

# Real Estate Tax Services News

Keeping you informed

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## European Court of Justice (ECJ) to decide on discrimination of foreign real estate funds under the German Investment Tax Act (InvStG) 2004

### In brief

An appeal is pending before the Federal Fiscal Court (*Bundesfinanzhof*, or BFH) in respect of the tax exemption provided for under section 11(1) sentence 2 of the German Investment Tax Act for German real estate funds (in the version applicable until 31 December 2017). The question of the appeal is whether the failure to grant the exemption constitutes discrimination against foreign real estate investment funds and violates the free movement of capital principle. The BFH suspended the proceedings and asked the ECJ for a preliminary ruling on the matter.

### Facts and starting position

The sub-fund concerned in the pending proceedings was established under Luxembourg law in the legal form of a *fonds commun de placement* (FCP) and was structured as a specialised investment fund (*fonds d'investissement spécialisé*, or SIF) with income from the letting and sale of domestic real estate. The sub-fund is suing for the granting of a tax exemption under Section 11 (1) sentence 2 InvStG, which is applicable to German regulated real estate investment funds. Both the tax office and the Fiscal Court of Münster have denied the application for the tax exemption.

The plaintiff has two institutional investors who have neither their registered office nor their management located in Germany. The affairs of the fund are directed by a management company based in Luxembourg. The plaintiff alleges that the decision constitutes discrimination against German regulated investment funds. Additionally, the plaintiff's eligibility for corporation tax is disputed in the proceedings. The Münster Fiscal Court, as Fiscal Court of first instance, had affirmed the domestic tax liability and has denied that a violation of the free movement of capital principle has occurred. The Federal Ministry of Finance has also joined the appeal proceedings.

The fund's entity legal form of an FCP without legal personality is broadly comparable to the typical German regulated legal entity form without legal personality known as "*Sondervermögen*". Both FCPs and *Sondervermögen* are frequently used as regulated investment vehicles for real estate funds managed by a regulated fund manager.

## Decision of the BFH

The appeal has no basis **in national law**, according to the BFH in its decision (there: ref No 20ff). The specific tax exemption in question is of limited relevance. According to section 11(1) sentence 1 of the InvStG 2004, the **domestic** fund (*Sondervermögen*) is considered a special-purpose fund as defined in section 1(1) No 5 of the German Corporation Tax Act, or KStG, (*Zweckvermögen*). It is exempt from corporation tax and trade tax. For this reason, direct application of this provision to the plaintiff (as a **foreign** fund) fails due to the unambiguous wording of the law.

However, in the BFH's view, the provision contained in the second sentence of Section 11(1) InvStG 2004 could infringe the **freedom of movement of capital guaranteed by EU law**. In its recent case law, the ECJ has commented in four judgments on the taxation of funds and on unequal treatment in the tax treatment of dividends (para 37). In each case, the ECJ considered that there was a **restriction on the free movement of capital** which was not justified. It has not yet been uniformly assessed as to whether the EU law requirements specified in the above-mentioned ECJ rulings lead to the conclusion that the exclusion of a foreign fund from the tax exemption under section 11(1) sentence 2 InvStG 2004 must also be regarded as an infringement of the free movement of capital. In the opinion of the Federal Fiscal Court, however, the tax exemption of only domestic funds ordered by section 11(1) sentence 2 of the InvStG 2004 could be compatible with the free movement of capital principle because of the legal peculiarities of national investment tax law and the factual peculiarities of the dispute (plaintiff as a special property fund). In the case of participation in a German regulated special real estate fund with German real estate investments, the foreign investor is directly (proportionately) attributed the domestic rental income of the fund as its own income with limited tax liability. In case of the FCP, the FCP itself would be subject to corporate tax on its income from German real estate operations.

Due to remaining doubts, the BFH suspended the proceedings and referred the following legal question to the ECJ for a preliminary ruling:

*"Does Article 56 of the Treaty establishing the European Community (now Article 63 of the Treaty on the Functioning of the European Union) preclude legislation of a Member State under which domestic special-purpose real-estate funds with exclusively foreign investors are exempt from corporation tax, whereas foreign special-purpose real-estate funds with exclusively foreign investors are subject to limited corporation tax liability in respect of their rental income earned in Germany?"*

The BFH sees the decisive criterion to be the question of whether the exclusion of the plaintiff from the tax exemption under Section 11(1) sentence 2 InvStG 2004 could be **justified in order to preserve the coherence of the tax system**. According to the ECJ's case-law on funds, an argument based on this justification can only be successful if there is a **direct link** between the tax advantage in question and its offsetting by a specific tax burden. In the event of a dispute, such a direct connection could be argued to apply by virtue of the fact that the tax exemption of the domestic special real estate fund is offset by the direct tax enforcement of the foreign institutional investors by way of full transparency in accordance with section 15(2) sentence 2 of the InvStG 2004 (margin No 67 et seq)

## Reference

BFH, ECJ submission of 18 December 2019 (I R 33/17), published on 22 October 2020, see (in German only): [www.bundesfinanzhof.de/de/entscheidung/entscheidungen-online/detail/STRE202010208/](http://www.bundesfinanzhof.de/de/entscheidung/entscheidungen-online/detail/STRE202010208/).

## Our view

The decision of the ECJ will be of significance as there are numerous tax regimes in the EU where domestic funds or domestic REITs enjoy a tax privilege which is not granted to foreign comparable market players. These privileges exist because legislators risk being unable to tax the German-sourced income of foreign funds where an equivalent exemption is granted.

The German legislator has decided to minimise the above described possible infringement risks by introducing a fully revised Investment Tax Act applicable from 1 January 2018, which in principle applies the same treatment to German and non-German funds. The ECJ will have the opportunity to apply aspects specifically related to real estate investment activities and its decision will therefore be of far-reaching influence.

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