*Legal and tax developments*

**April 2014**

# *Asset Management Tax & Legal Newsflash*

## *'First Clarifications on the Interpretation of the AIFM Tax Amendment Act'*

***On 24th of December 2013 the new regulations of the German Investment Tax Act (GITA) came into force in the context of the implementation of the AIFM Tax Amendment Act. Especially with respect to the interpretation of the requirements to be met for a fund to qualify as an investment fund, there was a certain level of ambiguity. The most questionable points have recently been raised by industry associations with the Federal Ministry of Finance (BMF). The BMF replied in its letter dated 23rd of April 2014.***

## A) Executive Summary

- For the qualification as an investment fund it needs to refer to the overall fund level and NOT to share class level!
  → Grandfathering possible even for share classes incepted after the 23rd of December 2013
  → Investment restrictions need to be met at fund level

- Strong restrictions for hedge funds:
  → Trading partnerships are non-eligible assets
  → Portfolio monitoring capacities will be decisive to sell hedge funds to Germany
  → The 10% limit on investments in corporations will become a major obstacle

- Relief for special funds:
  The requirement of collective account does not refer to the actual number of investors. Even funds only having one investor can qualify as investment funds.

- Expected clarification for fund of funds & master-feeder-structures:
  Investments in target & master funds qualifying as investment funds are regarded as eligible assets and are not subject to any restrictions

- Relief for fund of hedge funds:
  Less strict modus operandi in case of breaches of investment regulation occurred at the level of the target fund

# B) Privileged Taxation as Investment Fund

## 1) Background

***(→ For more details we refer you to our Newsflash of December 2013)***

According to the new regulation introduced in connection with the AIFM tax Amendment Act the GITA is applicable to **all investment asset pools** which are subject to the new **German Capital Investment Code (GCIC)**, i.e. to UCITs and Alternative Investment Funds (AIF). Due to the very extensive definition of investment asset pool within the meaning of the GCIC almost any investment vehicle will be subject to the regulations of the GITA in the future.

Based on this very broad scope of application the new GITA differentiates between **three different categories** of investment vehicles:

- Investment funds
- Partnership-like investment companies
- Corporation-like investment companies,

each of these three vehicles being subject to different taxation regimes. However, please keep in mind that for all funds launched **before 24th of December 2013** and which meet the fund requirements of the former German Investment Act (GIA) in its version dated 21st of July 2013 a comprehensive grandfathering clause is applicable up until the first business year-end after **22nd of July 2016**.

You should not underestimate the consequences the categorization of a fund by one of the three taxation regimes can have on the investors after **tax return**. Certainly, in most cases a classification as investment fund should lead to the most tax beneficial result at the level of the fund and its investor as the fund can opt for the well-known tax transparency reporting. However, a prerequisite for being subject to this privileged taxation regime is that the fund fulfills specific investment requirements which have been significantly tightened in comparison to the former fund requirements of the GIA.

The BMF letter of 23rd of April 2014 deals in particular with the specification of some of these tightened investment requirements.

We have summarized those points in the BMF Letter which should be the most important to your business from our perspective.

## 2) Qualification at Fund Level

The BMF clarifies that with regard to the qualification as an investment fund in the sense of the GITA as well as to the application of the grandfathering clause, the necessary analysis should generally be applied at **fund level** and not at share class level.

With respect to the grandfathering regime this should mean that share classes that have been launched **after the 23rd of December 2013** also benefit from this clause as long as the fund has been launched before the 24th of December 2013.

## 3) Investment Requirements

### a) Redemption Rights

In order for a fund to qualify as an investment fund in the sense of the GITA the investor in principle has to be granted the right to redeem his shares in the fund at least **once a year**. However, there are certain exceptions to this rule.

In case of an extraordinary circumstance in the sense of the GCIC (→ a suspension of the redemption of shares seems to be **in the interest** of investors to protect them) the tax authorities will not object to the suspension of the investors' right to redeem, as long as this suspension will not surpass **a time period of 36 months**. The same is applicable during the liquidation of a fund, however the period of suspension **cannot last more than 60 months**. If the regulatory law allows for a longer period, this can also be considered for tax purposes.

### *b) Collective Investment & Business Purpose*

Collective Investment
The investment and management of fund resources has to be done for a **collective** account of investors.

According to the tax authorities a collective account is given if the investment requirements, the fund's statute or articles does not limit the maximum amount of investors to only one investor. In contrast **the actual number of investors of the fund is not relevant**.

Business Purpose
The objective business purpose of the fund must be limited to the investment and management of the funds' resources and **active entrepreneurial behavior must be precluded**.

With regard to **open real estate funds,** which invest in eligible assets in order to generate rental income at regular intervals, income in the form of dividend and interest payments as well as an increase in the value of the property, the BMF has confirmed that such open real estate funds should be in line with **the business purpose requirement** and thus can qualify as investment fund in the sense of the GITA.

### *c) Risk Spreading*

Investment funds have to invest their capital according to the principle of risk spreading. This criterion is met if the fund's capital is invested in more than three different assets with differing investment risks. For the interpretation of this rule the previous administrative practice of the BaFin can still be considered.

With respect to the principle of risk spreading the BMF has granted some alleviations and specified the definition of indirect risk spreading.

UCITS
For **UCITS** funds the tax administration will assume that the principle of risk spreading is always fulfilled.

Alternative Investment Funds (AIF)
For AIFs and real estate funds (REF) the tax administration will not reject if during the **beginning** and **liquidation period** of an AIF the risk spreading principle is not fulfilled. In case of REFs it will generally suffice if the risk spreading principle is fulfilled within the **four year start-up period** set out in the GCIC and for AIFs it should be sufficient if they comply with it within **six months** after inception.

Indirect Risk Spreading
Risk spreading can also be achieved indirectly if the UCITS or the AIF holds shares to a '**not inconsiderable extent**' in one or more other risk diversified investment funds. However, it was unclear what actually constitutes a 'not inconsiderable extent'.

The tax authorities will assume this condition to be fulfilled if the capital of the fund is **at least 50%** invested in one or more other funds which are invested according to the principle of risk spreading.

### *d) Eligible Assets*

Investment Companies

Investment funds in the sense of the GITA are in principle only allowed to invest in a specific catalogue of **eligible assets** and certain **investment restrictions** apply to some of those eligible assets. It was in dispute as to how shares in **investment companies** (e.g. target funds which do not qualify as investment funds) should be classified into this asset catalogue and, if so, whether these investments are subject to certain restrictions.

The BMF takes the view that for the classification of investment companies the following categories can be considered:

- **Securities**
  Generally the BMF confirmed that in principle the security definition of the regulatory provisions is relevant for tax purposes, too.

  As a result, all securities qualifying as eligible assets in the sense of the GCIC can be regarded as being eligible for tax purposes as well. In particular, this includes shares in investment companies which fulfill the relevant requirements of the Commission Directive 2007/16/ec.

- **Real Estate Companies and Corporations**
  Shares in investment companies which qualify as real estate companies or corporations in principle qualify as eligible as they are explicitly listed on the eligible asset catalogue of the GITA and thus can be directly allocated to these asset categories. Shares in corporations have to be attributed to the 20% ‘private equity threshold’.

- **Asset Management Partnership**
  In the case of an investment in an **asset management** partnership (except for certain real estate companies) for the eligibility analysis a look-through perspective has to be applied. Non-eligible assets held by the partnership will be allocated **on a pro-rata basis** to the UCITS or AIF and **treated as non-eligible at the level of the investing entity.** As a result, they have to be allocated to the 10% ‘trash bucket’.

- **Trading Partnership**
  Shares in **trading partnerships or partnerships with commercial** characteristics no longer qualify as eligible assets. Therefore, these investments can only be made as part of the **10% ‘trash bucket’**.

  Furthermore, the tax authorities are of the opinion that shares in trading partnerships should also be attributed to the 20% ‘private equity threshold’. A simple allocation to the 10% trash bucket without a consideration in the 20% ‘private equity bucket’ is not in line with the law.

  *This is especially surprising as the relevant section in the GITA dealing with the 20% private equity threshold explicitly refers to investments in **corporations** and **not** in trading partnerships.*

<u>Real Estate Investments via a General Partner GmbH</u>
In the case of real estate investments made by a fund via a GmbH & Co. KG (→ limited partnership with a limited liability company as a general partner) the holding in the General Partner (→GmbH) is considered as an eligible asset in the sense of the GITA.

### *e) 20% Limit for Investments in non-listed Corporations*

Investment funds in the sense of the GITA may only invest 20% of their total value in non-listed corporations (→ 20% 'private equity threshold').

<u>Fund of Funds & Master-Feeder-Structures</u>
With regard to fund of funds and master-feeder-structures the question has been raised how far the investment of a fund of fund in a target fund and the investment of a feeder into the master, respectively, might also be subject to the 20% 'private equity quota'.

The tax authorities have clarified that only an **entrepreneurial** interest, i.e. an interest in a company which actively runs an **operational business**, should fall under this investment restriction. However, an UCITS or AIF which fulfils the requirements of an investment fund is **not** regarded as actively running an **operational business.** As a result, holdings in investment funds will always be considered as an eligible asset, regardless of the legal form of the target fund or the master fund. As a result, these types of investments are not allocated to the 20% 'private equity threshold'.

<u>Offshore Corporations</u>
The BMF points out that holdings in non-listed corporations which are neither actively running an operational business nor qualify as a security nor as a share in an investment fund in the sense of the GITA cannot be regarded as an eligible asset. As an example the BMF mentions an offshore corporation not actively running an operational business.

*We would assume that such offshore holdings should be attributed to the 10% 'trash bucket', but not to the 20% private equity threshold.*

### *f) 10% Limit for Holdings in Corporations*

Based on a specific investment restriction the investment of an investment fund in a corporation is **limited to less than 10% of the total capital of the corporation** in question. It was in dispute whether this restriction might also affect shares that a feeder fund holds in the master fund.

The tax authorities have confirmed that the holding of shares in a master fund should **not fall under this restriction** as long as the master fund qualifies as an **investment fund** in the sense of the GITA. However, if the master fund is not classified as an investment fund, the 10% holding limit has to be adhered to.

**Holdings in the general partner GmbH (LLC)** of a real estate company structured as a GmbH & Co. KG (→ limited partnership with a limited liability company as a general partner) are not affected by this restriction as long as the general partner GmbH (LLC) qualifies as an eligible asset. However, this only applies if the general partner GmbH (LLC) is **not participating in any profits**; ceteris paribus this is also true for similar company structures of foreign jurisdictions.

## *4) Special Regulations for Fund of Funds*

The GITA has comprehensive rules in the case that an investment fund is reclassified as an investment company (e.g. due to a change in the investment strategy or a breach of the investment requirements) and the taxation regime to be applied will change accordingly.

In particular, in the case of **fund of funds** these regulations can become problematic as the eligibility of shares in a target fund is based on the **tax status of the target fund**. However, fund of fund generally cannot control whether the target fund constantly complies with the investment regulations for investment funds at its own level.

The tax authority has confirmed that in cases where the tax status of a target fund changes and where this leads to a reclassification of this investment into a non-eligible asset, at fund of funds level this will only be treated as a **passive breach of limits** and not instantly as a major breach (→ a major breach would directly result in a loss of the privileged tax status of the fund of funds and would last for at least 3 years). However, once the fund of funds takes notice of this reclassification it needs to ensure that the fund of funds complies with the investment regulation applicable to investment funds as soon as possible.

*In particular with respect to fund of hedge-funds this level of tolerance should help to manage the monitoring of the **fund of funds portfolio** since the fund is now able to react appropriately in case of investment violations occurred at target fund level without losing its investment fund status directly.*

### 5) Conclusion

The BMF Letter brings some clarity especially with respect to the interpretation of certain investment restrictions applicable for investment funds in the sense of the GITA.

Asset managers, in particular of **alternative investment funds**, should use the time granted under the grandfathering regime to analyse the implications of the AIFM Tax Amendment Act in more detail now. In particular, **comparative analyses** (comparing the after tax return of a fictitious investor under the different tax regimes) should provide additional insights. Following this, **appropriate adjustments** of the fund structure might be considered. **Systematic restructuring** should help to achieve the preferred tax regime even after 2016. If this is the aim, the implementation of appropriate systems to **constantly monitor** a fund's portfolio will be essential to avoid **undesired tax consequences** and **liability risks**.

The ability to reliably monitor the GITA compliance of a fund's portfolio will be of major importance with respect to **marketing hedge funds** to Germany. This applies in particular to **fund of hedge-funds**.

The **Fund Reporting Cloud®** offers a **regular monitoring** routine of the GITA compliance of fund portfolios for both **fund of funds and single funds**. For funds which already use the **Fund Reporting Cloud®** for the calculation of their German tax numbers a **comparative analysis** on the tax impact resulting from a potential change in the tax regime could be prepared upon your request based on the data readily available on our system.

## C) Further Topics

### 1) Allocation of Indirect Expenses

For fund business years ending after the **31st of December 2013** the allocation of indirect expenses will follow a new methodology. A BMF Letter which changes the transition period to a later date is soon to be enacted.

With regard to the ongoing application of this regulation the tax authority has acknowledged the following relief. It won't be objected if the allocation ratios which need to be determined based on the **positive prior year balances** are not used for the first **four months** in the new business year. Instead it will be accepted if for these first four months the allocation key used in the **previous business year** is still applied.

According to the tax authorities, for **traditional funds** there is no necessity to later correct the interim profit, equity gain and real estate gain values calculated based on the positive balances of the preceding year of the prior year. For **special funds,** however, a **retroactive correction** of the published values will have to be conducted. *Investment funds which use the **Fund Reporting Cloud®** are not affected by this, as the correct allocation keys are always being calculated as of the **first trade date of a new business year.***

### *2) Distribution of Liquidity Surplus*

The BMF has confirmed that a liquidity surplus resulting from **allowance for depreciation** and **repayment of contributions** can still be distributed preferentially as it was in the past.

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