

Abstract

The taxation of investment funds was based on the tax transparency of the fund itself since special tax rules for investment funds were first adopted in 1957. The investment tax reform taking effect on 1 January 2018 brought fundamental change. For the first time, both investment funds and their shareholders are taxable entities. Taxation of investors, therefore, is comparable to the taxation of stock corporations and their shareholders. The reformed investment taxation does, however, provide for means piercing the corporate veil, thus enabling taxation of the fund's profit at the level of the investor prior to profit distributions. One of these measures is the so-called *Vorabpauschale*. It is a new fiscal instrument, which calculates the taxes owed by applying an interest rate determined by the German Treasury to the value of the shares that an investor holds in investment funds. The taxable amount is limited by the increase in value the shares in the investment fund yielded within a given fiscal year. The increase in value itself is calculated by comparing the prices for said shares at the beginning and at the end of each fiscal year. If the value of the investment fund shares decreased in a fiscal year, the *Vorabpauschale* will not accrue. Thus, the *Vorabpauschale* assumes that each investor generates interest on the capital he invested in investment fund shares. The reformed Investment Tax Act provides for mechanisms reducing the tax burden upon the distribution of profits or disposal of shares in order to prevent a double taxation on actual gains and fictitious interest gains.

While much attention was drawn to the diametrical change regarding the underlying assumption of investment funds being taxable entities, less attention has been paid to the implications of the investment tax reform regarding the relationship between investment fund taxation and controlled foreign company (CFC) rules. Investment funds typically generate passive income while being subject to favourable taxation, often being exempt from standard income tax or corporation tax. Therefore, resident investors of non-resident investment funds are frequently subject to CFC taxation. Since both investment taxation and CFC taxation implement measures similar in effect in order to tax investors on undistributed profits from the investment fund, such investors could theoretically be taxed under investment taxation as well as income taxation resulting from the application of CFC rules. To prevent double taxation of foreign investment income, the tax code must, therefore, stipulate which tax regime shall prevail. Sec. 7 para. 7 of the Foreign Tax Act (*Außensteuergesetz – AStG*) provides for a general supremacy of investment taxation.

This dissertation analyses whether Sec. 7 para. 7 AStG achieves systemic equity between investment taxation and CFC taxation. Systemic equity is understood here as a prerequisite for tax equity. Hence, any rule governing the intersection between investment taxation and CFC rules must adhere to systemic equity. Since legal principles are the building blocks of legal systems, this dissertation induces the legal principles from both the reformed investment taxation as well as existing CFC rules. In order to examine the horizontal systemic equity of Sec. 7 para. 7 AStG, the principles and underlying assumptions of the investment taxation and of the CFC rules are juxtaposed. The juxtaposition shows that horizontal systemic equity can only be achieved by applying CFC

rules instead of investment taxation. Thus, Sec. 7 para. 7 AStG does not allow for horizontal systemic equity.

Vertical systemic equity, on the other hand, can only be achieved by obeying the ability to pay principle as the fundamental principle of equitable taxation. Both, investment taxation and CFC rules implement means to pierce the corporate veil and thereby violate the ability to pay principle. CFC rules, however, serve as anti-abuse rules which justifies a violation of the ability to pay principle. Therefore, only CFC rules may achieve vertical systemic equity, since a justification for the violation of the ability to pay principle by the investment taxation could not be identified.

Because systemic equity may only be achieved by applying CFC rules instead of investment taxation, a reformed Sec. 7 para. 7 AStG is proposed, stipulating that CFC rules shall prevail. To minimise eventual difficulties arising from the application of CFC rules to non-resident investment funds, this dissertation recommends taking inspiration from secondary European legislation. In particular, the adoption of certain measures provided for in the Anti-Tax Avoidance Directive (ATAD) is proposed. Moreover, requirements for fund management arising from the Directive on Alternative Investment Fund Managers (AIFMD) should be considered in applying the substantive economic activity test allowing investors to escape from possible CFC taxation.

This dissertation concludes that combining the supremacy of CFC rules with instruments provided for by the ATAD achieves systemic equity at the intersection between investment taxation and application of CFC rules to non-resident investment funds, thus enabling equitable taxation of resident investors of non-resident investment funds.