02

German CFC and PFIC law in fund structures

Expert's report

The regulations on the German Controlled Foreign Company (CFC) and Passive Foreign Investment Company (PFIC) rules were fundamentally reformed by the ATAD Implementation Act, which was announced on June 30, 2021. This included changes to the control concept (introduction of a shareholder-based approach), the elimination of the concept of lower tier intermediate companies, the revision of the catalog of active income, amendments to the interaction between the German Investment Tax Act (GINVTA) and the German CFC/PFIC rules and the revision of the motive test.

The new regulations are to be applied for the first time for financial years of an intermediate company that begins after December 31, 2021 (Sec. 21 (4) sentence 1 of the Foreign Tax Act [FTA]).

In particular, the interaction between the provisions of the FTA and the GINVTA poses particular challenges for investors, fund managers and advisors.

The following comments provide a brief overview of the practical challenges textin the context of investments through funds.

A. Control together with a related party

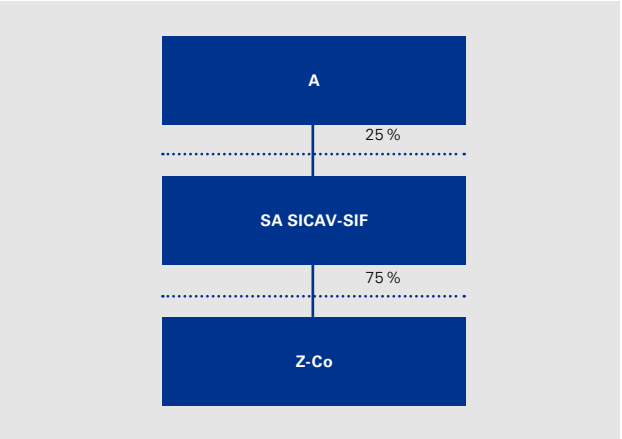
A foreign intermediate company is deemed to be controlled if a taxpayer alone or together with related parties holds more than 50 % of the voting rights, shares, profit rights or rights to participate in liquidation proceeds at the end of the financial year of the foreign company (so-called shareholder-related approach, Sec. 7 (2) FTA). The term „related party" is generally determined in accordance with the provisions of Section 1 (2) FTA.

In the opinion of the tax authorities, shareholdings of related parties are fully attributed to the German taxpayer for purposes of determining control over a foreign entity. Related parties , in particular also include limited partnerships (Sec. 7 (3) sentence 2FTA) as well as domestic and foreign investment funds.

It should be noted here that (special) investment funds that are separate in terms of liabilities and assets from each other are to be treated as independent in accordance with the treatment in the GINVTA.[1]

This means that a non-controlled Investment Fund may lead to control over an intermediate company in case it would be regarded as a related party and the statutory priority of application of the GINVTA for PFICs would not apply in this case (Sec. 13 (5) FTA).

Example:



Source: KPMG Germany, 2025

Unlimited domestic taxpayer A holds 25 % of the units in a Luxembourg investment fund in the legal form of an S.A. SICAV-SIF. The provisions of theGINVTA apply to the Luxembourg investment fund. The Luxembourg investment fund holds a 75 % interest in the foreign intermediate company Z.

Solution:

Due to the investment of A in Luxembourg S.A. SICAV-SIF, the latter is a related party of A.

1 *BMF Decree of December 22, 2023, IV B 5 – S 1340/23/10001 :001 Rz. 282.*

The domestic taxpayer A therefore controls the intermediate company Z together with a related party. The control ratio of A is 75 %. The add-back ratio of A is 18.75 % (25 % of 75 %).

The amended concept of the control rule means that, in theory, a calculated shareholding of only 12.501 % in an intermediate company can already lead to control and thus to the application of the German CFC taxation (Sec. 7 (1) FTA).

B. Related parties due to concerted behavior (Sec. 7 (4) FTA)

Special challenges arise for investors in fund vehicles in the legal form of a partnership such as an investment limited partnership or a comparable foreign legal form such as a société en commandite simple (SCS) or a limited partnership. Persons are also deemed to be related parties if they act in concert with the taxpayer in relation to the intermediate company (Sec. 7 (4) sentence 1 ITA). In the case of direct or indirect partners in a partnership or co-entrepreneurship who have an (in)direct interest in a foreign intermediate company, acting in concert is rebuttably presumed (Sec. 7 (4) sentence 2 ITA). The provisions therefore extend the concept of a related party irrespective of the existence of a specific shareholding.

The consequence of this legal fiction is that, due to the assumed acting in concert, an attribution of the shareholding of other partners in a partnership could lead to control even if an investor with unlimited tax liability only holds a smaller shareholding.

Foreign fund vehicles are often established in the legal form of a partnership that holds shares in foreign companies. The ability to apply the rebuttal is therefore of particular importance

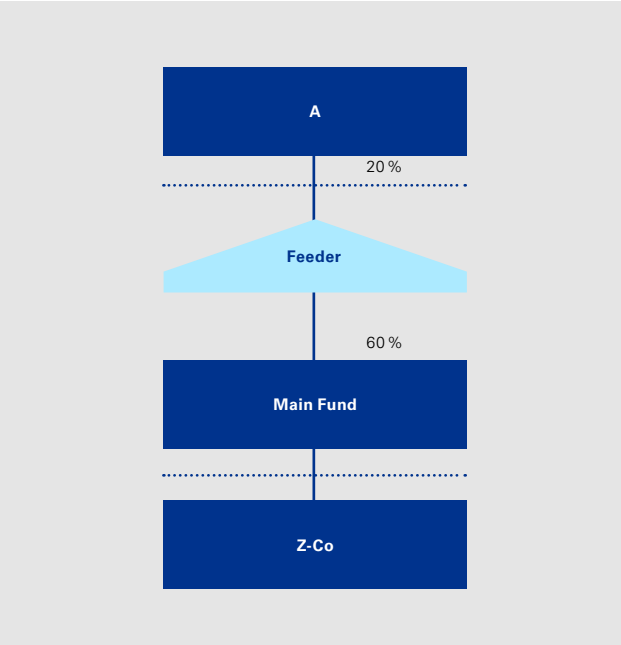
Within the framework of the application decree issued by the tax authorities on December 22, 2023, the tax authorities assume that a rebuttal is generally to be assumed for an investment of a maximum of 5 % in a partnership due to the small investment.[2] For all shareholdings that exceed this de minimis limit, an active refutation is required. The burden of proof lies with the taxpayer.[3]

According to the tax authorities, a rebuttal should be possible if the common purpose of the investors is the investment of assets and the investors do not know each other or the investors are only entitled to information rights.[4]

In the case of investments in fund vehicles in the legal form of partnerships, it is therefore advisable to make appropriate arrangements in the fund documentation or agreements between the fund and the investors (so-called side letters) in order to simplify the refutation of acting in concert.

Interesting questions arise when investing via a partnership, particularly for structures where there are participations in domestic and foreign investment funds in the investment chain, as the application of the rebuttal also affects the potential priority of application of the GINVTA.

Example:



Source: KPMG Germany, 2025

Domestic investor A holds a 20 % interest in a fund partnership in the legal form of an SCS SICAV-RAIF („Feeder"). The Feeder SCS holds an interest in a Luxembourg investment fund in the legal form of an S.C.A. SICAV-RAIF („Main Fund"). For German tax purposes, the Main Fund qualifies as an investment fund („Chapter 2 Fund"). The Main Fund holds investments in foreign subsidiaries that qualify as intermediate companies.

Solution:

A, who is subject to unlimited tax liability, does not control the intermediate companies either alone or together with related parties in accordance with Section 7 (3) FTA, meaning that a general priority of application of the GINVTA would apply (Sec.13 (5) FTA). However, through the participation in Feeder

2 *BMF Decree of December 22, 2023, IV B 5 – S 1340/23/10001 :001 Rz. 301.*
3 *BMF Decree of December 22, 2023, IV B 5 – S 1340/23/10001 :001 Rz. 217.*
4 *BMF Decree of December 22, 2023, IV B 5 – S 1340/23/10001 :001 Rz. 300.*

SCS, an acting in concert with the other investors is rebuttably assumed, with the result that control over the Main Fund and the Z companies is deemed to be given. If no rebuttal is possible, no priority of application of the GINVTA would apply at the level of the Z companies.

C. Uncertainties in connection with investments via special investment funds

The amended regulations also give rise to questions of doubt for German special investment funds, which are relevant when determining the basis of taxation and preparing declarations of assessment in accordance with Section 51 GINVTA.

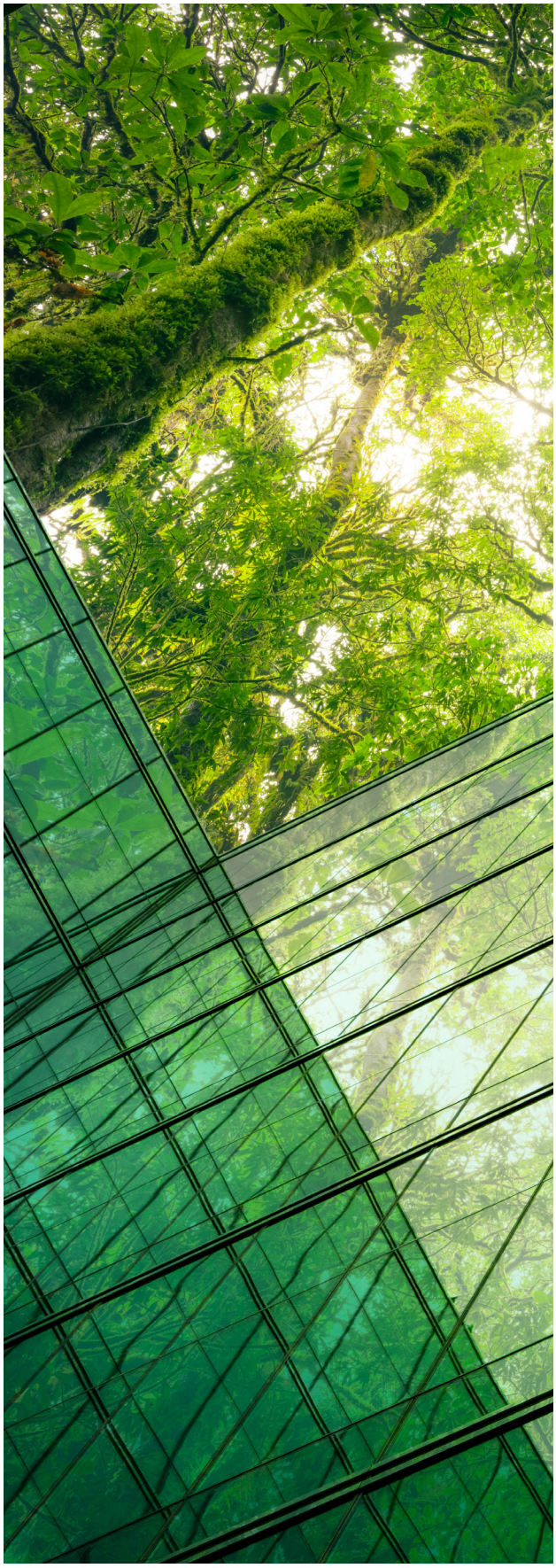
For the purposes of German CFC taxation, domestic special investment funds are deemed to have unlimited tax liability and therefore generally fall within the scope of the German CFC rules. When determining the income of special investment funds, CFC income qualifies as deemed distributed income ("ausschüttungsgleiche Erträge") within the meaning of Section 36 (1) no. 1 GINVTA.[5]

If CFC income is already included in the deemed distributed income at the level of the special investment fund, the CFC income allocable tothe investor is to be reduced by the amount of the deemed distributed income allocable to the respective investor (Sec. 10 (6) FTA). However, the provision only benefits those taxpayers who fall within the scope of the German CFC rules due to the size of their investment and no shielding affect applies. For investors who do not fall within the scope of the German CFC rules due to their level of participation and lack of control, the reduction provision of Section 10 (6) FTA would be ineffective.

The regulations in the GINVTA are therefore excessive and may lead to a disadvantage for investors who themselves do not fulfill the control criterion.

Depending on the investor structure, the view of the tax authorities expressed in the GINVTA application decree could lead to a suspension of the priority of application of the GINVTA provided for in the FTA, as in this case CFC income would have to be taken into account as deemed distributed income for the investor irrespective of control.

In this context, the fundamental question arises as to how such deemed distributed income in the form of CFC imcome can arise at all at the level of the special investment fund.



5 *BMF Decree of May 21, 2029 IV C 1 – S 1980-1/16/10010 :001 Rz. 36.6*

Investment funds or special investment funds are generally exempt from submitting a declaration of assessment for the purposes of CFC taxation, insofar as CFC income is not taxable at the level of the (special) investment fund. A tax return should only be submitted upon request by the German tax authorities.[6] At the level of the special investment fund, a tax liability on CFC income would generally only possible if such an amount were to be generated via a domestic permanent establishment (Sec. 6 (5) sentence 1 no. 1 GINVTA in conjunction with Sec. 49 para. no. 2(a) German Income Tax Act). In practice, this should be an exception. Under procedural law, an add-back amount can only be taken into account if it is determined at all (Sec. 18 (1) FTA), which means that there should hardly be any scope for taking it into account in the context of add-back taxation at the level of the special investment fund. In this respect, the respective investor would need to ensure that all relevant information on any add-back amounts is recorded directly as part of their personal tax return.

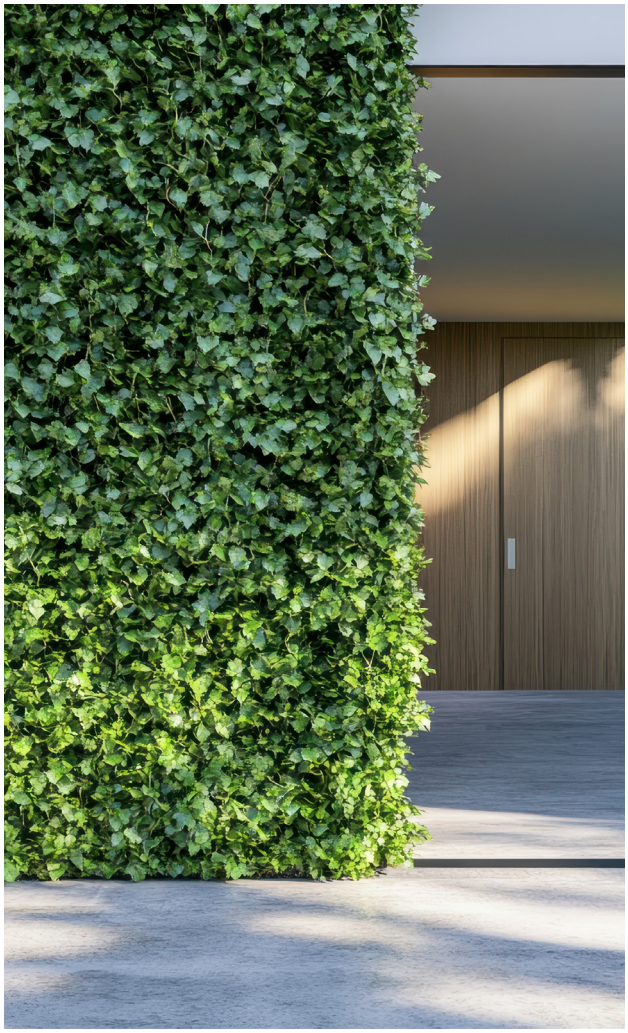
The Federal Ministry of Finance has apparently recognized the aforementioned ambiguities in relation to special investment funds. The discussion draft of the Minimum Tax Adjustment Act provides that add-back amounts at the level of the special investment fund are not to be taken into account when determining income (Sec. 37 (1) GINVTA draft).[7] This is intended to avoid the double recognition of add-back amounts for special investment funds and their investors.

D. Challenges in the context of tax return filings

The amended regulations on German CFC taxation have led to a significant expansion of the scope of application in the fund context. The current lack of an electronic submission option for declarations of assessment poses a particular challenge in practice. The option of electronic submission is still in development and is scheduled to be introduced from the 2025 assessment period (Sec. 21 (7) FTA).

The declaration of assessment must be signed by each taxpayer (Sec. 18 (3) FTA) in person, which leads to an almost unmanageable administrative burden, particularly for funds with a large number of investors, as only those with unlimited tax liability are involved in the assessment. In the case of investments via partnerships, the partnerships are not taken into account when determining the CFC income amounts.[8]

The tax authorities also seem to have recognized the associated complexity, with the result that, in addition to the technical simplifications promised, tax offices are also granting further extensions beyond the statutory submission deadline.



6 *BMF Decree of December 22, 2023, IV B 5 – S 1340/23/10001 :001 Rz. 956.*
7 *Discussion Draft of a Minimum Tax Adjustment Act of December 2, 2024*
8 *BMF Decree of December 22, 2023, IV B 5 – S 1340/23/10001 :001 Rz. 233,259, 706, 934.*

E. Possible changes due to the second discussion draft of the Minimum Tax Adjustment Act

On December 2, 2024, the Federal Ministry of Finance published the second discussion draft of the Minimum Tax Adjustment Act.

In addition to the aforementioned elimination of the consideration of CFC income in the context of determining the income of special investment funds, a retroactive elimination of the regulations for PFICS Gein accordance with Section 13 FTA is also planned.[9] This would reduce the scope to scenarios where a control is given only. As this is only a discussion draft, it currently has no effect on a possible obligation to submit an FTA assessment declaration.

In cases of control, the exemption limit for mixed income is to be increased.

An implementation of the proposed amended regulations would only occur within the next legislative period.

Facts

The amended control concept has led to a significant expansion of possible cases of application of German CFC taxation, which means that investors who hold shares in foreign intermediate companies via (special) investment funds may also fall within the scope of the German CFC rules.

However, at the level of the special investment fund, based on our view, the scope of application of CFC rules should be limited.

If the stricter rules for PFICs were to be abolished, the rebuttal would be of particular importance for investments via partnerships in order to exclude the application of German CFC rules. To this end, it is advisable to conclude appropriate agreements when acquiring fund units, which should rule out any interaction.

The lowering of the low tax threshold for financial years of an intermediate company beginning after December 31, 2023 to 15 %, should restrict the scope of application of CFC rules.

Katrin Bernshausen
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9 *The retroactive abolishment would apply to all financial years of the intermediate companies that begin after December 31, 2021.*

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