

Flash News

Flat rate tax (Abgeltungsteuer) voted by the German Federal Council 6 July 2007

The German Federal Council has accepted today the introduction of a flat rate tax („Abgeltungsteuer“) on income and gains from capital investments as part of the German “Corporate Tax Reform 2008” („Unternehmensteuerreform 2008“). This will result in to a fundamental change of the taxation of capital income for private investors. In addition to capital income (interest, dividends, short-term transactions), which is already taxable today, all capital gains on shares, bonds, certificates and investment fund units will become taxable at a rate of 25 % („Abgeltungsteuer“). The 50% tax exemption on dividends (half income system) will no longer be applicable. A lump sum deduction of EUR 801 (EUR 1,602 in case of joint tax assessment) will now be made, although further indirect expense in excess of this lump-sum amount will not be deductible.

The new rules are generally applicable to all capital investments (shares, bonds and investment funds), which are made after 31 December 2008. Specific rules apply to debt instruments qualifying as so-called “Financial Innovations” and newly to certificates not granting any interest or guaranteed return

A considerable increase in the tax charge on capital investments will be caused in many cases by the implementation of the flat rate tax. This, in addition to the required transition period, means that short-term actions should be considered by all market participants.

Please find below an overview of the main implications of the flat rate tax. Owing to the high complexity, this overview is focused on the major implications for private investors.

Summary of key changes

The transition rules from the old to the new tax system for income and capital gains from capital investment are very complex and require in certain areas further clarification. Please find below an overview on the key features:

Interest and other income	All payments after 31 December 2008 are subject to the flat tax at a rate of 25%. Under the present legislation taxable at the investors marginal tax rate.
Dividends	All payments after 31 December 2008 are subject to the flat tax at a rate of 25%. Under the present legislation only 50% taxable at the investors marginal tax rate, the 50% tax exemption will be no more applicable.
Income and capital gains from certificates not bearing any coupon or guaranteed return	Capital gains taxable at 25% for all certificates, which have been purchased after 15 March 2007 and sold/matured after 30 June 2009. Under the present legislation these are tax exempt.
Capital gains from shares	Taxable at 25% if shares have been purchased after 31 December 2008. These are tax exempt under the present tax regime.
Capital gains on so-called Financial Innovations	All capital gains from transactions after 31 December 2008 taxable at 25%. Under the present legislation these are taxable at the investors marginal tax rate.
Capital gains on bonds and other securities and capital investment	All capital gains from investments purchased after 31 December 2008 are taxable at 25%. These are tax exempt under the present regime.
Capital gains on investment fund units	Taxable at 25% as far as units have been purchased/subscribed after 31 December 2008 (please see details below).

1. German Corporate tax reform 2008

The introduction of a flat rate tax ("Abgeltungsteuer") is part of the German "Corporate Tax Reform 2008". It's major aim is to lower the overall tax charge for businesses in Germany in an effort to increase their competitiveness internationally. The reform's major elements are:

- Cutting of the corporate income tax rate to 15 %. The intention is to achieve together with the municipal business tax a global taxation of corporates at 29,83%;
- Implementation of further thin capitalisation rules ("Zinsschranke"); debt interest in excess of EUR 1 Mill. is only deductible under certain conditions aiming to avoid excessive repatriation of profits;
- Accumulated profits of business other than corporates are, upon request, subject to a particular income tax rate of 28,25%. In case of a subsequent withdrawal (distribution), these profits will be subject to an additional tax charge of 25%.

The implementation of the extended thin capitalisation rules has already led to intensive discussions on an international level as it will likely result in a strong demand for a restructuring of financing of German investments by multinational groups.

2. Flat rate tax (“Abgeltungsteuer”) for private investors

The scope of taxable income from capital investments will be considerably extended as from 1 January 2009. As from that day, the following will be taxable at a rate of 25%:

- Investment income, such as e.g. dividends and interest
- Capital gains on shares, bonds and all other capital investments (e.g. certificates)
- Capital gains on dividend and interest coupons, interest receivables, participations as a silent partner as well as from other rights
- Capital gains on investment fund units (see below)
- Option premiums

The inclusion of certificates and similar instruments within the scope of the flat rate tax is significant as it puts funds on a level playing field for tax purposes.

Dividends will become fully taxable, whilst the present 50% tax exemption being no longer applicable.

The flat rate tax (“Abgeltungsteuer“) will be withheld at a consistent rate of 25 % at source. Where this is not possible, for example if the transaction is made via a foreign bank, this income and capital gain should be declared in the investors income tax return and will then also be taxed at a rate of 25 %. In both cases, the investors may request the application of its individual tax rate in case it is lower than 25 %, e.g. as no income from other sources has been earned.

The investor will be able to deduct an amount of EUR 801 as a lump sum (“Sparer-Pauschbetrag“). In case of joint assessment this amount will be raised up to EUR 1,602. With this deductible lump sum, all indirect expenses are compensated. Further indirect costs, such as those for account management and asset management, are no longer deductible.

Under the new rules, the possibilities to offset losses from capital investments will be very much restricted. Losses from the sale of shares are offsettable only against capital gains from shares. Losses from other investments (e.g. bonds) are offsettable against all other capital gains on capital investments. Offsetting of overall losses from capital investments with other income (e.g. business, rental income) is not possible, such losses are to be carried forward and to be offset against positive capital gains from capital investments in following years.

3. Flat rate tax (“Abgeltungsteuer”) on shares of investment funds

Following the principle of transparency, the new rules concerning the flat rate tax for a private investor have been transposed into the Investment Tax Act. Nevertheless, today’s distinction between investment income (dividends, interest) and capital gains is still to be made. Thus, capital gains realised indirectly via an investment in fund units will in some cases be subject to tax later than in case of a direct investment.

Dividend and interest income will under the new rules still be taxable in case of distribution or accumulation (Deemed Distributed Income). Capital gains realised on fund level will not become taxable until distribution or disposal of the investment fund units; after deduction of the Deemed Distributed Income already subject to tax during the holding period, capital gains at the investor level are than taxable at the flat rate tax.

The new rules apply in general to all income earned and capital gains realised by the investment fund after 31 December 2008, respectively to all investment fund units purchased / subscribed after the 31 December 2008. The combination of the applicable transition rules as per the Income Tax Act and as per the Investment tax Act will result in an additional administrative workload. However, there will also be some considerable tax advantages for investors.

Distributed capital gains from shares, which were purchased by the investment fund before 1 January 2009 will be tax-exempted for all private investors, regardless of when they have purchased / subscribed the investment fund units. In case of accumulation, those capital gains would increase the capital gain at disposal / redemption of the investment fund units and will therefore be taxable at investor level if the units were purchased / subscribed after 31 December 2008. This results in the requirement to record capital gains from shares purchased before 1 January 2009 separately from those related to shares purchased on/after that date. This applies accordingly to capital gains from bonds or short-term transactions.

The provisions on the Interim Profit as well as the scope of the tax reporting according to Article 5 Investment Tax Act will only be slightly modified. A certification of the annual tax reporting will still be required.

4. Advantages of investment in funds compared to direct investments

In contrast to direct investments, indirect expenses remain deductible from taxable income at fund level.

According to the transition rules, capital gains from the disposal / redemption of investment fund units, which have been purchased / subscribed before 1 January 2009 remain tax exempt without any time restriction. This applies irrespective of changes in the funds portfolio. All instruments held directly by an investor (i.e. not via a fund), which have been purchased after 31 December 2007 will be subject to the new system, i.e. all capital gains will be taxable. Changes in the portfolio at fund level will not make future capital gains taxable; the flat rate tax would not become applicable (exemptions for distribution of capital gains). Capital gains realised by the investment fund remain therefore tax-exempt if they are accumulated and the investment fund units were purchased / subscribed before 1 January 2009.

Purchasing investment fund units before 1 January 2009 can therefore result into major tax advantages for all type of private investors. Further advantages for investors in Luxembourg funds could result from the fact that the 25% flat tax is not levied at source (e.g. German funds need to transfer the flat tax on Deemed Distributed Income to the tax administration out of their assets) but only after assessment of the investors individual income tax, e.g. tax deferral.

5. New regulations for business investors

Most aspects of the existing legislation on fund investments by business investors remain unchanged. The 50% tax redemption on dividends will be lowered to 40 %. The scope of tax reporting for business investors according to Article 5 of the Investment Tax Act is also slightly reduced.

Conclusion

As can be seen, there are a number of detailed changes arising from the new tax act, however, the primary changes may be summarised as follows:

- The new tax code provides a level playing field between funds and certificates or similar structured products. Historically, certificates represented a tax advantaged investment route when compared to funds and this differential will be removed under the new act.
- In numerous instances, investors will suffer a higher effective tax charge whether investing directly or via funds/certificates - however....
-if investors place their money into funds prior to January 1, 2009, they will remain protected from the increased tax charge.

Overall, changes for the funds industry are both positive and negative, but the detailed implications should be assessed taking into account the specifics of your product and German investor base. Should you wish to discuss further issues and opportunities arising from the forthcoming changes with your German tax experts at PricewaterhouseCoopers, please do not hesitate to contact the people listed below or your usual contact within the team.

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