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January 21, 2015

Opinion of the Advocate General regarding the German lump-sum taxation of investment funds

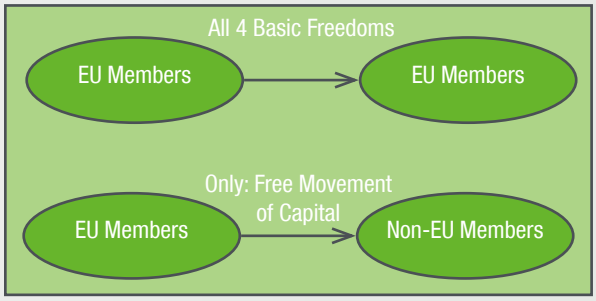
Following the Decision of the European Court of Justice (ECJ) dated October 9th, 2014, in which Sec. 6 of the German Investment Tax Act (GITA) that regulates the German lump-sum taxation of investment funds was under scrutiny, the Court now has to deal with the question whether Sec. 18 para. 3 of the German Foreign Investment Act (GFIA) infringes the principle of the free movement of capital, ECJ C-560/13 (Wagner-Raith). Sec. 18 para. 3 GFIA, effective until the end of 2003, is the predecessor of Sec. 6 GITA and provides for the application of the German lump-sum taxation of income received from third-country funds. On December 18th, 2014, the Advocate General referred his opinion on the preliminary question of the German Federal Court of Finance (Bundesfinanzhof) in the Wagner-Raith Case to the ECJ.

According to the opinion of the Advocate General, Sec. 18 para. 3 GFIA is not subject to the principle of the free movement of capital in Art. 56 EC as the 'standstill' clause stipulated in Art. 57 EC is applicable.

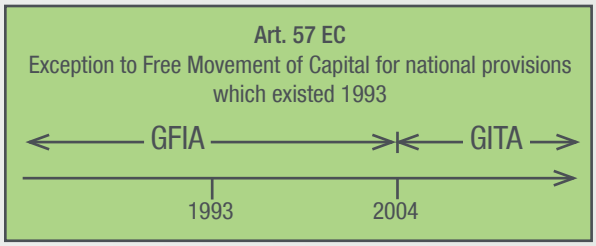
On October 30th, 2013 the German Bundesfinanzhof submitted a request to the ECJ for a preliminary ruling on the question whether the principle of the free movement of capital in Art. 56 EC precludes national legislation, such as Sec. 18 para. 3 GFIA, which stipulates the taxation on a lump-sum basis of investors in non-reporting third-country funds, or whether Sec. 18 para. 3 GFIA is a provision within the meaning of Art. 57 EC, which protects national restrictions to the free movement of capital that existed on December 31st, 1993. Thus, it is of particular importance whether the 'standstill' clause precludes the scrutiny of the former lump-sum taxation of the German Foreign Investment Act in light of the principle of the free movement of capital.

The relevant case concerns a German investor who held shares in an investment fund domiciled on the Cayman Islands in 2003. The German Financial Authorities assessed the investor's income from the fund on a lump-sum basis and rejected the investor's distinctly lower determination of its tax base instead.

The Bundesfinanzhof is of the opinion that the lump-sum taxation, provided for in Sec. 18 para. 3 GFIA, violates the principle of the free movement of capital as it prevents German investors from investing in foreign, non-reporting 'black funds' because those funds are subject to a tougher taxation regime than German funds.



The relevant question of the case is the scope of application of the so-called 'standstill' clause set forth in Art. 57 EC. According to Art. 57 EC, Member States are allowed to maintain certain restrictions on the free movement of capital if the restrictions result from national legislation that already existed on December 31st, 1993, and concerns the provision of financial services or direct investments in a third-country investment fund. Thus, Art. 57 EC only applies if all of these three criteria are fulfilled: (i) the relevant national provision concerns a third country, several third countries or applies to those countries; (ii) the relevant restriction already existed on December 31st, 1993, and (iii) the relevant capital movement resulted from one of the activities stipulated in Art. 57 para. 1 EC.



According to the opinion of the Advocate General, the answer to the preliminary question of the Bundesfinanzhof should be as follows: Sec. 18 para. 3 GFIA, which has remained unchanged since December 31st, 1993 refers to capital movements in connection with the provision of financial services within the meaning of Art. 57 para. 1 EC. Thus, the Advocate General affirms the application of the so-called 'standstill' clause, so that Sec. 18 para. 3 GFIA is not subject to the scope of application of the principle of the free movement of capital.

The Bundesfinanzhof is of a contrary opinion. According to the Bundesfinanzhof, a restrictive understanding of the scope of application of Art. 57 para. 1 EC should prevail. Thus, national legislation regulating the provision of financial services only includes regulations that address the financial institutes themselves or regulates the performance of or the prerequisites for the provision of those services, whereas national legislation affecting the investors of such financial service should not be within the scope of Art. 57 para. 1 EC.

According to the Advocate General's understanding of the 'standstill' clause, the "provision of financial services" also includes national laws addressing the recipient of such services, i.e. the investors themselves. Furthermore, there was a close link between the objective of Sec. 18 para. 3 GFIA, i.e. the taxation of national investors of third-country funds and the activities of the funds themselves, as said tax regime only applies if the funds do not comply with the required disclosure obligations as stipulated in Sec. 17 para. 3 and Sec. 18 para. 2 GFIA. In other words, Sec. 18 para. 3 GFIA concerns the provision of financial services as it provides at least an indirect incentive for foreign investment funds to comply with the necessary reporting requirements.

In this case, the investment in a third-country fund, from which the investor receives dividends that are subject to lump-sum taxation, inevitably entails the provision of financial services. Without these financial services, the investment in a third-country fund does not make any sense. Only these financial services provide for the opportunity to invest in a variety of investments, particularly for non-institutional investors, who would be prevented from investing directly in third-country markets. Furthermore, these financial services optimize the proceeds of an investment, which are then subject to national taxation.

The European Court of Justice will presumably follow the opinion of the Advocate General. If this is the case, the application of the lump-sum taxation according to Sec. 18 para. 3 GFIA would be protected by the 'standstill' clause of Art. 57 para. 1 EC and thus it would not violate the principle of the free movement of capital.

be in touch: If you have any questions, please do not hesitate to contact us!

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