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A legal update from Dechert's International and Domestic Tax Group

New German Capital Income and Capital Gains Laws Mean Increased Taxes for Investors

Germany has enacted a new 25% flat rate income tax *(Abgeltungsteuer)* on all capital income and capital gains for individual investors, effective 1 January 2009. This substantial revision to prior law, and other related changes, will result in increased taxes to German investors in German and foreign companies, especially to management and other individual investors, and to some foreign investors in German companies.

New Flat Rate Income Tax for German individual Investors

Under prior law, individual investors generally were taxed only on dividends, interest and on certain capital gains (e.g. in case of major shareholdings in corporations). However, capital gains on investment fund units and on corporate shares were tax free if the individual sold the shares or units after a holding period of one year, and in the case of corporate shares provided that the shareholder owned less than 1% of the company.

The new law eliminates these tax exemptions and imposes tax on all capital items:

- Capital income, such as dividends and interest;
- Capital gains on shares, bonds and other capital instruments (e.g. full risk certificates, options and swaps);
- Capital gains on dividend and interest coupons, participations as silent partners and on other capital rights; and
- Capital gains on investment fund units.

Due to this change in law, any capital gains on corporate shareholdings are now subject to tax. This affects equity investments of German employees and management who own shareholdings in their employers, and also investments of German private investors into private equity or hedge funds, which could have been made tax free under prior law (assuming that their investment represented less than 1% of the underlying equity).

The new tax rate on investment income is 25% (plus a 5.5% solidarity surcharge on that rate and church tax where applicable). The old 50% tax exemption on dividends and on capital gains on shares and investment fund units (the "half income system") has been abolished. The new flat rate income tax is charged on the gross investment income – no related costs, besides a small annual lump sum allowance against all investment income (€801 per year, or €1,602 in case of married couples), are tax deductible. Due to the technical separation of investment income from the rest of taxpayer income, losses from investment income can only be set off against other investment income; moreover losses from the sale of shares can only be set off against capital gains on shares.

Changes for business and institutional investors

The new flat rate income tax does not apply to individuals holding shares as business assets *(Betriebsvermögen)* or holding shares of a corporate entity equivalent to 1% or more of the company's stated share capital. The former 50% tax exemption of dividends and capital gains of such investors has now been reduced to a 40%

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tax exemption, making 60% of such income taxable. Furthermore, interest payments on shareholder loans granted by individuals holding at least 10% of the share capital of the borrowing entity remain taxable at the individual's tax rate (up to 45%). Unlike under the flat rate income tax regime, costs related to this income are tax deductible.

The new law does not change the taxation of investment income of institutional investors that are corporations. As under prior law, 95% of their dividends and capital gains on shares or investment fund units are tax-free and their interest income is taxable at the regular income tax rates.

Flat Rate Income Tax as Withholding Tax

In general, the flat rate income tax will be withheld by the payer of the income (e.g. in cases of dividend or interest payments) or by the paying agent (e.g. a German bank in cases of capital gains on shares or investment units held in a German bank deposit). In the case of foreign investment income (e.g. capital gains on shares held through a foreign broker), the investor has to include such income in his or her regular tax returns. Further, if the individual's income tax rate is below 25%, he or she can elect in his or her tax return to have the lower rate apply.

Where a single investor holds multiple capital instruments through one bank or broker, the bank will set off capital profits and losses in calculating the withholding tax paid to the fiscal authorities. Unused tax losses can be carried forward into the next year (and to unlimited years after that, if needed), but cannot be carried back. Losses from capital instruments held in deposits at other banks will not be set off by the bank. Instead, the investor can set off such losses against other investment income by including them in his or her regular tax return.

Taxation of Foreign Investors

Foreign investors who invest in German companies or German debt also are subject to the above rules. In cases where the flat rate income tax applies, 25% (plus 5.5% solidarity surcharge thereon) of the gross income will be withheld in Germany, subject to reduction based on the applicable tax treaty. Dividends received by non-German corporate investors are subject to only a 15% withholding tax, again subject to treaty relief. Interest payments on shareholder loans or commercial loans granted by foreign investors remain non-taxable and are not subject to withholding tax in Germany (unless secured by German real estate).

Transition Rules

The new flat rate income tax (and the reduction of the 50% tax exemption to 40%) applies to any capital income received after 31 December 2008 and to capital gains on shares, investment fund units or on other capital instruments acquired after that date. Capital gains on such instruments acquired before 2009 remain subject to the old laws. Thus, shares (where the investor holds less than 1% of the share capital) and investment fund units acquired in or before 2008 can be sold tax-free by private investors if the one year holding period is satisfied.

The above grandfathering rules are restricted in respect of investments in certain special or family investment funds and in full risk certificates (i.e. corporate bonds where the investor may lose the entire investment). Capital gains on such instruments become subject to the new flat rate income tax if these capital instruments were acquired after the 9th of November 2007 in case of special or family investment funds, and after the 14th of March 2007 in case of full risk certificates, respectively.

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