

German Foreign Tax Act and Luxembourg Funds

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Effective 1 January 2022, investors in Luxembourg investment funds resident in Germany may be subject to controlled foreign corporation (CFC) rules under the German Foreign Tax Act if the investment fund invests in assets through subsidiaries not resident in Germany.

CFC rules apply if an investor resident in Germany controls a foreign subsidiary of the investment fund together with persons who are related parties, the subsidiary generates "passive income" as defined in the German Foreign Tax Act and is subject to a tax of less than 25% abroad. In the case of so-called "investment companies" generating income from holding or managing cash, receivables, securities or participations, an (indirect) participation of less than 1% can be sufficient to trigger CFC rules applicable to investors resident in Germany.

Background

With the German Foreign Tax Act (*Außensteuergesetz* or *ASiG*), German tax authorities aim to prevent investors resident in Germany from withholding profits from taxation in Germany by using companies that are taxed at a low rate abroad. Therefore, under the German Foreign Tax Act, if legal requirements

are met, profits generated by foreign companies are attributed to the investors resident in Germany, even though no distributions may have been made. In practice, this is also known as "CFC rules".

According to the legislation from 1 January 2018 to 31 December 2021, investment funds were largely exempt from the application of the German Foreign Tax Act. However, this broad exemption from the application of the German Foreign Tax Act for investment funds has come to an end as a result of the ATAD Implementation Act (*ATAD-Umsetzungsgesetz* or *ATADUmSG*) of 25 June 2021.

Although Section 7 of the German Foreign Tax Act exempts those investment funds defined in the German Investment Tax Act from the application of the German Foreign Tax Act, this exemption only applies to the investment fund itself and does not include its foreign (i.e. non-German resident) subsidiaries.

If foreign subsidiaries meet the requirements of the German Foreign Tax Act, including being subject to taxation of less than 25% and generating passive income, then investors resident in Germany may be subject to CFC rules. In such a case, investors in the investment fund must prepare a tax return in accordance with Section 18 of the German Foreign Tax Act and file it with the German tax authorities. The income of the

foreign subsidiary/subsidiaries must be determined according to German principles as set out in Section 10 of the German Foreign Tax Act.

In general, the provisions under the German Foreign Tax Act also apply to subsidiaries of investment funds in the legal form of (Luxembourg) partnerships that are not resident in Germany.

Below, we will briefly discuss when a tax return may become necessary in accordance with the German Foreign Tax Act.

Conditions for the Application of CFC Rules

The CFC rules require that:

- the foreign company/companies is/are controlled by an investor resident in Germany, either alone or together with persons who are related parties,
- the foreign company generates passive income as defined in the German Foreign Tax Act, and
- this passive income is subject to low taxation abroad (less than 25%).

The requirement of "control" has been amended and expanded extensively by the reform of the German Foreign Tax Act and plays a key role in determining whether the German Foreign Tax Act applies. From 1 January 2022, control is deemed to exist if:

- the investor resident in Germany,
- at the end of the financial year of the foreign subsidiary of the investment fund,
- either alone or together with persons who are related parties,
 - holds more than half of the voting rights either directly or indirectly, or
 - holds more than half of the shares in the nominal capital either directly or indirectly, or

- is directly or indirectly entitled to more than half of the profits or liquidation proceeds of that company.

As of 1 January 2022, the broad definition of a related party includes shareholdings of at least 25%, which will be subject to the CFC rules.

In addition, concerted practices of various persons, enabling them to jointly influence the foreign company, are also deemed to be related parties.

The situation is particularly bad for investment funds in the legal form of partnerships: Under the German Foreign Tax Act, investors in partnerships are considered related parties. Although this notion is said to be rebuttable, there generally is need for action because the statutory basis has been established with regard to investment funds in the legal form of partnerships with subsidiaries not domiciled in Germany.

Passive income, which is subject to CFC rules, includes all income not listed in the asset catalog of activities provided for in the law. These include, for example, interest income, license income or income from renting and leasing in certain cases.

Another distinctive feature applies to partnerships investing in "investment companies" as defined in the German Foreign Tax Act. These are companies that generate income from holding or managing cash, receivables, securities or investments. In such a case, an (indirect) participation of less than 1% can be sufficient to trigger CFC rules applicable to investors resident in Germany.

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