

# NEW FLAT TAXATION: EFFECTS ON INVESTMENT INCOME

On 6 July 2007, the German Federal Council (*Bundesrat*) voted the Corporate Tax Reform 2008 (*Unternehmensteuerreform 2008*). The reform is intended to strengthen competitive advantages of the German marketplace.



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Illustration: Thomas Fendler/Andreas

Accomplishing the reform of the corporate tax, a flat tax (*Abgeltungssteuer*) on investment income for private investors will be introduced. This will also have a significant effect on the funds industry.

The principles of taxation for different investment products (e.g. equities, bonds, investment funds, certificates, pension vehicles) and the significance of the products will change and will therefore need to be reviewed by each investor to optimise his individual portfolio. For the investment fund industry, there will be a need to develop products to cover expected changes in market demand and to explore tax opportunities, which are available to fund investors.

## Overview of the flat-tax system

Effective from January 1, 2009, private investors' investment income will no longer be subject to their progressive individual income tax rate but will instead be subject to a flat-tax rate of 25% with compensatory effect (plus solidarity surcharge and church tax if applicable) for all investment income.

The scope of the taxable investment income is extended and includes interest and dividend income, income from silent partnerships, gains from derivatives (financial futures, swaps, options, etc.), premium from the sale of options and realised capital gains from all kinds of investments in securities, stocks, investment funds, irrespective of a holding period (excluding real estate). The half-income procedure for private investors with dividend income and realised gain on equity will be abolished. Transitional rules have been introduced considering the different kinds of investment income. Capital income from interest (including capital gain from bonds qualified as financial innovations), dividends and received option premiums received after December 31, 2008 and capital gain from realised gain on securities, interest bearing instruments and profits from derivative instruments if purchased or entered into from 1 January 2009 are subject to the new tax regime. Certificates (full risk bonds) are included in the scope if purchased after March 14, 2007 and sold after June 30, 2009. Realised gains from securities or derivatives purchased before January 1, 2009 still remain tax-exempt (considering a holding period of one year). The flat tax will only be levied by credit institutions in Germany acting as paying agent. Investment income paid by foreign paying agents is taxed on the basis of individual tax declarations.

## Income from shares of investment funds

The new regulations for the flat tax are also transposed into the German Investment Tax Act. The principle of transparency and the main current regulations are, in general, maintained. Capital income is still taxable on a yearly basis (as distributed or deemed distributed income). Capital gain realised from the fund's investments are subject to tax only if distributed or realised as included in the net asset value when the investment fund shares are sold. The new flat-tax system will in general apply to income earned and capital gain realised at the fund level after 31 December 2008, except for realised gain on securities or derivatives purchased before 1 January 2009. At the investor level, realised gain on disposal of investment fund units will be tax-exempt (considering a holding period of one year) if purchased or subscribed before 1 January 2009.

## Influence on the Luxembourg market

The flat tax provides for significant advantages in liquidity due to a delayed taxation if the tax is not directly deducted by the German paying agent, i.e. for custody of assets kept in Luxembourg or other foreign countries where the investor has to be taxed on the basis of the annual tax declaration. This liquidity aspect could therefore affect the Luxembourg private banking sector. The investment fund sector is mainly concerned by the considerable tax advantages for investment fund shares purchased until 1 January 2009 relating to the tax exemption for realised gain. These rules are in general applicable to all investment funds including the German funds. Luxembourg may benefit from its extensive experience to effectively develop optimised investment fund products in the transition period until January 1, 2009. || Jörg Roth