GERMAN WEALTH MANAGEMENT

A tightrope walk between risk and opportunity

A great deal of work may need to be done to adjust tax strategies in light of the economic climate, but Hans Lauermann and Achim Obermann believe that wealth managers are better off staying put rather than turning away from the German market

The financial crisis plus the numerous reforms of German tax laws – is this reason enough for the wealth manager to turn away from the German market and to look for a quieter life far away from hostile tax regimes?

The answer is no for two reasons: firstly, crisis and change create opportunities. Secondly, the OECD has at its Cape Town meeting earlier this year committed to plans for a global tax attack on the private wealth business – so there won't be a lot of safe places left on this planet. So rather it is best to tackle the issue and deal with it.

THE CURRENT SITUATION

The first step to take is a rigorous analysis of the current situation. As from 1 January 2009 the German taxation rules for private investments will change fundamentally. There will be a flat rate withholding tax (WHT) on dividends and interest income as well as capital gains of 25 per cent and an additional solidarity surcharge of 5.5 per cent thereof (overall: 26.375 per cent plus church tax if applicable). The tax exemption for capital gains on the sale of privately held assets will be abolished.

Furthermore, the German legislator is in the process of creating modifications regarding taxation of investment funds' earnings, which are going to be enacted in 2009 (Annual Tax Act 2009, "Jahressteuergesetz 2009").

At the same time, the financial crisis has led to dramatic losses on equity, bond and hedge fund investments. Cash has become king for the majority of investors, at least for the immediate future. It depends on the risk appetite of each individual whether he prefers the "super secure" savings bank account or whether he can live with non-enhanced cash fund products.

Achim Obermann

"CASH HAS BECOME KING FOR THE MAJORITY OF INVESTORS, AT LEAST FOR THE IMMEDIATE FUTURE"

There is a great demand for safety in the market, while some investors start to spot golden opportunities from purchasing grotesquely undervalued assets.

Now, if the wealth manager wants do something to boost his Christmas sales, he may want to consider the following:

- Offer products which provide enhanced grandfathering on capital gains tax. This requires a high degree of sophistication as many avenues have been shut by the legislator, whose response time to innovative tax products has decreased substantively. If only he was as quick on other matters of greater significance!

- Offer strategies which allow for a deduction of expenses against the currently high rates and benefit from lower rates on income as of next year.

- Moving investors from one product to another without triggering intolerable capital gains tax charges.

- Tread carefully with a view to products which convert income into capital gains as they currently do not have the full sympathy of the German Minister of Finance.

- Anticipate massive redemptions: where funds do not operate equalisation, the investor who stays loyal to the fund manager until the bitter end may be the one who has to pay the tax burden for everyone who left before him. This is widely unknown and can create millions of Euros of taxable phantom income.

- Tell the client where to realise

taxable losses prior to year end.

• Advise clients how to save taxes on cash products. With interest rates above five per cent, this is worth doing and, yes, it is possible.

• Reduce the filing burden for the client – the new regime introduces a completely new set of filing requirements and if products are carefully chosen, filing requirements can be reduced to a minimum.

• Respect investor preference for regulated fund vehicles over products with inherent issuer risks.

Those interested in more details on the use of fund vehicles for private investors under the new rules, should read the following overview of key changes introduced by German tax reform. In particular, the taxation until 31 December 2008 and as from 1 January 2009 will be compared for various types of funds.

Hans Lauermann

"FOR DOMESTIC REAL ESTATE, THERE MAY BE A GREATER ATTRACTION IN MOVING TO OPEN ENDED INVESTMENTS, WHICH BENEFIT FROM FLAT RATE TAXATION"

INVESTMENT FUNDS

The private investor's tax charge depends on the investment fund either earning regular income from investments (e.g. dividends, interest payments) or capital gains (irregular income) derived from sales of the fund's assets (i.e. shares, securities, real estate, others) and whether the fund's income is distributed or accumulated.

Starting from 1 January 2009, all earnings from investment income will be subject to a flat WHT on the investor's level. However, from a tax perspective, investment funds can still be advantageous as outlined below:

EQUITY / DEBT SECURITY FUNDS

Taxation of investment fund income until 31 December 2008: The investment fund's regular income is subject to tax on the investor's level regardless if accumulated or distributed. The interest accrued at the level of the investment fund is fully taxable with the investor's individual income tax rate, whereas dividend income is subject to the half income method. Furthermore WHT is levied on both, interest (30 per cent) as well as on dividend income (20 per cent).

The fund's capital gains (irregular income) from equities/securities are in general not taxable, whether they are accumulated or distributed. The main exceptions are capital gains of so-called financial innovations (e.g. zero bonds) which are deemed to be (interest like) regular income and therefore they are fully tax-able on the investor's level.

Taxation of investment fund income from 1 January 2009: The investment fund's regular income (i.e. dividends, interest) is subject to WHT (26.375 per cent overall tax charge plus church tax if applicable) on the investor's level irrespective of whether it is distributed or accumulated. Income deriving from distributed capital gains is taxable subject to the above mentioned WHT rate. The individual tax rate and/or the half income method no longer apply.

Conversely, capital gains (irregular income) are in general not taxable if accumulated and reinvested at fund level. However, an exemption for so called "full risk certificates" will apply. Full risk certificates are certificates that neither feature a current return nor allow for the accounting of income on an accrual basis. Thus, capital gains resulting from the sale of such certificates become taxable irrespective of whether they are distributed or accumulated.

REAL ESTATE FUNDS

Rental income from domestic real estate is considered as regular income and will therefore be taxable at the end of the fund's business year or earlier if distributed.

Conversely, rental income from foreign real estate is usually tax exempt in Germany since the relevant tax treaties predominantly provide for taxation in the country of location.

For domestic real estate, there may be a greater attraction in moving to open ended investments which benefit from flat rate taxation. This tax advantage may be combined with greater liquidity and improved asset management as well as enhanced portfolio diversification.

Revenues from the sale of real estate tax remain tax free if the relevant holding period has been respected. This generally applies for direct and indirect investments alike.

FUND OF FUNDS STRUCTURES

In a fund of funds structure capital gains from the sale of underlying fund units will remain free of taxes even after 31 December 2008 as

long as they are accumulated and reinvested in other assets. WHT will be triggered upon distribu-tion to the investor.

The fund of funds structure may therefore enable the inves-tor to save taxes. This will need to be balanced against other features of a fund of fund.

A fund of funds structure is of particular interest if it is set up before 1 January 2009. The Grandfathering rules extend the current tax exemption for capital gains from securities, shares etc. after 31 December 2008.

Thus the sale of the aforementioned assets which were purchased before 1 January 2009 leads to tax-free capital gains provided they were sold after the speculative period.

The same applies to the sale of units in investment funds. The fund of funds structure and the Grandfathering therefore offer the possibility to receive tax-free income on three levels: capital gains achieved by the underlying fund as well as the sale of the fund units of both, the underlying and the fund of fund after the speculative period.

In order to prevent abuse of such structures, the legislator decided not to grant the grandfathering rules for foreign or domestic special investment vehicles or in connection with funds whose statutes (or local legislation) only provide investments for

"INVESTMENTS IN OFFSHORE SILENT PARTNERSHIPS MIGHT BE CONSIDERED AS AN ALTERNATIVE INVESTMENT FOR PRIVATE INVESTORS TO MITIGATE GERMAN WHT EXPOSURE"

professional investors or minimum investments of €100,000.

For those investment vehicles (e.g. the Luxembourg SIF) capital gains deriving from the sale of units will be taxable if they are set up after 9 November 2007.

In order to reduce further advantages, the government currently plans to initiate a special legislation for so called "tax saving funds".

"Tax saving funds" combine for example low interest foreign bonds with swaps or use short term forward contracts to generate an interest like return being shown as a capital gain. For those funds the accumulation benefit shall not be granted.

ALTERNATIVE INVESTMENTS

Investments in offshore silent partnerships might be considered as an alternative investment for private investors to mitigate German WHT exposure. This would require the relevant agreements to be structured such that the investor's profit will be considered as commercial income rather than as a dividend or a capital gain from a tax perspective.

If all conditions are fulfilled (especially those of German CFC law) the earnings may be tax-exempt in Germany and taxable at a lower tax rate of e.g. 15% in the foreign domicile country.

CONCLUSION

The above described indicates that a lot of homework may need to be done prior to the end of the year to adjust tax strategies on private wealth management to proposed changes bearing in mind the new economic landscape. Since the current legislative process regarding these changes is not completely finished yet, it will be necessary to carefully observe the development until 31 December.

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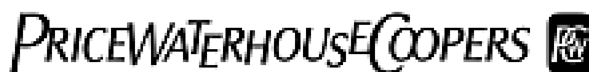

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