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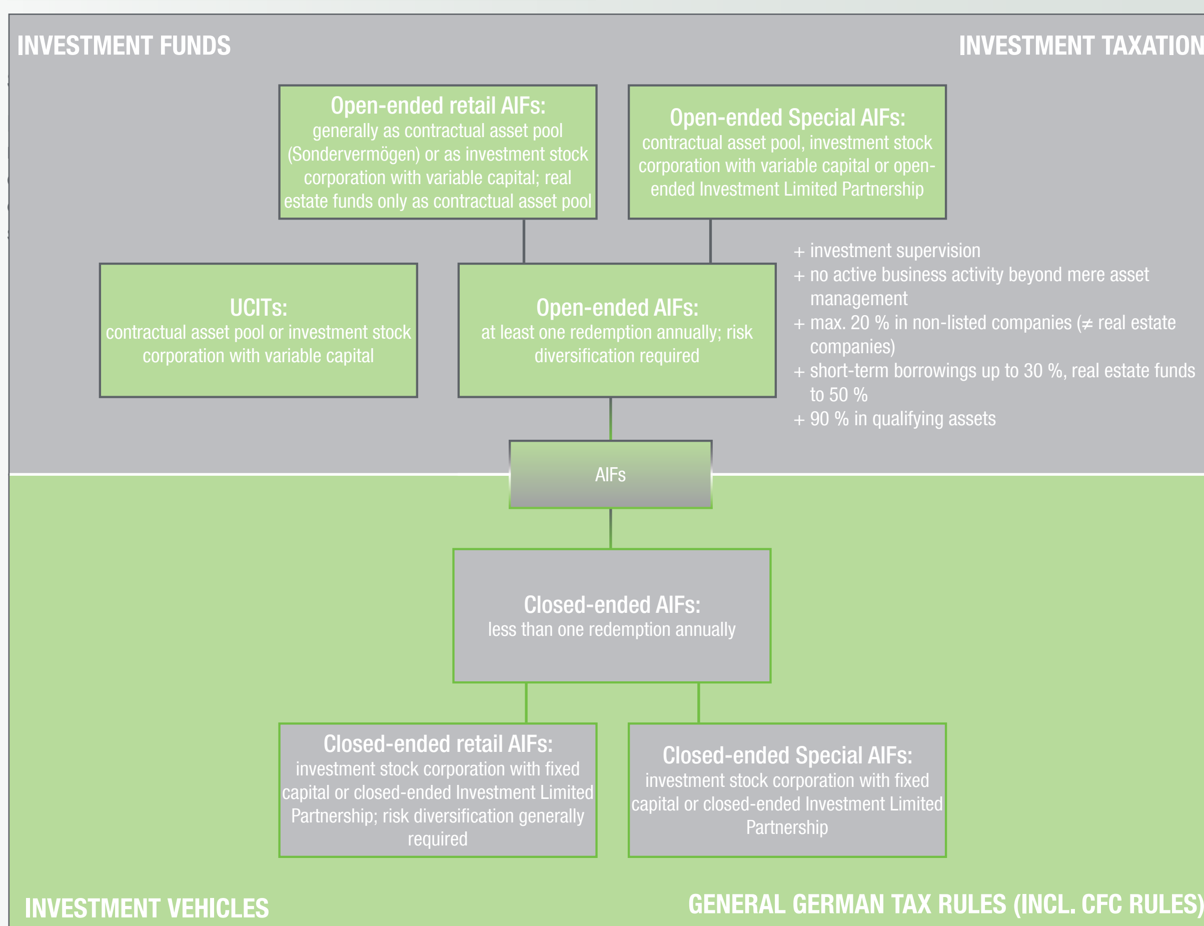
Implementation of AIFMD also affects German tax laws

http://bepartners.pro/documents/2013-01-30_AIFMStAnpG_RegEntwurf.pdf

On 30 January 2013, the German federal government introduced the draft Act Amending the German Investment Tax Act and Other Acts (AIFM Tax Amendment Act, or "GITA-AIFM") in order to adapt the German tax laws to the new regulatory regimes which implement the AIFMD into German law, thereby commencing the legislative enactment process, which requires the approval of the upper house of the German parliament.

In the following Client Newsletter, we will focus on outlining the scope and timing of the application of the GITA-AIFM and the consequences thereof for different asset and fund types. Please refer to the Glossary attached hereto for clarification of defined terms.



The GITA-AIFM generally applies to all Investment Asset Pools, i.e. UCITs and AIFs within the meaning of the AIFMD. However, the GITA-AIFM differentiates between open-ended and closed-ended funds for German tax purposes. On the one hand, UCITs and open-ended AIFs that comply with the requirements of the new Sec. 1 (1b) GITA-AIFM ("qualifying AIF") all qualify as "Investment Funds" under the GITA-AIFM and remain subject to the principles of investment taxation. On the other hand, AIFs that not do comply with the requirements of the new Sec. 1(1b) GITA-AIFM ("non-qualifying AIF") will now be defined as "Investment Vehicles" and will be subject to the general German tax rules. Thus, while the GITA-AIFM introduces new definitions and new distinctions for German tax purposes, the general principles of taxation for different fund types will generally remain under the GITA-AIFM.

1. Investment Funds

Certain AIFs may seek to be treated as Investment Funds and benefit from investment taxation under the GITA-AIFM (in particular capital gains generally will only be taxable in the hands of the investors upon distribution). These AIFs will have to satisfy the following requirements and set forth said requirements in writing in their constituting documents:

- The AIF must be subject to investment supervision in the country in which its registered seat is located;
- redemption of fund units must be possible at least once a year;
- limitation of activity to asset management according to the principle of risk diversification whereby a business activity going beyond mere asset management is prohibited;
- investment of at least 90 % of the total fund assets in qualifying assets, i.e. securities, money market investments, derivatives, bank deposits, real estate, real estate companies and real estate equivalents, Investment Funds, Public Private Partnership's project companies, precious metals, non-bearer loans and corporations (max. 20 % in non-listed corporations);
- investment of less than 10 % of the overall capital of a corporation (with an exception for real estate companies); and
- limitation of short-term borrowings to 30 % in general and other leverage to 50 % for real estate funds.

The GITA-AIFM has introduced several changes to the requirements for qualifying as an Investment Fund. Prior to the GITA-AIFM, an investment entity could qualify as an Investment Fund and enjoy the resulting tax treatment by being either subject to investment supervision **or** allowing a redemption of fund units at least once annually. One of the main changes under GITA-AIFM is that in order to qualify as an Investment Fund for German tax purposes, an investment entity now needs to be subject to investment supervision **and** allow annual redemptions.

While real estate funds must satisfy the two above-mentioned requirements (supervision and redemptions), the GITA-AIFM includes certain exceptions for real estate funds. In summary, if properly structured real estate funds continue to enjoy a similar tax regime under the GITA-AIFM as under the previous tax regime. However, hedge funds do not fare as well under the revised requirements. For newly established hedge funds, the requirement of investment supervision as well as the revised limitations on short-term borrowings (max. 30%) will be difficult to satisfy. As a result, investors in hedge funds would not enjoy the benefits of investment taxation under the GITA-AIFM.

2. Investment Vehicles

For AIFs that cannot satisfy the above-mentioned requirements and therefore do not qualify as Investment Funds the GITA-AIFM introduces a new definition: Investment Vehicles.

Under the GITA-AIFM, foreign Investment Vehicles will be divided into Investment Partnerships and Investment Corporations. According to the draft law, each Investment Vehicle that does not qualify as an Investment Partnership will then automatically qualify as an Investment Corporation. Thus, the first step for determining the qualification of a foreign Investment Vehicle is by applying the so-called "partnership test". If the Investment Vehicle fails this test, it will then by default qualify as a corporation for German tax purposes.

An Investment Partnership requires a legal structure comparable to a German Investment Limited Partnership. The principles of comparing and determining the legal form are limited to the comparison of foreign vehicles with a German Investment Limited Partnership. Controversially discussed in the past, but based on this comparison, Luxembourg FCPs thus qualify as Investment Corporations: FCPs themselves, which hold German real estate assets directly, will become subject to limited corporate tax liability in Germany. However, the GITA-AIFM is silent regarding the German tax treatment of other foreign legal forms. For example, what about foreign trusts, which are structured in accordance with the German

trust principles? What about foreign funds, which are structured similarly to a general partnership and not a limited partnership? Do these vehicles now qualify as non-transparent corporate vehicles and can this really be the legislators' intended result? The wording of the draft law does not provide any guidance for such questions. Although the intention of the law is obviously to qualify general partnerships as Investment Partnerships and foreign trusts as Investment Corporations, failing to pass the newly introduced partnership test can lead to unintended tax results.

Foreign Investment Partnerships are to be treated as transparent under the GITA-AIFM similar to a German partnership and thus do not qualify as a taxable person. Income generated by the Investment Partnerships is taxable in the hands of the investors only. Distributions by Investment Corporations qualify as dividends. However, the privileged dividend treatment (partial exemption for German individuals and full exemption for German corporate investors) is only allowed if the income is taxed at the general corporate tax rate for EU-/EEA- Investment Corporations and at least 15 % for non-EU/non-EEA Investment Corporations. As a result, distributions by Luxembourg FCPs and SICAVs to German investors will be fully taxable in Germany due to the tax exemption of said vehicles in Luxembourg.

In addition, the current draft law clearly states in Sec. 19 (4) GITA-AIFM that the German CFC rules specifically apply to foreign Investment Corporations. Please note that in a previous draft (December 2012) of the GITA-AIFM, the German legislator introduced an even more onerous tax burden, namely lump sum taxation (comparable to the rules for non-transparent funds under the current law) on retained earnings of Investment Corporations at the level of the German investors. Private equity funds set up as Luxembourg SICAV S.A./SCA, in particular, would have been hard hit under the lump sum taxation provisions of this previous draft. To everyone's great relief, the current draft has dropped this language. The German Ministry of Finance, however, may still reintroduce the lump sum taxation during the legislative process if it deems lump sum taxation to be appropriate in the future. Thus, this detrimental rule still can come back to haunt us!

3. Application and Transitional Rules

The new distinction between Investment Funds and Investment Vehicles under the GITA-AIFM will enter into effect as of 22 July 2013. At the same time, funds that were established before 22 July 2013 will be grandfathered indefinitely. Under the grandfathering provision, an investment entity that qualifies as an investment fund under the still current investment tax rules, i.e. either the entity is subject to investment supervision or annual redemptions are permitted, will continue to qualify as an Investment Fund after 22 July 2013 and enjoy the same tax treatment as before. On the basis of this grandfathering provision, fund sponsors should consider establishing fund structures under the current, and in many ways more favorable, requirements before 22 July 2013 in order to ensure that the fund and its investors benefit from the investment tax regime.

Please note, however, that there is need for action before the GITA-AIFM enters into force for foreign funds that currently fall within the scope of the GITA only due to certain transition rules granted by the German fiscal authorities for fiscal years commencing before to May 31, 2013.

We will keep a close watch on future developments of the GITA-AIFM. We expect further revisions and clarification as the draft law makes its way through the upper house of the German parliament.

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be in touch: If you have any questions, please do not hesitate to contact us!

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