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German Court Says Tax-Privileged Millionaire's Funds Were Lawful

by Alexander F. Peter

The tax privileges awarded to German investors in Luxembourg special funds were permissible under the German Investment Tax Act because a third-party fund administrator was not required at the time, a German court has ruled.

In a decision (12 K 1540/19) published February 27, the Tax Court of Cologne overturned a decision of the tax authority's administrative appeals panel, which had held that the Investment Tax Act contained an implied mandatory separation of fund management from its investors. The court said no such requirement can be found in either the act itself or in the legislative history or any officially announced opinion of the tax authority.

"As of 2018, the millionaire's fund privilege has been practically abolished for private investors," said Marco Brinkmann of Ebner Stolz in Frankfurt. "An explicit third-party administrator requirement has still not been explicitly included in the act, though. The inapplicability of the millionaire's fund privilege was achieved by excluding private investors from this type of special investment fund and limiting it to institutional investors."

In 2007 a Luxembourg resident A SA (a public limited company) set up the B Global Value Fund as a special investment fund governed by Luxembourg law. That type of fund is aimed exclusively at institutional, professional, and other knowledgeable investors as defined in article 2(1) of the Luxembourg law of February 13, 2007, on specialized investment funds, which allows for the establishment of single-investor funds for private individuals making a minimum deposit of €1.25 million (dubbed millionaire's funds).

The unidentified taxpayer, who apparently subscribed to all units in the B Global Value Fund, was a German resident. He took advantage of a grandfathering clause in the German Investment Tax Act, under which the previous taxation regime still applied, and "saved himself the German final flat-rate withholding tax on capital gains from fund units introduced in 2009,"

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Brinkmann said. "Under that rule, private investors could sell fund units tax-free after a holding period of one year."

There was no official management agreement between the taxpayer and the fund. When he wanted to have assets acquired or purchased for the fund, he filled out an investment proposal form and submitted it to the A SA. All proposals were executed as suggested.

In 2011 the taxpayer declared capital gains without withholding tax. The German tax authorities started a series of criminal tax fraud investigations in 2015 because of missing third-party administrators in foreign funds. That same year, the taxpayer explicitly disclosed to the tax authorities that he was the sole administrator of the B Global Value Fund. The tax authorities submitted his case to the criminal tax investigation department. The criminal tax investigation of the taxpayer was ultimately closed in 2019 because the tax authorities never published a uniform tax opinion about third-party fund administrators. In the same year, the local tax office rejected the taxpayer's appeal against a tax assessment consisting of a final flat-rate withholding tax on the capital gains.

"The fact that the local tax office involved the criminal investigation department here is remarkable in light of a nonexistent official opinion of the tax authorities regarding third-party funds administration," Brinkmann said. "That means the taxpayer had precisely no obligation to disclose any factual circumstances to avoid criminal tax proceedings, as the return position did not deviate from the tax authorities' published guidance."

In appealing the assessment, the taxpayer claimed that the German Investment Tax Act did not require him to have the fund administered by a separate party. The local tax office asserted that the third-party administrator principle is also implied in Directive 2007/16/EC concerning undertakings for collective investment in transferable securities.

The Cologne court sided with the taxpayer because neither the Investment Tax Act nor the Investment (Fund) Act on which it relied mentioned a third-party administrator principle during the year at issue.

A teleological reduction of the Investment Tax Act's wording can only be considered — in accordance with the case law of the Supreme Tax Court (Bundesfinanzhof) — if the interpretation of the wording leads to a result that is contrary to its meaning and it can be concluded that the legislation has been implemented in a way that is contrary to the legislature's intent, the court said. On the other hand, it is not the task of a teleological reduction to correct legal policy errors — that is, to improve the law, it added. According to the principle of separation of powers, legislative deficits can be eliminated by the legislature alone, the court said.

The legislative history demonstrates that the legislature was aware of the Luxembourg law and did not outright exclude millionaire's funds from the grandfathering clause. Only in 2016, when another investment fund reform was entertained, did the legislative materials indicate that a third-party administrator should be mandatory for the investment fund tax privilege to apply. A retroactive application of the legislature's intent to 2011 would be a violation of the separation of powers and cannot be judicially legislated, the court said.

The court also rejected the local tax authorities' argument that a third-party administrator principle is implied in EU law. An alleged implied content of an EU directive that does not directly apply to a member state's domestic law has no relevance for the interpretation of domestic law, it said.

The tax court allowed an appeal to the Bundesfinanzhof, which has been filed (VIII R 18/22) by the local tax office. ■

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