

OGAW-IV Implementation Act in Germany: Conversion of issuer taxation to paying agent taxation for dividend payments as of 2012

On June 25, 2011 the OGAW-IV Implementation Act was finally enacted by publication in the Federal Tax Gazette. By this act the present issuer taxation regime for German dividend payments will be replaced as of 2012 by a paying agent regime.

The main features of the new legislation have already been highlighted in our February 2011 newsletter on basis of the draft act. The final act, however, contains some important changes compared to the former draft. The most important change refers to the future tax withholding in case of German accumulating mutual funds. Based on the final act the withholding on all portions of taxable income accumulated as of 2012, i.e.

- domestic dividend portion,
- foreign dividend portion and taxable capital gains,
- interest portion and
- domestic rental income

will solely take place on level of the paying agent. In contrast thereto the former draft did only cover the change in withholding with respect to the domestic dividend portion and the domestic rental income portion.

Upon fund business year end the fund company will then be obliged to decrease the fund's net wealth by 27.99% of the taxable accumulated income as respective „tax distribution“. This tax distribution then has to be forwarded to the paying agents for funding of the actual tax withholding (KEST, SOLZ and, if applicable, church tax). If the actual withholding made by the paying agent would be lower than the tax distribution received, the resulting difference amount has to be credited tax-neutral to the customer's cash account.

As result of the change in the withholding regime for domestic accumulating mutual funds the final levy taxation will also fully apply on these products, i.e. it will no longer be required for the customer to declare the respective accumulated income for church tax assessment purposes.

Another change comprises the treatment of domestic special funds. The shifting of the complete withholding tax obligation to the paying agent will only apply on domestic mutual funds, but not on domestic special funds (either accumulating or distributing). For domestic special funds the tax withholding obligation will in contrast be fully shifted as of 2012 to the fund company.

Please note, that the final act does not contain any changes compared to the draft regarding the new withholding tax regulations for domestic dividend payments or distributions of domestic mutual funds.

Although the law has been enacted there are still some points in discussion between the financial industry and the tax authorities. Main issue in this connection is the double tax withholding in case of domestic stocks or mutual fund shares held in custody abroad. Based on the act the respective taxable gross amounts on domestic dividend income and domestic rental income on these assets held in custody abroad would generally become subject to a 26.375% tax withholding. The withholding would have to be made by the last domestic custodian within the chain, i.e. Clearstream Banking.

However, if the respective assets are only be held abroad in intermediary custody for a domestic financial institution (including funds), the respective taxable gross income will again become subject to tax withholding in the amount of then 27.99% (calculated on the gross income) on level of the final domestic paying agent of the customer.

Besides negative cash-flow-effects this might also result in a final double taxation for the customer, since it can be assumed, that he will not be in a position to receive a tax credit for the withholding made by Clearstream Banking. Although Clearstream Banking will be obliged to provide a respective tax certificate upon the taxes withheld, the tax certificate will most likely be issued on the name of the foreign (intermediary) custodian and not broken down to the underlying German customers. This would formally exclude any potential tax credit for the customers. However, at least an application for partial refund of the taxes withheld by Clearstream Banking based on the lower double tax treaty rate of 15% might still be possible in order to at least minimize the negative effects.

Finally, the fund industry has also addressed another issue to the tax authorities. Subject is the future handling of foreign source tax credits on accumulated income of mutual funds. The question was raised, whether such foreign source tax credits have to be considered within the determination of the tax distribution (i.e. comparable to the current procedure). If so, the tax distribution might then be decreased from a unique rate of 27.99% to a case-by-case variable rate. However, the respective minimum rate should be 26.375%, i.e. 25% KEST plus 5.5% SOLZ thereon (neither church tax nor foreign source tax credits), and would apply for mutual fund shares held e.g. in business wealth.

The aforementioned changes will have a significant impact on (e.g.):

- fund reporting,
- data sourcing of the paying agent and
- accounting and reporting systems of the paying agent

Since the first income subject to the new withholding tax regime can be expected as of January 2012, the required changes must have been implemented by the end of the year.

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