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By PwC Deutschland | 11 December 2013

Finance ministry rejects bond stripping scheme

The finance ministry has published a decree asking tax offices to reject brokered bond stripping schemes between German and Luxembourg investment funds abusing the treaty protection of dividends.

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The scheme criticised by the ministry involves a short-term investment by a German taxpayer in a privileged investment fund. This acquires at least 25% of a Luxembourg fund (SICAV) with the cash and – if necessary – a bank loan. The SICAV then invests its funds in long-term fixed interest securities. Shortly afterwards, it sells the interest coupons for cash, which it remits to the German fund as a dividend. This dividend is free of withholding tax under the treaty and tax-free in Germany under the rules for investment funds. However, the investment in the SICAV must now be written down to reflect the depletion of its assets. This write down is a tax deductible expense. The fund thus shows a large tax loss which it attributes to the investor before winding itself up. Ultimately, the investor is left with a small net outflow of cash (the expenses of running the scheme) and a large tax loss from netting a tax deductible write-down against tax-free income.

The finance ministry sees this scheme as abusive and has requested tax offices to challenge it. It offers three angles of attack:

- The income of the German fund is not a dividend, but interest collected in advance. Interest income is not protected as dividends under the rules for significant holdings
- The scheme was brokered as a model – this has to be shown in each specific instance – and thus falls under the offset prohibition rules for brokered tax deferral schemes
- The scheme is abusive as it cannot make a profit for the investor if the tax saving is ignored.

Keywords

SICAV, bond stripping, broker, scheme