds, the period will be for tax purposes only and will not entail a change to the date of the financial statements.

The new rules will affect all distributions made from January 1, 2018 onward. Hence should a fund wish to distribute under the present tax regime, the distribution should be made on or before December 31, 2017. The fund should be aware of the tax consequences of making distributions under the 2017 regime and the 2018 regime.

An investor's units in investment funds falling within the new 2018 regime are deemed to be sold on December 31, 2017 and required on January 1, 2018. This will ensure any tax free elements under grandfathering or other provisions are captured. However, if this deemed disposal and reacquisition results in a gain it will only crystallize upon actual disposal.

Summary

What will be required for the 2018 regimes and what considerations need to be made?

OPAQUE FUNDS	RESPONSIBILITY
• Prepare final reporting under present regime; Consider and manage potential distributions before January 1, 2018	• Fund
• Calculate, monitor and publish fund qualification exemption (i.e. the percentage of equity or real estate investments)	• Fund. Default option for the investor to assess. Further information pending on the market regarding calculation and monitoring
• Calculation of the NAV at the beginning and end of each calendar year	• Fund
• Calculation of the distribution amounts	• Fund
• Provision of the base interest rate (not determined by the fund)	• Market driven (not fund specific)
• Obtain tax exempt investors' tax exempt certificate and provide to the paying agents	• Fund and investors
• Obtain a Fund status certificate and provide to the paying agents	• Fund
• Develop a monitoring system in respect of the anti-avoidance provisions	• Fund
• Develop a tracking system for asset ratios and tax reclaims and tax returns, where required	• Fund
SPECIAL FUNDS	
• Prepare final reporting, manage potential distributions before January 1, 2018	• Fund
• Consider compliance with the investment and regulatory conditions to meet Special fund status	• Fund and investors
• Daily reporting: Redefined equity gain, real estate gain and partial tax exemption gain	• Fund
• Annual reporting: financial information to the tax authority (yet to be defined)	• Fund
• Develop a reporting regime under new accounting requirements with respect to daily reporting and information requirements to investors	• Fund

FOR MORE INFORMATION, PLEASE CONTACT YOUR RELATIONSHIP MANAGER OR THE GLOBAL TAX SERVICES GROUP.